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C H A N C E

January 2016

Your 2016 AGM and beyond

The forthcoming AGM season will raise some challenges, not least the heightened focus on financial reporting and risk management in the Corporate Governance Code.

This is the first time that most companies will prepare a long-term viability statement and have to undertake the diligence to enable them to make that statement. In this update, we examine this change and other key developments affecting this season's AGMs.

Best practice around directors' remuneration reporting is evolving. Most companies will be required to put their remuneration policy back to shareholders for the first time in 2017 and so this season provides a window of opportunity for companies to revisit their policy behind the scenes, reflect on what has worked well and identify those areas where change may be required.

What's new for 2016?

Forward looking statements in financial reports

The current version of the Corporate Governance Code (the **Code**) applies to financial years beginning on or after 1 October 2014. For a company with a calendar year-end, the new reporting requirements will apply for the first time to its 2015 year-end financial report.

The key areas of change centre around section C of the Code (financial reporting and risk management) and are intended to add a more forward-looking focus to both a company's narrative reporting and risk identification and management issues. Listing Rule 9.8.6 was updated in October 2015 to require UK listed companies to include the following statements in their annual financial reports:

Going concern statement: The annual financial statement (and half-yearly

Key Changes

- New provisions in the Corporate Governance Code and Listing Rules requiring companies to make two distinct statements in their annual report as to (i) whether the directors consider it appropriate to adopt the going concern basis of accounting and (ii) the long-term viability of the company over a specified period
- FTSE 350 companies must include a statement in their audit committee reports confirming they have complied with new audit rotation requirements
- Companies may seek a disapplication of pre-emption rights of a further 5% of the company's issued ordinary share capital, for a specific acquisition or capital investment. This was introduced part way through last year's AGM season
- Where there is a significant vote against an AGM resolution, companies must announce the actions they intend to take to understand the reasons behind the dissent
- Listed companies must report on their payment practices and policies from April 2016
- Listed companies in the extractive industries sector with a December financial year-end must make public their first report on payments to governments by 30 June 2016

At Clifford Chance we have a Public Companies team, specialising in advising listed companies on the application of the Listing Rules and Corporate governance best practice. Please contact us if you have compliance queries or need guidance on how the rules and evolving market practice apply to you. We are here to keep you up to date and can assist you with your 2015 Annual Report and Accounts, and preparing for your 2016 AGM.

Contact your Clifford Chance relationship partner, or

Robert Crothers
Partner – Corporate
T: +44 20 7006 1427
E:robert.crothers@cliffordchance.com

financial statement) must include an explicit statement as to whether the directors consider it appropriate to adopt the going concern basis of accounting and identify any material uncertainties affecting the company's ability to continue with this approach for at least 12 months from approval of the financial statements (Code provision C.1.3). The Financial Reporting Council (**FRC**) has provided guidance for boards when determining where any "material uncertainties" exist and recommends that consideration be given to the size of any potential impact of uncertain future events or changes in conditions on the company, the likeliness of their occurrence and the realistic possibility (and likely effectiveness) of taking any actions to avoid or reduce the impact of such events or changes[1].

Long term viability statement: The directors must explain how they have assessed the prospects of the company over a specified period and why they consider that period to be appropriate. They must also state whether they have a reasonable expectation that the company will be able to continue in operation and meet its liabilities as they fall due over that period (Code provision C.2.2). The FRC's guidance suggests that the relevant period should be "significantly longer than 12 months", but does not specify exactly how long.

Interestingly, a number of companies voluntarily published viability statements in their 2014 year-end annual reports, some covering a three-year period and others a five-year period. Although it is early days, for those companies that have published their 2015 year-end annual reports, the current trend points towards a three to five-year period, although, note that the company is required to explain why it has chosen the relevant period. Among the existing viability statements at least one company has chosen to link its viability statement to its group three-year strategic plan, which suggests that the statement will only look forward a full three years every third year.

Audit tender: new statement of compliance

FTSE 350 companies are now required to put their audit out to tender at least every 10 years. This new legislative requirement[2] is consistent with current best practice as the Corporate Governance Code already recommends a 10-year audit rotation cycle. Companies need to include a statement of compliance with the new legislative requirement in their audit committee reports.

