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For the attention of Catherine Horton

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Dear Sir or Madam

Proposed Revisions to the UK Corporate Governance Code

We write with our comments in response to the Financial Reporting Council ("**FRC**") consultation "*Proposed Revisions to the UK Corporate Governance Code*" published in December 2017 (the "**Consultation Paper**").

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Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of Herbert Smith Freehills' clients.

Our responses to each of the consultation questions are set out below. We have also then set out our other comments on the revised Code which do not relate to the specific consultation questions.

1. **Do you have any concerns in relation to the proposed Code application date?**
 - 1.1 We do not have any concerns in relation to the proposed application date for the revised Code, assuming that the revised version is published by early Summer 2018.
 - 1.2 We would welcome clarification as to the FRC's expectations in relation to reporting on compliance with the revised Code. We assume that, for financial years ending on or before 31 December 2018, companies should continue to report on compliance with the provisions in the 2016 edition of the Code in their annual report and so the content of that annual report will not need to contain the new information required by the revised Code even though it will be published during 2019. Then, during the course of the financial year beginning on or after 1 January 2019, companies should seek to put in place the behaviours required in the revised Code so as to enable them to report on those behaviours and comply with the new disclosure requirements in their annual report for the financial year ending 31 December 2019, which would be published in 2020. For example, Provision 2 of the revised Code introduces a new requirement that "*The board should*

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monitor and assess the culture to satisfy itself that behaviour throughout the business is aligned with the company's values. Where it finds misalignment it should take corrective action". It goes on to state that *"the annual report should explain the board's activities and any action taken"*. We assume that a 31 December year-end company will not be required to report on its activities in this area in its annual report for the financial year ending 31 December 2018 (notwithstanding that it will be published in early 2019) as it is only obliged to put in place processes and procedures to monitor and assess the culture of the company from 1 January 2019. It will then report on these matters in the annual report for the financial year ending 31 December 2019, published during the course of 2020.

2. Do you have any comments on the revised Guidance?

- 2.1 The stated objective of the revised Guidance is to *"assist companies in applying the principles of the UK Corporate Governance Code (the Code)"* (paragraph 1 of the revised Guidance). The revised Guidance is also stated not to be mandatory or prescriptive (paragraph 1 of the revised Guidance). However, the word "should" is used throughout the revised Guidance which implies that it is mandatory for companies to comply with its contents. For example, paragraph 12 of the revised Guidance states that *"the [committee] terms of reference and formal schedule of matters should be made available on the company website"* [emphasis added]. This purports to replace the requirements currently contained in Provisions A.1.1, B.2.1, C.3.2 and D.2.1 of the Code, but is more prescriptive than what is currently required, as the existing Provisions state only that each committee should *"make available its terms of reference"*. In contrast other parts of the Guidance, such as the lists of illustrative questions for boards, are of a completely different nature and are clearly just helpful suggestions.
- 2.2 We would therefore welcome further clarification as to the status of the revised Guidance, for example, clarifying that it is advisory in nature by using terminology such as "recommend" or "it is best practice that". Alternatively an express reference to the status of the revised Guidance could be included in the revised Code itself. If there are aspects of the revised Guidance which are procedural in nature and which the FRC considers that companies must comply with (rather than simply forming a best practice recommendation) these could be moved to an appendix to the revised Code. This would not clutter the revised Principles and Provisions and so maintain the "shorter and sharper" focus of the revised Code.
- 2.3 We have also identified a number of instances where the revised Guidance does not align to the content of the revised Code. For example, Provision 3 states that *"normally" the method for gathering the views of the workforce would be a designated director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director.* Paragraph 35 of the revised Guidance states that *"the Code requires boards to establish a method for gathering the views of the workforce and suggests three ways this might be achieved: a director appointed from the workforce, a formal workforce advisory panel, or a designated non-executive director. These are not the only possible methods and boards should be open [to] innovative alternatives if they believe these would be as or more effective [...] Provided the method chosen delivers meaningful, regular two-way dialogue and a means of listening to the workforce, the Code requirement will be met"* [emphasis added]. The wording in the revised Guidance therefore appears to offer more flexibility to companies in applying Provision 3 than available on the face of the Provision itself. If Provision 3 is intended to operate as described in paragraph 35 of the revised Guidance, we would suggest that Provision 3 be redrafted to reflect that.



