

FRC: Revised Corporate Governance Code – Willis Towers Watson response

27th February 2018

Preface

We welcome the shorter and more concise structure of the revised proposed Code. We believe that guidance should not add unnecessary complexity to business practices, but help promote clarity and transparency – a leaner Code is therefore a step in the right direction.

Our response is targeted at questions which address our key areas of expertise – primarily those centred on remuneration and talent. WTW’s Investment Advisory team have responded separately to the Stewardship Code Consultation. We have sought to provide an overview of our position, rather than an in-depth analysis of the pros and cons of the approaches proposed in the guidelines.

We strongly believe that the Code should remain principle-based and companies should be encouraged to comply or explain, provided any divergence from the code is supported by sound business rationale. While many large institutional investors have developed their own remuneration policies and guidance many large overseas investors continue to rely on proxy advisors to guide their votes on UK corporate governance matters. As we mention in our response to question 5, we observe that proxy advisors have considerable influence on voting outcomes and this power has the potential to create a ‘comply or else’ approach to remuneration. We would like to see further engagement with proxy advisor firms to ensure the Code remains principle-based in practice.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

- We and several of our clients found the reference to workforce engagement in multiple provisions of the Code to be slightly confusing and consider the Code could be clarified. For example is it intended that the same channel of engagement is expected to be used for both broader Board engagement and Remuneration Committee engagement, or is engagement by the Remuneration Committee, as proposed under Provisions 33 and 41 expected to be a subset of the broader engagement proposed in Provision 3? The answer may impact the choice of non-executive director chosen to oversee engagement.
- With regard to question 3, we agree that the methods proposed in Provision 3 will help facilitate improved engagement between the Company and its workforce and will provide useful platforms to enable the views of the workforce to be heard in the boardroom.
- We recognise that one single method of engagement may not be appropriate for all listed companies due to variations in size and structure. As such we consider it is appropriate that the proposed Code will provide a range of alternatives to enable boards to select and commit to the most appropriate mechanism of employee engagement for the company.
- We observe that large FTSE 100 companies in particular face additional challenges in engaging with their heterogeneous and globally disparate workforce and it is likely that a considerable investment of time and resources will be required to achieve meaningful and representative engagement. To address this we expect many companies will leverage digital methods of engagement, such as electronic pulse surveys and virtual focus group sessions, to support them in achieving meaningful engagement with their workforce.
- The current wording of the Code states that the FRC expect engagement will *normally* be secured using one of the three proposed methods. We understand that by including the term ‘normally’ the FRC intend that companies may use an alternative method for engagement if it is considered more appropriate.

- Following discussions with our clients, we understand a number of companies are considering using a method other than/in addition to the three proposed alternatives for engaging with their workforce. For example, one of the alternatives being considered is to include an ‘ombudsman’ role. It is anticipated that this individual would be independently appointed by the board and would be responsible for canvassing and representing the views of the organisation’s workforce. The role would likely be a part-time employment position and it is envisaged that with sufficient travel, the ombudsman would be in a position to properly represent the views of the organisation’s workforce to the Board.
- In our experience, effective engagement with employees is best achieved through a combination of anonymous and face-to-face feedback. Companies are moving towards more regular engagement with employees and covering a broad scope of employment-related topics. Instant regular engagement can be achieved through various digital means including (i) electronic pulse surveys and (ii) virtual focus groups, on topics ranging from the recruitment process to career progression. Electronic pulse surveys can take only minutes to complete with results available immediately. Similarly, virtual focus groups enable companies to engage with a broad and geographically diverse representation of their workforce, obtaining rapid, anonymous honest feedback. We observe that digital methods of employee engagement are becoming increasingly prevalent as they enable companies to secure relevant, insightful and honest feedback.
- The current wording with respect to a ‘formal workforce advisory council’ leaves room for interpretation and we anticipate there will be a broad range in how such a council is structured in practice, with some companies adopting a ‘box ticking’ approach to complying with the Principle. We consider the Code could be strengthened and meaningful engagement could be achieved if there was a requirement for companies to evidence how they have complied with the Code, and the steps that have been taken to achieve meaningful engagement.
- Although a formal workforce advisory council is unlikely to be a suitable mechanism for all companies, of the alternatives presented, this would likely be the most effective way of ensuring that the voice of the workforce is heard and has power in the boardroom, given that this alternative does not require a director conduit and enables the voice of more than one employee to be heard.
- With respect to Provisions 33 and 41, which are intended to govern engagement by the Remuneration Committee, as mentioned above we consider further clarity should be provided as to whether this is expected to be a subset of Provision 3. We also note that the current drafting fails to identify clearly what the key objective of engagement with the workforce is. For example, which of the following objectives is engagement intended to achieve?
 - Support the workforce in understanding how executive remuneration has been determined;
 - Provide the workforce with the ability to influence executive pay levels;
 - Provide the board with an understanding of how their workforce views executive remuneration;
 - Provide the board with an understanding of how the broader workforce views their own pay; and/or
 - Provide the board with a broader understanding of how total remuneration is practically implemented further down the organisation?

Q5. Do you agree that 20 per cent is ‘significant’ and that an update should be published no later than six months after the vote?