Additionally, where a company has not completed a tender process for the last five consecutive financial years, the audit committee must state in its committee report relating to the fifth financial year, the year in which it proposes to complete the next competitive tender process.

With changes in this area at both UK and EU level, audit rotation has become a key area of focus for listed companies, with over 90% of FTSE 350 companies making reference to the requirement to put their external audit out to tender in their last annual report[3]. There are further changes on the horizon, in particular, changes to EU legislation relating to the conduct of statutory audits must be implemented by Member States by June 2016 and the government and the FRC are currently consulting on the necessary changes to UK legislation and guidance. See page 7 below for further information.

Additional flexibility to make non pre-emptive share issues

In March 2015 the Pre-Emption Group published an updated Statement of Principles (the **2015 Principles**) allowing companies flexibility to seek a further 5% disapplication of pre-emption rights (in addition to the standard 5%), provided such additional shares are only issued in connection with a specified acquisition or capital investment.

As the 2015 Principles were published while the 2015 AGM season was underway, some companies did not have the opportunity to seek an enhanced disapplication and others chose to wait and see how market practice developed. Of those companies that have published their AGM notice since March 2015, approximately one-third have sought the enhanced authority in connection with a particular capital investment or acquisition. Generally speaking, investors have been supportive of companies seeking the broader authority and we expect that more companies will do so in the 2016 AGM season.

A company seeking the enhanced authority is expected to confirm in its notice of AGM that it only intends to use the capital in connection with a specific acquisition or capital investment which is either announced at the same time as the issue or has taken place in the six months preceding the issue and is disclosed in the announcement of the issue.

A word of caution, whilst ISS endorses the 2015 Principles and has updated its Proxy Voting Guidelines accordingly (see page 4 for link to the guidelines), it warns that where such enhanced authority is given and the company abuses the authority (for example by issuing non-pre-emptive shares for a purpose other than that specified), shareholders may be advised to vote against the authority at the following AGM.

A copy of the 2015 Principles is available here.

1 FRC "Guidance on Risk Management, Internal Control and Related Financial and Business Reporting" (September 2014).

2 The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) Order.

3 Figures taken from Practical Law's report "Annual Reporting and AGMs 2015: What's Market Practice?".

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Shareholder voting: companies to take steps to understand any "significant dissent"

Where a significant proportion of votes has been cast against a particular resolution at an AGM, updated Code provision E.2.2 requires the company, when announcing the results of the AGM, to explain what action it intends to take to understand the reasons behind the outcome to the vote.

The Code does not define "significant dissent" but, in its updated Proxy Voting Guidelines, ISS has suggested that dissent of around 20-30% is considered *significant* and states that where a company has received a significant level of dissent, it may make a negative recommendation against the relevant resolution at a future general meeting.

Whilst market practice is still developing, of the 17 companies that received a vote of 20% or more against a proposed resolution at their 2015 AGM, four complied early by including a voluntary statement in their results announcements setting out details of the action they intended to take to understand such dissent.[4]

