

New “shorter, sharper” UK Corporate Governance Code

Introduction

On 16 July 2018, the Financial Reporting Council (“FRC”) published the new UK Corporate Governance Code (the “Code”). The new Code replaces the version of the Code issued in April 2016 and applies to Irish-incorporated companies listed on the Main Securities Market of Euronext Dublin (formerly the ISE), as well as Irish companies with a premium listing on the London Stock Exchange.

Companies to which the Code does not strictly apply, but which strive for the highest standards of corporate governance, may also wish to review and renew their governance structures in light of the new Code to ensure that they continue to meet stakeholder expectations.

The new Code applies to accounting periods beginning on or after 1 January 2019. Boards should review existing policies and procedures and consider the need for new/updated ones to ensure that the company is in compliance with the new Code during 2019 and in a position to report on that compliance in their annual report issued in 2020.



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The new Code highlights the importance of:

- Positive relationships between companies, shareholders and other stakeholders.
- A clear purpose and strategy aligned with healthy corporate culture.
- High-quality board composition and a focus on diversity.
- Remuneration which is proportionate and supports long-term success.

“This new Code, in its new shorter and sharper form, and with its overarching theme of trust, is paramount in promoting transparency and integrity in business for society as a whole.”

(Sir Win Bischoff, Chair, FRC)

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Code Structure and Reporting

The new Code is more focused than the previous Code, achieved by removing the “Supporting Principles” and moving the more procedural Provisions out of the Code into the new [Guidance on Board Effectiveness](#) (the “Guidance”). The new Code has been reorganised into five main sections.

Companies are required under the Listing Rules to state how they have applied the Principles set out under the Code in a manner which enables shareholders to evaluate how they have been applied. With respect to the Provisions of the Code, the “comply or explain” approach has been maintained, offering flexibility to companies to either confirm their compliance with the Provisions or explain any non-compliance in their annual report.

The FRC emphasises that companies should avoid a “box-ticking” approach and should instead focus on meaningful reporting on the application of the Code’s expanded Principles.

Section 1 - Board Leadership and Company Purpose

Culture

Under the new Code, the Board should establish the company’s purpose, values and strategy, and satisfy itself that these, and the company’s culture, are aligned. Where they are not, the Board should seek assurance from management that corrective action has been taken.

Key stakeholders (including workforce)

The new Code requires the Board to ensure that workforce policies and practices are consistent with the company’s values and support its long-term sustainable success. In addition, the company’s approach to investing in and rewarding its workforce should be disclosed in its annual report.

There is a focus on meaningful engagement by the Board with the company’s other key stakeholders (beyond shareholders). The annual report should describe how their interests and the matters under section 172 of the UK Companies Act 2006 have been considered in Board discussions and decision-making. Section 172 requires directors to have regard to wider matters (such as the interests of employees) in seeking to promote the success of the company for the benefit of its members as a whole. While Irish-incorporated companies are clearly not subject to the provisions of the UK Companies Act 2006, the Board would be expected under the new Code to describe in the annual report how the matters mentioned in section 172 have been considered.

To strengthen the employee voice in the boardroom, companies must establish and regularly review a method for engaging with its workforce. The term “workforce” is designed to capture the diversity of relationships between companies and those working for them. The new Guidance does not explicitly state which individuals should be included, but provides that companies should consider including employees, agency workers, consultants and remote workers.

Workforce engagement should involve one or a combination of the following methods:

- (i) appointing a director from the workforce;
- (ii) establishing a formal workforce advisory panel; or
- (iii) designating a non-executive director (“NED”).

The Board can establish an alternative method for workforce engagement provided the annual report explains how the alternative arrangement delivers regular, meaningful dialogue with the workforce.

Key Changes

Structure and Reporting

- Shorter and sharper
- Re-focus on the application of the Principles
- Reduction in number of Provisions
- Avoid “box-ticking” exercise and boilerplate reporting

Key Changes

Board leadership and company purpose

- New Principle on alignment of culture with the company’s purpose, values and strategy
- Requirement to establish a method for engaging with the workforce
- Companies must address shareholder resolutions with 20%+ opposition by providing updates on shareholder engagement and actions proposed or taken
- New reporting obligation on the directors’ statutory duty to promote the success of the company, whilst having regard to wider matters such as employee interests

The old Code requires companies to establish a whistleblowing procedure for “improprieties in matters of financial reporting or other matters”. The new Code expands this requirement, allowing the workforce to raise “any matters of concern”. Whistleblowing policies and procedures should be updated to reflect this expanded scope.

