

# Change ahead – reflections on the Draft UK Corporate Governance Code

February 2018

## Introduction

On 5 December 2017, the Financial Reporting Council (FRC) published a consultation on proposed revisions to the UK Corporate Governance Code (Draft Code).

EY submitted a response to the consultation. During the consultation period (which has just closed), we held roundtable discussions with company secretaries, non-executive directors (NEDs) - primarily from FTSE 350 companies - and investors, to discuss some of the key proposed changes and gather feedback. **In this paper, we share what we heard and include our own points of view and reflections.**

Our December 2017 summary of the FRC's proposed changes can be found [here](#).

Many of the changes reflect the [requests of the Government](#) announced in its August 2017 reform package, following its earlier consultation as well as the [recommendations of the BEIS Select Committee](#) inquiry.

The FRC has also taken the opportunity to do a comprehensive review of the Code and make wider changes.

Given the wide ranging nature of the consultation and the FRC's extensive review of the Draft Code, there were a variety of views expressed on both. We haven't covered all of them here, but instead focused on what generated most debate<sup>1</sup>:

1. Stakeholder engagement
2. Independence and composition
3. Other issues
  - a. Structure and application of Principles
  - b. Stewardship

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<sup>1</sup> While there are substantial changes proposed in the Draft Code on remuneration, we have not covered these here.

## 1. Stakeholder engagement

**Draft 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.

### Draft Provisions

3. The board should establish a method for gathering the views of the workforce. This would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously. The board should review this and ensure that arrangements are in place for the proportionate and independent investigation of such matters and for follow-up action.

4. The board should explain in the annual report how it has engaged with the workforce and other stakeholders, and how their interests and the matters set out in section 172<sup>2</sup> of the Companies Act 2006 influenced the board's decision-making.

The Draft Code elevates stakeholder consideration and engagement into a Principle, and a stakeholder focus is woven throughout. Roundtable attendees told us that leading companies already engage their stakeholders, but it is an area that requires more development. It seems that while companies are engaging with stakeholders, the feedback and outcomes do not always filter up to the board systematically and neither are they reported on in a meaningful way in annual reports.

There were mixed views on the language in Draft Principle C which seems to place shareholders and stakeholders on an equal footing. This is seen to be going beyond the law, where directors have a primary duty to promote the success of the company for the benefit of its members, but in doing so have regard to a number of other issues and stakeholders. Some investors and companies countered that in practice there should not be a conflict between shareholders and stakeholders over the longer-term as interests often align when looking at a longer-term horizon, however it is in the short-term where this can present more of a challenge.

There was also some disappointment expressed in the focus of the Provisions being mainly on the workforce, away from stakeholders more widely (customers, suppliers, pensioners, local communities, etc.). While we broadly agree with this, we also want to emphasise that Principle C - which covers a company's wider stakeholders - must be read in conjunction with Provisions 3 and 4. Additionally, under Provision 4, the disclosure should cover *all* stakeholders, not just the workforce.

We heard that many listed companies already engage with their employees, but are using current developments as a springboard to review the mechanisms they have in place. Important in this consideration is the widening to 'workforce' as opposed to 'employees'.

<sup>2</sup> The matters set out in section 172 are:

- (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.

The consultation document highlights that the word '*workforce*' (rather than *employees*) has been chosen in an effort to encourage companies to think beyond those with employment contracts. Some companies, particularly where contractors are relied upon heavily, stated they were unsure how far 'downstream' to look in their labour supply chain. Many had also interpreted this to just refer to the UK workforce, but it is our understanding that this is not intended to be geographically bound. We agree with the need for the FRC to provide greater clarity on this.