New requirement to report on payment practices and policy

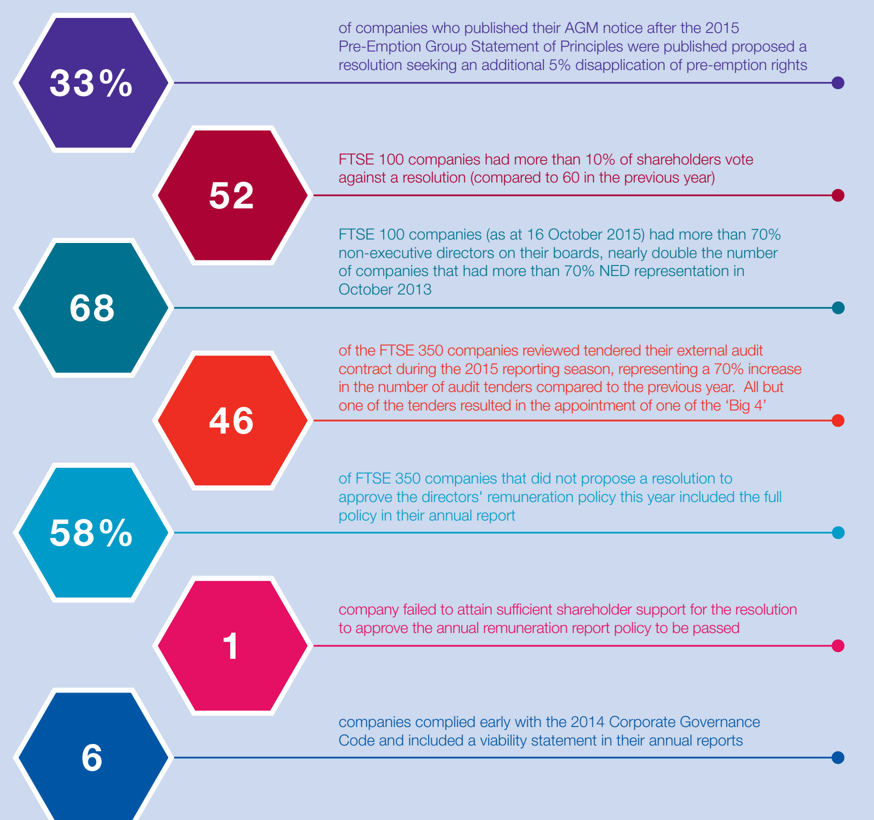
The Small Business, Enterprise and Employment Act 2015 contains a power for the Secretary of State to make regulations requiring certain types of large organisations to report on their payment practices and policies. On 20 March 2015, BIS published a statement setting out its plans for implementing this regime and an indicative format for the report. As a result, large organisations will be required to report on their payment practices and policies from April 2016. The stated purpose of these provisions is to tackle the UK's late payment culture.

The final regulations are still awaited, but the relevant requirements are unlikely to vary from the BIS statement in which the government has concluded that the reporting duty should only be mandated for large organisations, by which they mean large quoted companies, large private companies and large LLPs.

A company is large if it satisfies two or more of the following conditions: turnover of more than £25.9m; balance sheet total of more than £12.9m; or more than 250 employees.

The types of payment which are caught by the regulations are in respect of business to business contracts (for example contracts for goods, services or intangible assets (such as intellectual property)) which are connected to the

Key trends from the 2015 reporting and AGM season[5]



5 Statistics taken from Practical Law's "Annual Reporting and AGMs 2015: What's Market Practice?" Statistics based on PLC's review of the notices of AGM and annual reports of 305 FTSE 350 premium equity commercial companies that published their notice of AGM between 31 October 2014 and 30 October 2015 and that held their AGM in 2015.

4 Figures taken from Practical Law's report "Annual Reporting and AGMs 2015: What's Market Practice?" published on 23 November 2015.

carrying on of a business. Financial services contracts are specifically excluded. The payments report will include, amongst other things, details of standard payment terms; the average time taken to pay; and the proportion of invoices paid in 30 days or less ("good practice"), between 31 and 60 days and beyond 60 days ("bad practice"). Reporting will be on a half-yearly basis and the reports will need to be provided in open data format to a single central location.

First reports on payment to governments to be published by 30 June 2016

The Reports on Payments to Governments Regulations 2014[6] (the **Regulations**) require large UK companies in the extractive industries sector to prepare an annual report on payments to governments in respect of financial years beginning on or after 1 January 2015. Under the Regulations the relevant report must be prepared and submitted within 11 months of the end of the relevant financial year.

However, the introduction of a new DTR 4.3A means that companies with their shares admitted to trading on a regulated market in the UK and whose home state is the UK must prepare a relevant report which must be made public within six months after the end of each financial year. Listed companies are not required to include the report in their annual report, but may wish to do so and it will be interesting to see how practice evolves in this regard. The report will need to be published by means of an RIS.

As a result of changes to the EU Transparency Directive, this reporting regime was extended to all companies active in the extractive and forest industries sector which have securities listed on an EEA regulated market, regardless of their country of incorporation. UK-incorporated listed companies that are caught by both the Regulations and DTR 4.3A will also need to file their report with Companies House.

A UK parent undertaking is required to prepare a consolidated report covering payments made to governments by both it and its subsidiary undertakings, regardless of whether such subsidiary undertakings are incorporated in the UK or overseas.

UK subsidiaries of a parent required to prepare consolidated group accounts in another EU Member State benefit from transitional relief exempting them from the requirement to prepare a report in respect of any financial year commencing prior to 1 January 2016.