Significant shareholder opposition

Where 20% or more of votes are cast against the Board recommendation for a shareholder resolution, a company must immediately explain what actions it intends to take to consult with shareholders to understand the reasons for the result. The company should then publish an update within 6 months on the views received from shareholders and actions taken. A final summary must be included in the company’s next annual report and, if applicable, in the explanatory notes to resolutions at the next shareholder meeting.

Section 2 - Division of Responsibilities

Board independence

The FRC has decided not to implement the proposed changes regarding the independence of NEDs and the chair. The new Code retains the requirements for the chair to be independent *on appointment only* and for at least half the Board, *excluding the chair*, to be independent.

In response to feedback during the consultation process, the new Code also retains Board discretion to determine whether a NED is independent, notwithstanding the existence of factors which may indicate otherwise. The FRC does, however, expect greater detail to be provided by companies when reporting on the independence status of NEDs.

Directors’ time commitments

The new Code requires the Board to take into account other demands on a director’s time when making new appointments. Significant commitments should be disclosed with an indication of the time involved before appointment.

Following appointment, any additional external appointments of the directors should be subject to prior approval of the Board, with the reasons for permitting “*significant*” appointments explained in the annual report.

Section 3 - Composition, Succession and Evaluation

Diversity and succession planning

The new Code aims to ensure that both appointments and succession plans promote not only diversity of gender, but also diversity of social and ethnic backgrounds and cognitive and personal strengths.

To enhance transparency on diversity, there is a new obligation to explain in the annual report how the company’s policy on diversity and inclusion is linked to the company’s strategic objectives. The annual report must also include the gender balance of those in senior management and their direct reports.

Tenure of the chair

Provision 19 focuses on the tenure of the chair, which introduces a nine-year term limit from the date of their first appointment to the Board (i.e. including time spent as a NED before election to chair). This period can be extended for a limited time, particularly where the chair was a NED on appointment, to facilitate succession planning and development of a diverse Board. A clear explanation should be provided where this extension is availed of.

Key Changes

Division of Responsibilities

- Directors’ other time commitments to be considered before appointment
- Board approval required for additional external appointments
- Approval of significant external appointments must be explained in the annual report

Key Changes

Composition, Succession and Evaluation

- Nine-year term limit for the chair (limited extension permitted)
- Renewed focus on diversity at Board and senior management level
- New reporting obligations regarding diversity, gender balance in senior positions and external Board evaluation

Board evaluation

The new Code requires additional disclosures in the annual report on any actions taken following the Board's evaluation and how the evaluation has or will influence Board composition. Following external evaluation (required for FTSE 350 companies every three years), the nature and extent of the external evaluator's contact with the Board and individual directors must also be publicly disclosed.

Section 4 – Audit, Risk and Internal Control

This section substantially replicates the requirements contained in the old Code, including duplication of obligations under the Listing Rules and Disclosure and Transparency Rules. The new Code also includes additional reporting obligations regarding:

- (i) a company's emerging risks; and
- (ii) where there is no internal audit, how internal assurance is achieved and how this affects the work of external audit.

Section 5 – Remuneration

Remit of the Remuneration Committee

Under the new Code, the remit of the Remuneration Committee is expanded to include oversight for wider workforce remuneration and related policies for the workforce generally and the setting of pay for senior management. This will be a big change for many Remuneration Committees who have traditionally focused only on executive pay.

Remuneration Committee chair

The new Code provides that a Remuneration Committee chair must have served for at least 12 months on a Remuneration Committee.

Use of discretion

The new Code seeks to rein in excessive executive pay. Importantly, the Code provides that formulaic calculations of performance-related pay may be rejected. Remuneration Committees should apply discretion when the resulting outcome is not justified.