While the phrase '*would normally be*' used in Provision 3 is intended to offer companies flexibility in implementing different engagement mechanisms (to the three listed in the Draft Code), companies expressed some concern that if they do not adopt one of the three they would be 'marked down' - despite already having other mechanisms in place. We agree that the wording of this Provision could make more explicit reference to allowing alternatives which are more appropriate for a company's circumstances. We heard that other favoured mechanisms that companies had adopted to date, or were being considered, included town halls and 'staff AGMs'. Alongside these forms of engagement, companies also said they were keen not to dismiss the importance of staff surveys. When executed well, we heard that these can be more effective than face-to-face interactions for gathering genuine views - on an anonymous basis - and highlighting issues at a local level.

It seemed that the most popular choice was to appoint a designated NED, with some already having done this. One company said it was considering having multiple designated NEDs each with a different remit e.g., different stakeholder groups or different geographical regions. Over time this would rotate so the NEDs would have exposure to different areas of the business or different stakeholder groups. There was some discussion of the fact that the designated NEDs may need further support and potentially even training e.g., in workforce relations.

We heard that many companies already had workforce advisory panels. However in the main, these report to executive management, and some companies are now considering 'elevating' their reporting lines to the board. Other companies said they were currently considering establishing these panels including thinking through the mechanics involved e.g., who would chair the panel, the information flows and the impact on insider lists - all of which are important practical implementation issues.

Unsurprisingly, directors appointed from the workforce caused the most debate and controversy amongst attendees. We heard from a couple of companies who have an employee director, and they explained the advantages of this, notwithstanding a number of challenges including that:

- ▶ Directors on unitary boards have broader statutory duties and should not be 'representing' a specific interest group, but promoting the success of the company for its shareholders with due regard to all stakeholders.
- ▶ Some may find formal board meetings intimidating and their ability to make meaningful contribution to the broad discussion was limited especially without adequate support and training.
- ▶ In financial services, directors must be 'approved persons' (by the Financial Conduct Authority and Prudential Regulation Authority), and this would preclude many employees from joining the board or attending board meetings.

More commonly, where companies have chosen to have staff representatives attend board meetings their remit is limited to representing the workforce rather than having to fulfil the broader statutory duties of a board director - but even with this method some of the challenges persist e.g., individuals finding board meetings intimidating.

Some companies believe Draft Provision 4 is the biggest potential change for them. The results of a [poll we conducted in September 2017](#) (see Figure 1) showed that over 44% feel that they engage with stakeholders effectively but do not fully capture this in their reporting - and this was re-confirmed at our roundtables. For the change to have an impact, companies will not only need to explain processes of engagement, but also the outcomes of engagement and how this influenced the board's decision-making.

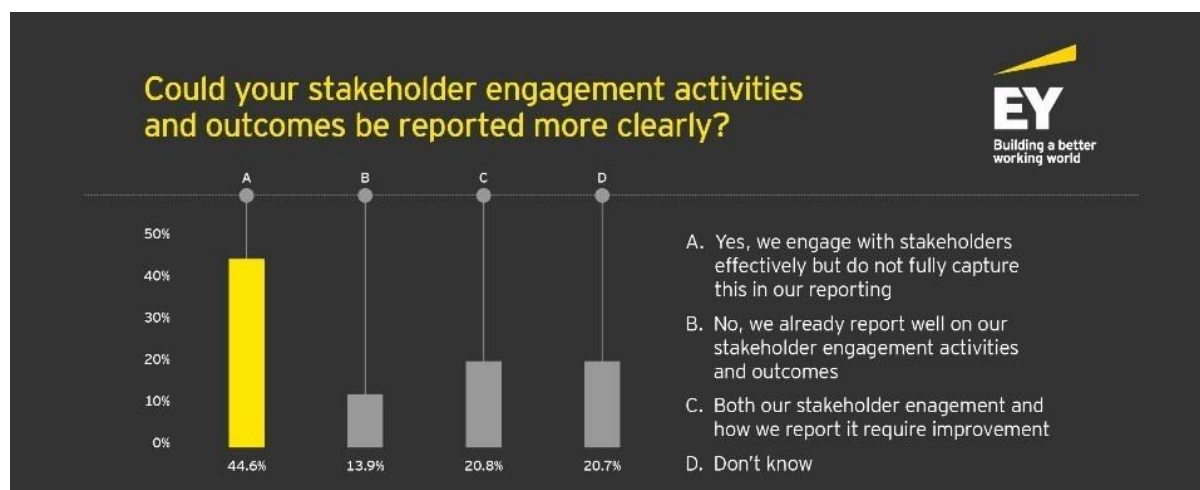


Figure 1.