- 2.4 We would also query whether the revised Guidance can and should properly still be referred to as "*Guidance on Board Effectiveness*" given its revised contents and scope.
3. **Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?**
- 3.1 We do not express a view as to whether the particular methods described in Provision 3 will achieve meaningful engagement – this will need to be assessed on a case by case basis by each company and its stakeholders. We would note that many companies already have in place processes which address employee matters and engage with the workforce in a variety of different ways and they consider those processes and activities to be effective. As noted above in paragraph 2.3, we would welcome further clarity as to the intended operation of this Provision 3 and how much flexibility companies have to continue with such methods of engagement, or adopt methods of engagement which are not referred to in Provision 3. In particular, we do not consider the use of "*normally*" in Provision 3 is adequate to provide the flexibility for companies to adopt a method not set out in Provision 3, as expressed in the Government's Corporate Governance Response Paper (August 2017) (paragraph 2.5) which was acknowledged in paragraph 27 of the Consultation Paper.
- 3.2 Provision 3 currently refers to "*a designated non-executive director*". We believe that it would be helpful to refer to "designated non-executive director(s)" so as to expressly afford companies the flexibility of creating a committee of non-executive directors to have responsibility for workforce, and wider stakeholder, engagement. Many companies already have a "Corporate Responsibility Committee", "Sustainability Committee" or similar and boards may think it appropriate for this committee, or a new committee, to take responsibility for gathering the views of the workforce rather than an individual non-executive director. Delegation to a committee would ensure that a number of non-executive directors, under the supervision of an appropriate committee chair, were taking collective responsibility for engagement. The revised Guidance acknowledges and endorses delegating responsibility to a committee of the board in relation to workforce remuneration and incentives (paragraph 104 of the revised Guidance) and we consider that delegation to a committee in relation to workforce engagement should be endorsed too.
- 3.3 We would also recommend that paragraph 35 of the revised Guidance refer to the ability of any non-executive directors designated for the purposes of Provision 3 to determine the appropriate communication channels with stakeholders, including, for example, the ability to delegate certain tasks to appropriate executive team members such as the Human Resources director. This would not detract from the overall responsibility of the board or the non-executive directors but would reflect the fact that certain members of the executive team will already be engaged in such discussions as part of their roles.
- 3.4 We would also comment that, for clarity, it would be preferable to move the requirements on whistleblowing into a separate Provision given that it is a separate issue to that of workforce engagement.
4. **Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?**
- 4.1 We do not believe that it is necessary to include any such references in the revised Code. We do not believe that the revised Code should refer to guidance or standards which the FRC does not have responsibility for, or oversight of, as such guidance could be amended, and impose additional compliance or other burdens on companies without the approval of the FRC.



- 4.2 If references are to be included, it would be more appropriate to include them in the revised Guidance, where they could be added to the Appendix which lists other resources.
5. **Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?**
- 5.1 We agree that it is clearer, and more helpful for both companies and investors, to replace the current "significant vote against a resolution" language in Provision E.2.2 of the Code with a defined percentage in the revised Code. We do not comment on the proposed percentage itself.
- 5.2 We do not agree that companies should be required, as an interim action, to publish an update within six months of the vote. Our view is that this is a too bureaucratic one-size-fits all requirement. Companies are best placed to determine whether there is a need to publish an interim update, based on factors such as:
- (i) the resolution in question, for example, some companies attribute votes against allotment authorities and disapplication of pre-emption rights resolutions to long-standing institutional investor guidelines;
 - (ii) the percentage of votes cast against noting that in most cases where there has been a significant vote against, in nearly all instances contained on the Investment Association's register, the majority votes were cast in favour of the resolution; and
 - (iii) the board's existing investor engagement activities.
- 5.3 Our view is that disclosure in the following annual report or AGM notice is an appropriate requirement. Shareholders can review this commentary, and any shareholder engagement activities, when the annual report is published and it can inform their voting decisions at the forthcoming AGM. However, given the varied nature of the resolutions and the reasons for the significant vote, we consider that it would be more appropriate to refer to a summary of "any steps that have been taken by the board as a result of the voting result or the feedback".
6. **Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.**
- 6.1 We agree that in principle, all listed companies regardless of size and index inclusion, should strive for the highest standards of corporate governance. However we believe that some flexibility may be warranted for smaller listed companies, for example in relation to committee composition, given that smaller companies often have smaller boards.
- 6.2 We acknowledge that externally facilitated board evaluations have the potential to bring a new perspective to the board. However, given the additional costs, we would suggest that the current exemption for companies below the FTSE 350 is removed only if there is sufficient evidence that externally facilitated evaluations are effective and do generate substantive findings, including critical ones when appropriate.
- 6.3 We recommend that Provision 21 be amended so as to refer to the evaluation of board committees ("*there should be a formal and rigorous annual evaluation of the performance of the board, its committees, the chair and individual directors*" [emphasis added]) as current Provision B.6.2 refers to committees in the context of evaluation.



