

Financial Reporting Council
8th Floor
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London
EC2Y 5AS

28 February 2018

Dear Sir/Madam,

Response to the Financial Reporting Council's Consultation on the UK Corporate Governance Code and Guidance on Board Effectiveness

Thank you for giving us the opportunity to comment on your proposals. Linklaters LLP is a leading international law firm which advises many UK listed companies.

Our overall view is that the revised Code is helpful in:

- focussing attention on better governance by seeking to implement the Government proposals for corporate governance reform in a balanced way,
- helping companies by bringing together existing separate sources of guidance, such as that on diversity, and
- clarifying some points of practice, most notably what level of shareholder dissent should be classed as significant and ways in which the company should respond.

We have also set out below some more detailed comments and observations. Our commentary has been informed by feedback and questions that we have received from a number of listed companies. We have also consulted listed company clients for their views on these matters as part of the process of understanding and engaging with the changes.

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A36082969/0.0/28 Feb 2018

1 Workforce engagement

- 1.1 While all companies generally already have some type of system for listening to employees, companies we spoke to consider it helpful to have a specific recommendation to do so as a focus for board engagement efforts.
- 1.2 Some examples of engagement systems which are currently used, include:
 - 1.2.1 detailed engagement surveys followed by focus groups and upwards and downwards communications through the organisation, and
 - 1.2.2 regular meetings at different work sites so that the board can meet and talk to employees of all levels.
- 1.3 In building on existing systems, companies need time to work through different options. Many companies think that having a designated NED will work well as it is helpful to have one person responsible for focussing on the topic and putting together and pursuing a coherent set of ideas.
- 1.4 Other companies would like to use a combination of systems, such as having a designated NED and also a formal employee council. There is also a suggestion that it may be helpful to start with one system and work through the others in time.
- 1.5 Taking into account the diversity of approaches above, it is unclear what the term "normally" in Provision 3 means. Companies which use and describe alternative systems of consultation do not want to be seen as being non-compliant with the Code or marked-down as such by rating agencies. We suggest, therefore, that the language of this Provision could helpfully be modified to make it clear that the three systems of engagement given are not the only ones which can legitimately be used.

2 Stakeholder engagement

- 2.1 Listed companies recognise that their social licence to operate is essential and those we have spoken to believe that they take wider stakeholder interests into account as an integral part of doing business. For example, companies in the extractive sector must take account of the environment in which they operate. Directors of large multi-national companies are also used to dealing with different legal regimes, which may give more weight to certain stakeholder issues and require careful thought about how different interests can best be balanced.
- 2.2 In terms of reporting on their activities, listed companies seek to deliver full, relevant and informative reporting on topics of interest, such as sustainability. Companies have also expanded their reporting over the last few years to deal with a number of new obligations to provide more non-financial information and information to be delivered outside as well as inside the annual report, such as that on gender pay, payment practices, tax strategy and supply chain workforce issues.
- 2.3 Companies are considering what more can be done to deal with the recommendations to engage with wider stakeholders under the revised Code and also to comply with the new statutory requirement to make a S.172 CA 2006 compliance statement, which the Government has promised to introduce later this year.

3 Remuneration committee

- 3.1 Companies we have spoken to believe that they already take account of employee pay in the organisation as this is necessary for understanding the business.

- 3.2 However, companies welcome the chance to deliver stronger reporting on what has been done as helpful in focussing attention on the issue (in the same way that gender pay information has concentrated attention on that area).
- 3.3 Companies also feel that it is important for all reporting and explanations to be properly analysed by investors. Many companies still feel that there is a danger of proxy advisers taking a "tick-box" approach and identifying issues which investors are not in fact concerned about.
- 3.4 The new Code provides for the remuneration committee to have responsibility for setting pay for senior management (Provision 33). This is a substantial change from the current Code provision (D.2.2) that remuneration committees should recommend and monitor the level and structure of remuneration for senior management. Remuneration committees do not feel that it is right or practical for them to be drawn into managerial issues (which setting senior management pay will involve), as it will interfere with their duty to set and oversee strategy. Neither the draft Guidance (paragraph 107) nor the Code consultation document (paragraph 85) give any details of this expansion of the committee's remit. It would be helpful to have clarification of what is intended by this wording.

4 Pay structures

- 4.1 Holding periods of five years for share options are already accepted and used by many companies.
- 4.2 Companies we have consulted are also making efforts to ensure that where their remuneration policy states that discretion, malus and clawback can be applied, this can also be done contractually through the relevant employment contracts and pay award scheme documents in the ordinary course and where necessary.
- 4.3 Boards also continue to discuss what type of incentive scheme is best for their company and believe they should have the flexibility to do so. Whilst in some cases there is an argument for simplifying incentive schemes, in other businesses it is considered important for the directors to build up shareholdings.

5 Independence

- 5.1 We agree that NEDs and Chairs should maintain an independent attitude and that generally it is not helpful for Chairs to stay with the same company for excessively long periods.
- 5.2 Companies we have consulted also welcome the emphasis on succession planning and diversity of thought and feel that boards are moving in the right direction, whereas in the past these issues may not have been considered.
- 5.3 However, it is not clear that changing the way in which the independence requirements are applied will lead to better governance.
- 5.4 Companies feel that a blind focus on a technical definition of independence can come at the expense of making sure that the board has a deep knowledge of the business. It is, therefore, considered better to take a common-sense approach to this. It is not helpful to have a new Chair, for example, when there is also a new management team which needs guidance from an experienced chair.
- 5.5 It is also hard for a Chair to be effective if he/she comes straight in to a company and has no experience as a NED in that company beforehand. Imposing a time limit on the Chair, in particular,

is not helpful, therefore, where a knowledgeable and effective Chair has been in the business for a while and has been usefully building up his/her knowledge of it.

- 5.6** Companies we discussed this with consider that it is helpful for the Board to have the flexibility to make the ultimate decision on NED and Chair independence, as is currently the case. From a practical point of view, if the Board is required to apply the independence tests in Provision 15, rather than having the flexibility to assess directors with regard to those tests, more guidance may be needed on how and when the tests apply. In particular, queries have been raised about what exactly falls under a "material business relationship", "additional remuneration", "close family ties", "cross-directorships", "significant links" and "significant shareholder". Extensive guidance on these points, however, risks diluting the clarity of the Code and encouraging "tick-box" compliance.
- 5.7** Many companies that are now compliant with Code independence requirements face becoming non-compliant next year, although there will not be any change in the approach or attitudes of their NEDs or Chair. It may, therefore, be helpful to consider a transitional period for the application of Provision 15 in this form to allow for succession planning and for high levels of Code compliance to be maintained.

6 Shorter and sharper structure

- 6.1** The new length and layout makes it easier to read and access the Code.
- 6.2** This is helpful in condensing and refining changes made since 2010 in response to specific developments.

Yours faithfully,



Linklaters LLP