Many attendees questioned how engagement would work in practice. One attendee asked how a company could approach and then disclose meaningfully a situation where a decision is taken to close operations which has received strong negative feedback from workers. Others countered that taking into account the interests of one stakeholder group ought not to undermine the board's duty to promote the success of the company for the benefit of its members as whole, and that means that feedback might not always result in a change in outcomes desired by particular stakeholder groups.

The exact wording of this Provision is under review until the Government introduces its planned secondary legislation to require companies of significant size (private as well as public) to explain how their directors comply with the requirements of s172 of the Companies Act i.e., to have regard to employees and other interests. However, some also pointed out that a number of premium listed companies on the London Main Market are not UK incorporated, and therefore not subject to s172 or other relevant provisions of UK company law.

In concluding on workforce engagement, what was clear from discussions, is that whatever mechanisms are adopted, there are important practical considerations that companies will need to work through before they can start operating them. Also the effectiveness of the mechanisms would need to be reviewed within 12-18 months to ensure the policy outcomes were being met and if not changes made or alternatives adopted.

## 2. Independence and composition

**Draft Provision 11:** Independent non-executive directors, including the chair, should constitute the majority of the board. With reference to Provision 15, the board should identify in the annual report each director considered to be independent. The chair should hold meetings with the non-executive directors without the executives present.

**Draft Provision 15:** Individual non-executive directors, including the chair, should not be considered independent for the purposes of board and committee composition if any one of them:

- ▶ is or has been an employee of the company or group within the last five years;
- ▶ has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- ▶ has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- ▶ has close family ties with any of the company's advisers, directors or senior employees;
- ▶ holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- ▶ represents a significant shareholder; or has served on the board for more than nine years from the date of their first election.

### *Independence of the chair*

Provision A.3.1 of the 2016 Code which states that 'The chair should **on appointment** (emphasis added) meet the independence criteria set out in [Provision] B1.1...' has been removed in the Draft Code. The proposal under the Draft Code, is that the chair's independence will be assessed on an ongoing basis rather than on appointment only. It has always been the case that independent directors should constitute the majority of the board, but under Draft Provision 11, the chair can be counted as one of these independent directors.

To date, the chair's independence was recognised as being distinct from the independence of other NEDs, because of the time spent by the chair and their close relationship with the chief executive (a finding from the Higgs Report). Many attendees felt that the rationale provided in the Higgs Report still held, and therefore questioned why it was being changed.

Others felt that a chair could meet Provision 15 on paper, but in substance and practice, given their role and time commitment, there wouldn't be a change from their current 'way of working'. There was a discussion on this being a backward step in terms of increasing *true* board independence - especially if the chair counted toward the number of independent directors when determining board composition. Some participants also mentioned that this may affect internal progression to chair e.g., from senior independent director (SID) to chair, as someone who had already been a SID for a number of years might be less inclined to take the chair's role if they could only serve for a few years (up to a perceived maximum of nine years). One suggestion was whether there should be an extended time limit for the total time served on the board for example in a combined role as a SID and subsequently a chair.

### ***Director independence and board composition***

The FRC have proposed a change in emphasis to how the factors detailed in Provision 15 are used to determine a director's independence. Under Draft Provision 15, directors **should not** (emphasis added) be considered independent if they meet any of the factors. Previously, while these same factors were to be considered by the board in making their determination of independence, they were not definitive.