- 6.4 We note that the consultation question refers to an "independent" board evaluation but Provision 21 does not require independence. We recommend that Provision 21 state that an external facilitator should be independent of the company and have no significant connection with the company or any individual directors, rather than containing a reporting obligation in relation to any connections, so that an externally facilitated board evaluation can properly be said to bring a "*fresh perspective and new ways of thinking*" (paragraph 94 of the revised Guidance).
7. **Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?**
- 7.1 We have no comment on whether nine years is an appropriate period of time to be considered to be independent. However we would note that longevity of service as a non-executive director is not necessarily problematic in itself and often enhances the board room, for example, long-serving non-executive directors can in some cases be more effective in challenging the executive directors and management given their experience.
- 7.2 The revised Code states that, if any of the criteria listed in Provision 15 apply, the director "*should not*" be treated as independent for the purposes of the revised Code requirements on board and committee composition. We understand that, notwithstanding this change in language, a company is able to explain non-compliance with this Provision, as with any other Provision of the revised Code (paragraph 53 of the Consultation states that "*companies can still retain the option of offering an explanation if they believe that an individual is independent*"). However, it would be helpful if the FRC could clarify the consequences of any such explanation on compliance with the other provisions of the revised Code. For example, if the board considers a non-executive director to be independent notwithstanding the fact that he or she has served on the board for ten years, and explains this for the purposes of Provision 15, can that non-executive director then be treated as independent for the purposes of Provision 11 ("*Independent non-executive directors, including the chair, should constitute the majority of the board*"), Provision 12 ("*The board should appoint one of the independent non-executive directors to be the senior independent director*"), and Provisions 17, 24 and 32 (board committee composition) or would the company also be in breach of those Provisions as well if that is the consequence of the director not being treated as independent?
- 7.3 In relation to chairs, we consider that formalising the nine-year time limit for independence may make it more difficult for a serving non-executive director to subsequently be appointed as chair. This is because companies may be reluctant for the chair not to be considered independent for the purposes of the revised Code both from a reputational perspective and also because of the potential knock-on consequences to board composition (for example, the need to appoint a further independent non-executive director to ensure that a majority of the board is independent – although see our comment at paragraph 7.2 above). Large listed companies may see a number of advantages to appointing a serving non-executive director as chair, for example their familiarity with their large, and often complex, business. However it is likely to be a significant disincentive if that person can only serve as an independent chair for a few years before reaching the nine-year time limit for independence. Therefore, we consider that Provision 15 should be modified where a serving independent non-executive director steps up to the chair, so that they should not be considered independent once they have served on the board for more than a period of 12 years from their first election. This would alleviate the issue for many of those companies which have long-serving chairs, but which strive for the highest standards of governance. In addition, companies may need more time to properly consider and



address independence and succession planning issues without automatically being non-compliant with the revised Code from 1 January 2019 or being required to prescriptively change their chair in the near-term.

- 7.4 We are also of the view that, given the proposed change in relation to the criteria for independence (from a list of factors to consider into a specific set of tests) it would be helpful to more clearly define certain of the other independence criteria contained in Provision 15. In particular, we consider that the "*material business relationship*" criteria, "*close family ties*" criteria and "*significant shareholder*" criteria should be more clearly defined. At present, these descriptions are less problematic given the more flexible approach to determining independence contained in Provision B.1.1. of the Code. However, given that under the revised Code it is proposed that a non-executive director "*should not*" be considered independent if any of the prescribed criteria apply, companies will need to be clear on how to interpret the criteria. For example:
- (i) should "significant" for the purposes of the significant shareholder criteria be 20% (as "significant" has been interpreted to mean in the context of "significant" votes against resolutions);
 - (ii) what should be considered "material" for the purposes of a business relationship, and in particular is that materiality test by reference to the body that has the relationship with the company or the individual who is working for that body; and
 - (iii) what are meant by "close family" ties?
- 7.5 As an alternative to additional clarification in the revised Code itself, such clarification could be incorporated into the revised Guidance.
- 7.6 **Do you agree that it is not necessary to provide for a maximum period of tenure?**
We agree.
8. **Do you agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?**
We have no comments in relation to this question.
9. **Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.**
- 9.1 We do not express a view on extending the Hampton-Alexander recommendation beyond the FTSE 350.
- 9.2 We note that the definition of "senior management" proposed for the purposes of Provision 23 follows the definition contained in the Hampton-Alexander Review. We support that definition. However, as discussed in paragraph 69 of the Consultation, this definition is different to the definition of "senior managers" contained in section 414C(9) of the Companies Act 2006 ("**2006 Act**") which applies to UK-incorporated quoted companies which are required to disclose the number of persons of each sex who were senior managers of the company (excluding directors). Multiple definitions of "senior manager" or "senior management" for the purposes of diversity disclosures in the annual report will result in an unnecessary level of complexity and potential unintentional non-compliance with the revised Code or the 2006 Act or both. It would be helpful if the FRC liaised with the Government to seek to ensure that the secondary legislation being introduced to make