For more details, please see our briefing *BIS confirms early adoption of regulations requiring extractive industries to disclose payments to governments*.

ISS introduces "overboarding" policy in its updated Proxy Voting Guidelines

The ISS published an update to its UK & Ireland Proxy Voting Guidelines which takes effect for shareholder meetings held on or after 1 February 2016.

These guidelines introduce an "overboarding" policy, intended to limit the number of directorships an individual may hold. The Corporate Governance Code currently only goes as far as to recommend a limit for executive directors to hold no more than one FTSE 100 non-executive directorship. The ISS proposes the following limits on directorships of publicly-listed companies:

Executive Directors
- No other executive or chairmanship positions
- Up to two non-executive directorships

Board Chairman
- No more than one other chairmanship position
- No executive position elsewhere
- Up to three non-executive directorships

Non-executive director (no executive or chairmanship positions)
- Up to four non-executive directorships

The policy does include some flexibility (on a case by case basis) and the ISS will consider the nature and scope of an individual's various appointments and the complexity of the companies concerned.

The ISS may make recommendations against individual directors in circumstances where their appointment would exceed the overboarding policy. Nomination committees should bear these guidelines in mind when considering board appointments.

You can link to the ISS 2015 Proxy Voting Guidelines here.

6 The Regulations implement Chapter 10 of the EU Accounting Directive and require large undertakings or public interest entities to prepare a report on an annual basis on the payments that they make to governments across the world. The Regulations were amended on 18 December 2015 by The Reports on Payments to Governments (Amendment) Regulations 2015 in order to correct errors in the original Regulations.

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Directors' remuneration reporting: Hot spots for 2016

The 2016 AGM season is the third time UK quoted companies have prepared a new style directors' remuneration report (**DRR**) for shareholder vote. For many companies, 2016 is also the last year before the remuneration policy must again be put to a binding shareholder vote in 2017.

Here we look back at the 2015 AGM and DRR season and consider what should be on companies' agendas for 2016.

2015 AGM season trends

2015 saw a fairly quiet AGM season with few DRRs receiving low approval votes. Several companies asked shareholders to approve a new remuneration policy. In some cases this had been flagged up in 2014 as companies undertook a review of their remuneration structure as a whole while others found their original remuneration policy was no longer suitable due to changes in strategy or management. The positive AGM results were partly explained by the widespread adoption of "best practice" features across the FTSE 350. For example, almost all FTSE 350 companies now incorporate malus or clawback provisions in bonus and long term incentive plans and research published by BIS in March 2015 indicated that most companies are complying with a majority of the reporting regulations.

Looking ahead to the 2016 AGM season

As it will not be a policy vote year for most companies, it should again be a relatively straightforward AGM season for the majority of companies.

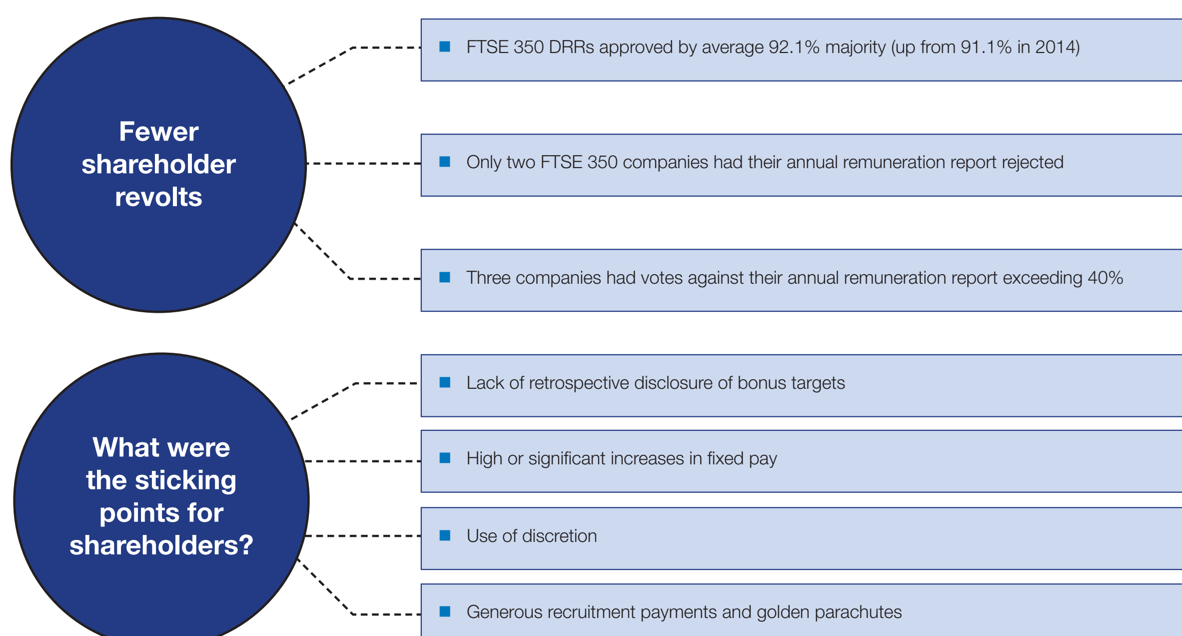
It is, however, an opportunity for companies to review their existing remuneration policy, consider what has worked and establish where changes are needed for the policy to fit the company's remuneration approach or to comply with best practice. This will ensure companies are well placed to prepare their new remuneration policy in 2017 and engage early with shareholders on any potential issues.

