



**RESPONSE TO THE FINANCIAL REPORTING COUNCIL CONSULTATION
ON PROPOSED REVISIONS TO THE
UK CORPORATE GOVERNANCE CODE PUBLISHED IN DECEMBER 2017**

INTRODUCTION

This response has been prepared by Skadden, Arps, Slate, Meagher & Flom (UK) LLP. Skadden is a global law firm and a market leader in the sphere of corporate governance in the United Kingdom and the United States.

We are taking this opportunity to comment generally on issues of boardroom independence and conduct within the scope of the FRC Consultation on Proposed Revisions to the UK Corporate Governance Code published in December 2017 and specifically on certain of the proposals identified in the Consultation. We have not sought to comment on all the questions or on all the matters discussed in the Consultation.

GENERAL

Our general comments relate to division of responsibilities in Section 2 of the Code and the related Guidance.

We agree with the emphasis on good corporate governance and decision making to promote long term success, generate shareholder value and recognize the wider stakeholder interest but also to protect stakeholder value. We applaud the efforts to reinforce culture, diversity and effective challenge in the board room. We believe the proposed revisions to the Code should go further to promote improvement in board process, particularly when addressing non ordinary course business, and better equip companies and their executive and non-executive directors to respond and defend their actions when the outcome of board decisions is not a success.

References are made in the Consultation to some high profile examples of inadequate governance and misconduct, which have led to poor outcomes for a wide range of stakeholders. We believe there is systemic weakness in corporate governance and the need for a shift in approach to reinforce the contribution of independent non-executive directors consistent with political and stakeholder expectations. Our comments are directed at the process of decision making. Poor decisions will occur in commerce. What is culpable is poor process in decision making, not decisions taken in good faith in pursuit of success that prove to be poor.

THE NEW ENVIRONMENT

While there are circumstances in which a director can incur a duty to shareholders, other than in cases of insolvency it has in general been the preserve of the company to determine whether or not particular director conduct has fallen short of the array of demanding fiduciary standards that directors must satisfy.

These fiduciary duties are owed to, and therefore in most cases are quite properly only capable of enforcement by, the company. Indeed, this is one of the superior features of UK corporate governance; a barrier to scapegoat litigation.

There are several circumstances in which a director might be disqualified from holding office where breach of fiduciary duty has occurred. However, absent insolvent or exceptional circumstances, the decision to bring proceedings for recovery against directors for breach of fiduciary duty has traditionally been in the determination of the company with a residual derivative right exercisable by shareholders in some limited circumstances. The great majority of such proceedings have in the past related to unjust or improper enrichment, where directors have expropriated corporate assets for their own benefit and should be held to account.

In recent years we have seen high profile examples of claimed failures of fiduciary duty that have been subjected to regulatory investigation and demands for accountability at the corporate and individual level, encouraged by political and public outcry, with associated significant cost and exposure for the companies and individuals involved. The decision to pursue director breach of duty is no longer with the company or its shareholders. Companies, senior executives and directors will struggle to defend these challenges and associated investigations, proceedings and liability unless they do more to encourage and reinforce the contribution of the non-executive independent body within the board and can demonstrate a strong decision making process in performance of the board's fiduciary duties. We expect continuing pressure to attack high profile examples of poor decision making as regulators are incentivized fiscally and impelled by political and public pressure.

BETTER SUPPORT FOR THE NEDS

We applaud any encouragement given to effective contribution of independent directors. However, there is natural resistance to fulsome and where appropriate challenging engagement by the non-executive body: traditional board procedures are a factor as well as the limited incentive for non-executives to be brave and commit beyond established norms. The survey conclusion in the Culture Report¹ that barely a majority of chairmen viewed the role of NEDs as influential or very influential is damning demonstration of a malaise. This body is expected to comprise a majority of the board and contribute a diversity of skills, experience, knowledge and independence; yet its influence is currently relatively weak.