changes relating to the strategic report disclosure requirements aligns with the test being proposed for the revised Code.

10. **What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.**

We have no comments in relation to this question.

11. **Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?**

11.1 In principle, we agree that retaining certain requirements in the revised Code which duplicate the Listing Rules, the Disclosure and Transparency Rules or 2006 Act can be helpful.

11.2 We note the footnote to Provision 4 in the revised Code, and the comments in paragraphs 30 and 31 of the Consultation, which refer to the Government's planned secondary legislation to require all companies of a significant size to explain how their directors comply with the requirements of section 172 of the 2006 Act, with regard to employee interests and to foster relationships with suppliers, customers and others. We query whether Provision 4 is necessary given the planned secondary legislation. We also note that this would be the only Provision in the Code which expressly refers to a provision in the 2006 Act and we query whether it is appropriate to include it in the Code. A perceived benefit of including Provision 4 would be to bring non-UK companies within the scope of the reporting requirement (as the Government's secondary legislation would presumably apply to UK incorporated companies only). However, given that non-UK incorporated companies will necessarily be subject to a different corporate law framework, and will not be subject to section 172 of the 2006 Act, it would not seem appropriate for them to have to report on those matters as this would in effect, be imposing UK company law requirements on an overseas company. This situation is not uncommon – for example, non-UK incorporated companies are not required to comply with the directors' remuneration reporting requirements as these apply only to UK incorporated companies.

11.3 Please also see our response to Q14 in relation to Provision 41.

12. **Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.**

We refer to our comments at paragraph 2.1 above in relation to the status of the revised Guidance and difference between Provision C.3.3. of the current Code and the language proposed in the revised Guidance.

- 12.1 **Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?**

12.2 We do not have any significant concerns with the proposed wider remit for the remuneration committee. However, we note that Provision 33 states that the remuneration committee "*should oversee the remuneration and workforce policies and practices*" [emphasis added] but the revised Guidance envisages that this function could be delegated to another appropriate committee with relevant responsibilities (paragraph 104 of the revised Guidance). Given that the remuneration committee is required to take into account



remuneration and workforce policies and practices when setting the policy for director remuneration (Provision 33), we believe that oversight of workforce policies and practices should properly be carried out by the remuneration committee rather than another committee of the board and, therefore, recommend that the revised Guidance reflect that position. Even if companies consider it more appropriate to delegate responsibility in this area to a committee other than the remuneration committee in accordance with the revised Guidance, this would as drafted be non-compliant with Provision 33, given that it states this function "should" be a responsibility of the remuneration committee, and such non-compliance would need to be explained in the annual report.

12.3 We believe that it is helpful that paragraph 105 of the revised Guidance indicates the steps that the remuneration committee may take to oversee remuneration and workforce policies and practices. However, we would recommend a change of emphasis in paragraph 105 to ensure that the oversight is not simply delegated to management to carry out on behalf of the remuneration committee.

13. **Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?**

13.1 We consider that it would be helpful if Provision 37 specified certain circumstances in which it would be appropriate to recover and/or withhold sums or share awards due to directors. Paragraph 111 of the revised Guidance suggests that such circumstances "*might include*" where there has been "*erroneous or misleading data, misconduct and misstatement of accounts*". We consider that it would be more appropriate for those examples to be incorporated into Provision 37 itself as the minimum circumstances in which malus or clawback powers could be exercised. This should not prevent the remuneration committee having an ability to exercise malus or clawback in a greater range of appropriate circumstances.