- We consider an 80 per cent threshold for support from investors in respect of remuneration is too high, for the following reasons:
 - Depending on a company's share register, a 20 per cent threshold could provide a single investor with significant power to influence the Board and Remuneration Committee decision making.
 - Our research shows that negative proxy voting agency recommendations can have a material influence on voting outcomes. A negative recommendation from ISS was shown to be associated with, on average, an approximately 25 percentage-point reduction in the level of support for the Annual Report on Remuneration in recent years. As such we consider achieving support from 80 per cent of investors it too onerous, has the potential to afford a single agency with too much influence and risks creating a 'comply or else' environment.
 - Due to the continued divergence of investor views, it is possible that any change to pay arrangements outside of the current status quo could lead to a vote below this threshold. As such we expect that, in many instances, Remuneration Committee members will become more risk averse in exercising their duties.
 - While many investor guidelines theoretically support companies in implementing a remuneration policy aligned with business strategy, there continue to be many 'red flag' issues that some investors will not support, irrespective of the business rationale or the contrasting views of other shareholders.
 - Our research shows that remuneration resolutions typically attract higher levels of voting dissent than any other issue for shareholder vote. For example, in 2017 we observed that in the FTSE 350 the number of remuneration resolutions that received less than 80% support was almost double that of any other vote on the AGM agenda.
- There is a risk that pushing to achieve 80 per cent may result in more conformity in the remuneration policies that are submitted for shareholder vote. These 'generic' policies will not necessarily be created to align with shareholder interests or business strategy, but will instead be drafted to avoid raising any 'red flags' and therefore risking a negative vote.
- We consider a 75 per cent threshold would be more appropriate, as it would be aligned with (i) the support required to pass a special resolution under current UK legislation and (ii) international practice in many other countries with similar rules, such as Australia.
- We consider that a six-month timeline to publish a preliminary update following the AGM is appropriate, albeit this is likely to be summary in nature if the Board / Committee are reviewing the pay arrangements in full further to the vote.

Q9. Do you agree that the overall changes proposed in Section 3 (Composition, succession and evaluation Section) of the 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 strongly support talented individuals, irrespective of their gender, ethnicity, religion, education or background, being provided with the opportunity to progress to the highest levels.
- The terminology included in the proposed Code implies companies should adopt static succession planning arrangements. However, we consider the Code could be strengthened by encouraging companies to adopt both static and dynamic succession plans, as appropriate:
 - In our experience, static succession plans, (i.e. where formal plans, processes and timelines can be implemented) are often appropriate for Non-Executive Directors, as

the skills required evolve at a slower pace and firm timelines for succession can be more readily identified.

- However, these types of plans are less effective for appropriately managing succession planning for Executive Directors where changes in the macro-environment mean that the skills and capabilities required from future leaders can be more diverse and changeable.
- As such many companies find that dynamic succession planning is most effective for Executive Directors. Dynamic succession planning provides for more fluid succession planning through continuous development and by ensuring executives are held accountable for identifying and developing a talent pipeline amongst the individuals several reporting levels below them.

Q11. 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 strongly support the inclusion of measures that will lead to improved diversity, in all forms, amongst UK companies.
- Unlike gender statistics, reporting ethnicity data is likely to prove more challenging in the short term. In our experience many companies have not yet gathered robust and consistent data on ethnicity within the workforce. In addition, ethnic identity is often difficult to define or categorise and, even where ethnicity can be identified, individuals are often unwilling to provide these details. As such, we consider that companies will need some time to facilitate collection of data in an appropriate manner that would enable them to comply with any proposed guidelines.

Q14. Do you agree with a 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?

- We agree that it is appropriate to broaden the oversight of the Remuneration Committee, to support the Code's overarching objective of 'fair rewards and recognition' for the workforce and informed executive remuneration decision making. Expanding the Remuneration Committee's oversight will require careful balancing of multiple stakeholder views as (i) Remuneration Committees currently have a full annual agenda, which has grown materially in recent years (ii) management's ownership of pay decisions for the broader workforce if often critical to success, and (iii) identifying key metrics to inform decision making and securing honest feedback from the workforce will take time.
- As mentioned in our response to question three, the Code could be clearer on the interaction between the Remuneration Committee's responsibility for engagement and the broader engagement agenda. Given the sensitivity of pay-related issues, we consider that consultation on remuneration might not be as frequent or broad-based as other engagement with the workforce – as this would place a disproportionate focus on remuneration.
- We consider it is appropriate that the Remuneration Committee remain responsible for **decision making** with respect to executive pay, and that their **oversight** on broader fair pay issues is expanded. If the oversight of the Remuneration Committee is to be expanded, this might include oversight of (i) pay for performance alignment, (ii) gender/other fairness issues, (iii) pay related risks and (iv) intended internal pay differentiators.
- In our view, it is important that the Code remain principles-based, and that companies are afforded the opportunity to comply or explain. As such we consider the current wording of

the Code is appropriate, as it permits companies to determine the appropriate split between Remuneration Committee decision and oversight for their organisation.

- While we agree that it is necessary for a newly appointed Remuneration Committee Chair to be suitably experienced and knowledgeable to fulfil the role, we consider the Code could be strengthened by expanding the wording to facilitate the appointment of individuals who may not have 12 months experience on a Remuneration Committee but who are considered to have “sufficiently relevant recent experience” in remuneration matters e.g. a former HRD or pay consultant.