Enhancing the NED role throws grit into the board review and approval process. Typically, the executive will promote proposals for board consideration, often supported by highly sophisticated experts and advisers with presentation materials designed to promote an outcome. We commend the encouragement given to NEDs to demand effective briefing and access to advice in paragraphs 67 and

¹ FRC May 2016

71 of the proposed Guidance but believe the Provisions should be reinforced until these demands have become standard business practice. Until they do, the prospect of a truly diverse group of independent directors making a fully effective contribution when debating challenging and complex business, especially non ordinary course proposals, will be limited.

REINFORCE PROCEDURES TO PROTECT THE COMPANY

It is in the nature of business and entrepreneurialism that poor decisions will be made on occasion. Should a decision prove to be a poor one, the honest exercise of business judgment is not culpable. However, a poor process of decision making is more likely to produce a bad result. Poor process is culpable and likely to lead to material destruction of value. It is right for the Code to sponsor a good process of decision making, fully mobilizing the diverse and independent elements within the board. As the evidence shows², diversity in the board is associated with better performance but it is not enough to populate boards without also creating an environment in which the diversity of contribution is fully supported.

We believe the Code should drive Board procedural standards and not rely on permissive provision in the Guidance. Mere permission is unlikely to change established practice. To encourage an environment where non-executives feel emboldened to orchestrate their involvement, call for more time or information, seek additional support and thoroughly equip themselves to challenge proposals, and genuinely 'boost the strength and effectiveness of the non-executive directors'³, we believe the Code should (i) express an expectation that the non-executive body will assess independently their response in particular to any material, non-ordinary course proposal or circumstance, and (ii) specify that the independent non-executive directors should as a rule conduct discussion to marshal their thinking, if appropriate without the executive and any interested director present, and satisfy themselves that the supporting materials are suitable, they have had the opportunity to address the materials and issues effectively and they are comfortable with the conclusions and proposals. The Code Provisions should provide that non-executives may call for additional material, require further discussion with the executive and the company's advisers or, if they feel it appropriate, obtain additional advice, expert assessment or other resources to help them reach a satisfactory conclusion.

The company secretary cannot always be expected to provide the full range of advice that might be appropriate to best position the response of non-executives to complex proposals or circumstances, as Provision 16 currently envisages. We are not suggesting that non-executive directors should serially challenge the executive, demand enhanced materials, second guess work done by the company's advisers or seek separate advice for the sake of it. There is no automatic reason or mandate to doubt the quality and substance of any proposal and the supporting analysis. Rather, non-executive directors should be encouraged to caucus and decide case by case how best to frame their assessment and the questions and concerns they should raise and where relevant, call for additional analysis and resources to help them orchestrate an effective review and rebalance the inherent imbalance. The executive is engaged full time in promoting the objectives of the company, supported by and directing the full resources of the company and its advisers. The chairman sits somewhere in the middle, will typically spend considerable

² Para 58 Consultation

³ HM Government response to Committee Recommendation 9; House of Commons Briefing Paper CBP 8143, 16 November 2017

time outside board meetings engaged with the executive and can become a part of the process in framing proposals for board consideration. The non-executives are by definition not full time and, when presented with complex or non-ordinary course materials, face the challenge to catch up, often wrestling with material that may be complex, beyond individual expertise or experience, and may struggle to assess whether the high standard for information provided for in the Provisions has been met.

The challenge for the non-executive body in the forum of the board meeting to make its assessment, demand time or better or alternative materials and otherwise respond effectively is inevitably daunting, particularly in the face of challenging corporate timetables. Without the change in emphasis and expectation in the Code Provisions that we propose, we believe the inherent imbalance within the board and the inherited assumption as to the manner in which boards should conduct their affairs will lead to circumstances that, judged with the benefit of hindsight, show the necessary resources were not in place to enable the non-executive to make an effective contribution. Ultimately that deficiency will undermine the quality of decision making and the ability of the company and all its officers to demonstrate good process. That in turn leads to destruction of stakeholder value and exposure to criticism or worse for the company and the entire board.