Investment Association (IA) guidelines – key issues for 2016: The IA published its updated Principles of Remuneration, along with a letter to remuneration committee chairmen on 11 November 2015. Two substantive changes have been made to the Principles:

1. Bonus target disclosure

The IA notes that retrospective disclosure of bonus targets in DRRs has improved but remains concerned that some companies are too glibly applying the "commercial sensitivity" exception to

Looking back at the 2015 AGM season



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avoid or delay disclosure. Whilst the equivalent 2014 Principles of Remuneration simply stated that reliance on commercial sensitivity should be exceptional and justified, the 2015 Principles require companies to explain to shareholders (a) the circumstances justifying non-disclosure on grounds of commercial sensitivity and (b) when disclosure will take place in the future. This applies to companies with a year-end on or after 1 December 2015.

Failure to disclose bonus targets fully or commit to full disclosure at a specified time is likely to lead to a Red Top of the DRR; failure only to specify a date for disclosure is likely to lead to an Amber Top.

2. LTIP holding periods

There has been a change of emphasis on LTIP holding periods. Instead of remuneration committees "considering" the use of post-vesting holding periods, the 2015 Principles now state that holding periods are expected by investors. Following Fidelity's lead, the IA states that the total vesting and holding period "should" be at least five years. The impact of this change is likely to be limited as a majority of FTSE 350 companies already operate a holding period for executive directors in connection with their LTIP awards.

The letter to remuneration committee chairmen sets out four areas of shareholder focus for 2016.

- ***Salary increases:*** Investors are concerned by the level and frequency of salary increases, especially those above inflation. The IA notes an increasing number of investors are of the opinion that executive directors should not receive any regular salary increases. Salary increases will continue to be scrutinised and companies should have a clear and explicit rationale for any increase to director and senior executive salaries.
- ***Joiners and leavers:*** For new joiners, there will be continued scrutiny of recruitment and buyout awards and there is particular concern about any attempt to re-grant or re-price recruitment awards where a company has fallen in value.

  In relation to leavers, the IA reiterates that remuneration committees must take a robust approach when making decisions on remuneration for leavers, particularly where they deem someone to be a good leaver who would not automatically fall into that category.

  In these circumstances, a company should also give a full justification of why it considers that a leaver should be a good leaver. This will give rise to some interesting debates for remuneration committees on the leaver treatment of executives who either resign or leave by mutual agreement.
- ***Service contracts:*** The IA notes that the majority of members remain in favour of 12 month notice periods, and are keen to see the same notice period for both the company and the director.

  One point of interest for any company putting new director contracts in place is that the IA expects new contracts to allow companies to withhold payments in lieu of notice during any regulatory or disciplinary investigation.
- ***Pensions:*** Members are concerned by large pension increases for directors and want to see simpler arrangements which are more in line with those of other employees.

  Further change is on the horizon. The IA indicated that its recently formed Executive Remuneration Working Group is currently working on proposals for "a radical simplification of executive pay". These are expected to be published in spring 2016.

What does a good remuneration report look like?