13.2 We note that to a large extent, Provision 41 replicates the requirements of the directors' remuneration report contained in Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. We consider this to be an area where duplicating legislative requirements in the revised Code is not helpful as the differences in wording and emphasis are likely to cause confusion in practice. If there are considered to be issues that the remuneration committee should report on over and above the legislative requirements, which support long-term sustainable performance, we do not object to their inclusion in the revised Code.

13.3 Paragraph 113 of the revised Guidance states that the remuneration committee "*should engage with the workforce to explain how executive remuneration aligns with wider company pay policy and promotes long-term value generation*". We consider that it would be helpful to clarify how this engagement process should interact with the other engagement processes advocated by the Code, including Provision 3, for example, could the remuneration committee rely on the work of another committee or non-executive director with delegated responsibility for gathering the views of the workforce to discharge this obligation or would having a director appointed from the workforce being a member of the remuneration committee discharge this obligation?

14. **Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?**

We believe that there is already significant pressure on remuneration committees from, amongst others, institutional investor groups, to exercise discretion appropriately. We agree that the wording of Provision 37 ("*Remuneration schemes and policies should*



provide boards with discretion to override formulaic outcomes" [emphasis added]) is appropriate.

Other Comments on revised Code

15. **Principle A: "A successful company is led by an effective and entrepreneurial board, whose function is to promote the long-term sustainable success of the company, generate value for shareholders and contribute to wider society. The board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned"**
- 15.1 We consider that the first sentence of this Principle should align better with the statement of directors' duties contained in the 2006 Act.
- 15.2 Section 172 of the 2006 Act requires that "A director of a company must act in a way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to – (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company".
- 15.3 Whilst the duty of directors to promote long-term sustainable success and generate value for shareholders is clear from the fact of section 172, there is no duty to contribute to wider society. Directors are required to have regard to matters which impact on wider society when exercising their duties. This reflects the principle of "enlightened shareholder value" and was the subject of considerable debate during the passage of the 2006 Act. We also note the Government's decision not to revisit the wording of section 172 as part of the corporate governance reform process (paragraphs 2.25 to 2.27 of the Government Response Paper).
- 15.4 In light of the foregoing we consider that the wording of Principle A should be amended to align it with section 172 such that the reference to the company's function to contribute to wider society be removed and replaced with a reference that the directors of a company should have regard to the company's contribution to wider society. Directors could be put in a difficult position if their duty under section 172 is not consistent with the Principle in the revised Code which they are applying.
- 15.5 In relation to the second sentence of this Principle, we are of the view that the reference to "purpose" should be omitted. Following the entry in force of the 2006 Act, a company is no longer required to have an objects clause in its constitution setting out its purpose and permitted activities and, unless its objects are expressly limited by its articles of association, a company's objects are unrestricted. In addition, section 172(2) uses the term "purpose" when referring to situations in which a company has a different "purpose" to that stated in section 172(1) ie. when it is something other than promoting the success of the company for the benefit of its members, which would not be the case for any UK commercial companies. We recommend that the wording of Principle A be more closely aligned to section 414C of the 2006 Act which requires quoted companies to report on the company's strategy and business model in its strategic report.



16. **Principle C: "In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties"**

Section 170(1) of the 2006 Act makes it clear that the general duties are owed by a director to the company only and that only the company can enforce them. Directors of UK companies owe no legal responsibilities to stakeholders and we consider that this Principle C should simply read "*The board should ensure effective engagement with, and encourage participation from its shareholders and other stakeholders*".

17. **Provision 7: "The board should take action to identify and eliminate conflicts of interest, including those resulting from significant shareholdings, and ensure that the influence of third parties does not compromise or override independent judgement"**

We recommend that this Provision should refer to the board taking action to "*identify and manage conflicts of interest*" with the reference to the elimination of conflicts of interest being removed. Conflicts of interest are an unavoidable part of board memberships and can arise in a range of different circumstances. Seeking to eliminate them completely is neither feasible nor desirable. The board should ensure that conflict policies and processes are in place to identify conflicts and then manage them appropriately. An understanding of conflict risk needs to be reinforced by effective policies and systems.

18. **General comment: Board responsibility**

We think that it would be helpful if, either as a Principle of the revised Code or in the Provisions covering the role of each board committee, it is expressly stated that the Board as a whole remains responsible for governance issues and that, particularly where there are difficult issues to be considered and approved by the board, including for example in relation to executive remuneration, the board as a whole needs to be satisfied as to the position taken.

We do not express a view on the initial consultation on the future direction of the UK Stewardship Code (and consultation questions 17 to 31) at this time.

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Yours faithfully

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