SELF-HARM

In an environment where poor decision making is now so open to attack through investigation and proceedings, we do not agree with the proposed approach in Provision 8 or Guidance 20. The minutes are discoverable and can be used in proceedings against the company and its directors. Unless the record of disagreement in the minutes is constructed with unusual care and sophistication, the existence of a discoverable record of disagreement is likely to leave the company and its officers exposed in subsequent proceedings. Any unwanted exposure of the company will risk distorting the outcome of any proceedings and represents a further source of destruction of stakeholder value.

INDEPENDENCE

The ultimate determination of independence is something that should be decided upon by the board, taking all relevant factors into account – the list of factors required to be considered by the Code in assessing director independence has long been understood and widely recognized as proportionate but it is not comprehensive. It is not possible to list comprehensively all factors that might impair independence.

A board may reasonably consider that a director who satisfies each of the identified tests nonetheless fails the standard of independence for some other reason. Alternatively, although a director might trip one or more of the identified tests, the ability of that individual to act independently might reasonably be determined to exist in the circumstances. For example, the independence of a very high net worth individual might reasonably be regarded as unimpaired despite commercial interests in or dealings with the company.

In the alternative, if the determination is not to rely on the judgment of the board, we observe that the proposed wording of the Provision and certain of the factors requires modification to allow determination director by director and leave room to distinguish relationships that do not in a particular context impair independence.

We believe it is better for the board to determine whether a director is or is not independent in particular circumstances taking into account the listed factors and, where a factor applies, to explain its reasoning, rather than to explain that the Code independence requirements are not complied with because the board determines that an individual is suitably independent even though a particular factor applies.

CONCLUSION

In submitting this response, we have drawn on decades of experience in effective board management developed in the notoriously aggressive environment in which director conduct is assessed in the United States. We recognise that the same pressure has not historically been evident in the UK, substantially as a result of the limitation of the scope to challenge the conduct of directors who owe their fiduciary duties to the company and the degree of difficulty in mounting claims against directors for breach of those duties. The environment is fast changing in the UK as we have noted above.

Effective empowerment of the independent element within the board is necessary if any company is genuinely to hold itself to account, ensure conduct consistent with its values and responsibilities and position itself effectively to defend its decisions. While our proposal to reinforce the manner in which the non-executive directors should orchestrate their involvement in board decision making reflects US experience, it is consistent with the concepts and objectives that underpin English company law and the Code.

SPECIFIC COMMENTS:

Our specific comments on proposed terms of the Code and Guidance are as follows:

Provision 8: We propose that where directors have concerns about the operation of the board or the management of the company that cannot be resolved, they should ensure that the fact of debate and disagreement are recorded in the minutes.

Provisions 11 and 12: we welcome the proposal that the chair should hold meetings with the non-executives without executives present and that the non-executive directors other than the chair should meet on occasion 'as necessary'. We propose that non-executives other than the chair should be encouraged to hold a separate discussion to assess whether there is a need for them to call for additional explanation or resources and otherwise orchestrate an independent response to any Board proposal that is not entirely ordinary course or otherwise when a non-executive director feels it appropriate.

Provision 15: as written, the Provision suggests that if an individual director falls within any of the itemised categories, none of the directors can be independent. We suggest substituting the following preamble:

'An individual non-executive director, including the chair, should not be considered independent for the purposes of the board and committee composition if that director:'

Some of the identified considerations are expressed in very broad terms:

Para ii: 'material business relationship';

Para iii: 'additional remuneration';

Para iv: 'close family ties' with any adviser, director or senior employee;

Para v: 'cross-directorships' or 'significant links' with other directors.

A director might reasonably be regarded as independent in particular circumstances although tripping one or more of those categories.

We suggest retaining the current discretion of the Board to assess independence while taking into account all of the identified considerations. Alternatively, the level of materiality relative to the individual director, assessed objectively, should be more prescribed.

Provision 16: We propose that 'All directors should have access to the advice of the company secretary on governance matters and the non-executive directors should assess what information, process, advice or resources they require in order to effectively consider any matter presented for board consideration, and should have access to such information, advice or resources at the expense of the company.'

If you have any questions or would like to discuss any aspect of this response please contact:

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