Share incentive schemes

The new Code extends the minimum vesting and holding period from three to five years or more for shares awarded to executive directors under a company's long-term incentive plans. This change is an attempt to align executive and shareholders' interests in the long term and reflects recent market trends.

Directors' pay policy and practices

A new Provision sets out a list of matters for the Remuneration Committee to address when determining directors' remuneration policy and practices. These focus on ensuring clarity, simplicity, risk, predictability, proportionality and alignment to company culture.

Reporting obligations

A description of the work of the Remuneration Committee must be set out in the annual report, including:

- (i) what engagement has taken place with shareholders and the workforce;
- (ii) how executive remuneration aligns with wider company pay policy; and
- (iii) to what extent discretion has been applied to remuneration outcomes and why.

“To address public concern over executive remuneration... formulaic calculations of performance-related pay should be rejected.”

(FRC Press Release)

Key Changes

Remuneration

- Expanded role of Remuneration Committee
- More demanding criteria for remuneration policies and practices
- Clearly linked to delivery of the company's long term strategy
- Remuneration Committee chair should have served on a Remuneration Committee for at least 12 months
- Discretion to override formulaic outcomes
- Mandatory five-year vesting and post-employment holding periods attaching to share awards to executives
- Pension commitments for executives should be aligned with those available to the workforce

Guidance on Board Effectiveness

The new Guidance published by the FRC supports the proposed changes to the new Code. It is much longer and more detailed than the old Guidance and includes questions and practical examples to assist Boards in complying with the new Code.

Next Steps

The new Code applies to financial years beginning on or after 1 January 2019. Consequently, unless companies decide to adopt some or all of the new Code early, companies must ensure updated policies and procedures are in place to ensure compliance with the new Code during 2019 and proper reporting on that compliance in the annual report issued in 2020.

Directors should familiarise themselves with the changes introduced as there will be additional reporting required in their annual report regarding how they apply the Principles of the Code. They will also need to reconsider whether their annual report contains all the necessary disclosures as it is likely that some additions and/or restructuring of the corporate governance sections may be required.

For example, additional information may be required on:

- how the Board obtains the views of the workforce and other key stakeholders and the method(s) used to ensure regular dialogue with the workforce;
- how the interests of key stakeholders and the matters mentioned in section 172 of the UK Companies Act 2006 have influenced the Board's decision-making;
- any expansion of the company's whistleblowing policy and procedures;
- the scope of Board and director evaluations and how the outcome of evaluations will influence Board composition/succession planning;
- promotion of diversity (of all types) through the company's appointments and succession planning;
- directors' significant external appointments;
- future remuneration policies and changes to existing ones, which should be developed with reference to the new Code and Guidance; and
- the role of the various Board Committees and the description of their work in the annual report.

Over the coming months, the FRC intends to make consequential changes to the *Guidance on Audit Committees* and the *Guidance on Risk Management, Internal Controls and Related Financial Business Reporting*. It will also increase its monitoring of compliance with the new Code, including more in-depth reviews of annual reports, to ensure companies develop their governance practices and reporting in response to the new requirements.

Key Contacts



David Fitzgibbon
Partner
Corporate
E. David.Fitzgibbon@williamfry.com
T. +353 1 639 5154



Mark Talbot
Partner
Corporate
E. Mark.Talbot@williamfry.com
T. +353 1 639 5162



Susanne McMenamin
Partner
Corporate
E. Susanne.McMenamin@williamfry.com
T. +353 1 639 5166



David Jones
Associate
Corporate
E. David.Jones@williamfry.com
T. +353 1 489 6455



Julianne Ellis
Solicitor
Corporate
E. Julianne.Ellis@williamfry.com
T. +353 1 489 6411



Jennifer Dempsey
Solicitor
Corporate
E. Jennifer.Dempsey@williamfry.com
T. +353 1 489 6408

WILLIAM FRY



INSTITUTE OF DIRECTORS
IN IRELAND

DUBLIN | LONDON | NEW YORK | SAN FRANCISCO | SILICON VALLEY

T: +353 1 639 5000 **E:** info@williamfry.com williamfry.com

Institute of Directors in Ireland, Europa House, Harcourt Street, Dublin 2

T: +353 1 411 0010 **E:** info@iodireland.ie www.iodireland.ie