There was a lot of debate on this more 'rule-based' approach:

- ▶ Many said it may encourage a tick-box approach - both at companies and with proxy advisors. Simply because a director did not meet any of the criteria in Draft Provision 15, did not mean they were independent. The more overarching test in Provision B1.1 of the 2016 Code (which has been removed in the Draft Code) was seen to be an essential qualitative assessment.
- ▶ There is a lack of clarity on whether this actually represents a change because the consultation document refers to companies being able to offer an explanation.
- ▶ Many of the individual factors in Provision 15 require clarification. For example, we discussed:
  - ▶ What was meant by a material business relationship i.e. material to whom?
  - ▶ The fact that cross directorships were prevalent currently but as long as the appointment process was conducted objectively and transparently, it did not matter. Some questioned whether this was designed to catch situations where for example the audit committee chair (ACC) on Company A's board was the CFO of Company B, and CFO of Company A was the ACC on Company B's board. Others discussed that the intention of this was to try and curb the 'old boys network'.

Finally, the 2016 Code requires a rigorous review of director independence after six years' tenure, and this has been removed in the Draft Code. There was some confusion about why the FRC was proposing to remove this. It was felt by many that six years has been a helpful reflection point, led to board refreshment and indirectly assisted with diversity, whilst providing the option for directors to stay on the board for a further three years where appropriate. There was some fear that this may signal that board appointments would last for a 'default' period of nine years. The counter view was that if directors' independence and contribution was being assessed rigorously annually e.g., as part of the board effectiveness review, the succession planning process etc., the six year reflection point was really not necessary. On balance though most felt it was helpful.

## **3. Other issues**

### ***a. Structure of the Draft Code and focus on application of Principles***

The FRC has taken the opportunity to do a comprehensive review of the Code. At just under 5,000 words, compared to 11,000 in the 2016 Code - at least at face value - the FRC seem to have achieved its objective of making the Draft Code shorter and sharper. They have achieved this by removing the supporting Principles and shifting the focus to **application of the Principles** rather than **compliance with the Provisions**. While this is not necessarily new, there was some discussion on the fact that this change in emphasis requires a mind-set shift amongst companies who largely remain focused on being able to demonstrate full compliance with all Provisions - perhaps led in part by how proxy agencies approach and issue voting recommendations on the basis of a company's



compliance with the Provisions. Companies need to be braver about 'explaining' but equally investors and proxy agencies need to apply qualitative judgement when assessing the disclosures by companies - particularly as the disclosures on Principles should enable shareholders to evaluate how those Principles have been applied. Some discussion also centred on the FRC's role in enabling this shift to occur - currently in its own assessment of governance standards in the UK, its emphasis is often on the percentage of companies that have complied with all/all but one or two Provisions of the Code, rather than how companies are applying the overarching Principles and hence the spirit of the Code.

### ***b. Stewardship***

During our roundtables, we did not cover in detail the 'initial consultation on the future direction of the UK Stewardship Code' that the FRC published at the same time as their consultation on the Draft Code. We did however get some feedback:

- ▶ The tiering exercise that the FRC undertook in 2016 could perhaps be improved by disclosing more granularly the scoring of performance against each of the seven principles of the Stewardship Code. Otherwise, underlying investors do not have much to engage their fund managers with in terms of improving their stewardship in certain areas.
- ▶ The UK will have to implement the EU Shareholder Rights Directive II into UK law soon and therefore the FRC should wait to see how this will be done before consulting on the Stewardship Code more fully.

### **Conclusion**

The FRC will be analysing all the responses and feedback it received with a view to publishing a new Code in June 2018 for periods beginning on or after 1 January 2019. This June timing for issuing a new Code, partly relies on whether the Government finalises related amendments to UK company law on reporting against s172. The two developments are inter-linked and from a company implementation perspective, it is important that the changes come into effect concurrently. We will be monitoring developments closely and will issue updates via our regular monthly e-bulletin *Governance Spotlight*.



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