Companies should communicate remuneration decisions taken during the year in their DRRs.

The Institute of Chartered Secretaries and Administrators has published guidance on "Good Practice for Annual Reports". This suggests that DRRs should include a clear introduction from the committee chairman (including an overview of how performance has affected pay), detailed disclosure on the discretions available to the remuneration committee, and information on how the company has engaged with institutional investors and other shareholders.

BIS research noted that companies should ensure adequate disclosure is provided on executives' pension entitlements, payments to past directors and any payments made for loss of office. BIS suggests that companies should include an appropriate negative statement where there is no information to disclose on these points.[7]

On 10 December 2015, the GC100 and Investor Group published a statement that it does not intend to make any changes to its current directors' remuneration reporting guidance but confirmed that it will undertake a full review of the guidance and publish an update during 2016.

7 BIS research paper number 2008 – How companies and shareholders have responded to new requirements on the reporting and governance of directors' remuneration, published March 2015, p.6.

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Looking Ahead

The 2017 AGM season will see many companies putting their remuneration policy back to the shareholder vote and over the next 12 months, remuneration committees and boards are likely to want to revisit the existing remuneration policy to check it remains fit for purpose.

Other key areas of focus after the 2016 AGM season will include:

Gender Equality on Boards: FTSE 100 has collectively met its milestone target but variants remain between individual companies

In 2010 Lord Davies set a target for all FTSE 100 firms to have at least 25% women on their boards by 2015. While FTSE 100 companies have now collectively exceeded the target of having at least 25% women on boards and FTSE 250 companies have more than doubled the number of women on boards, there is still some way to go to meet the 25% target on every company's board.

As at October 2015:

- 26.1% of FTSE 100 directors were women
- only 55 FTSE 100 companies had individually met the 25% target
- 19.6% of FTSE 250 directors were women
- there were no all-male boards in the FTSE 100 (compared with 21 back in 2011) and only 15 remaining in the FTSE 250
- in the FTSE 100, only 26 executive positions are held by women (up from 18 in 2011); the majority of female appointments having been to non executive directorship positions

Lord Davies' 2015 report recommends increasing the voluntary target for women's representation on boards of FTSE 350 companies to at least 33%, to be achieved in the next five years.

Modern Slavery Reporting

The Modern Slavery Act 2015 came into force in October 2015. Section 54 of the Act requires all commercial organisations with a total turnover of £36 million or more that carry on a business or part of a business in the UK (it may apply to non UK entities) to disclose what steps they are taking to eliminate slavery and trafficking from their own business and supply chain. This requirement applies to all financial years ending on or after 31 March 2016.

Firms operating in the UK must consider parent and subsidiary organisations within the group structure in order that they can make a full assessment as to whether slavery and human trafficking is taking place in any part of their business or supply chain. The statement must explain the steps the organisation has taken to ensure that human trafficking and slavery is not taking place in any of its supply chains or any part of its business. Alternatively, an organisation may fulfil its obligations under s.54 of the Act by making a statement that it has taken no such steps. The disclosure should take the form of a statement on the company's website, with a link to the statement placed in a 'prominent' place on the organisation's website.

Whilst the Act contains no time limit for the publication of such statements, Home Office guidance provides that the statements should be made as soon as reasonably practicable following the end of the financial year and in any event encourages reporting within six months of the end of the relevant financial year. Companies should start putting systems in place now to ensure that they are able to make the relevant assessments required to give their slavery and human trafficking statement. The statement must be approved by the board of directors and signed by a director before publication.

For more information, please see our briefing *Corporate Reporting under the Modern Slavery Act*.

Further changes to the Code and the FRC's Guidance on Audit Committees on the horizon

In September 2015 the FRC published a consultation in response to a new EU Regulation and Directive[8] relating to the conduct of statutory audits which will have effect in Member States from 17 June 2016. The Regulation and Directive taken together require revisions to the Corporate Governance Code. At the same time as consulting on these changes, the FRC has also taken the opportunity to review its guidance on audit committees, last published in September 2012, in order to align this guidance with the new requirements for audit committees and changes to its ethical standards for auditors.

Changes to the Code: The general approach has been to keep changes to the Code to a minimum, limiting them only to areas where it is felt that the current provisions are inconsistent with the Regulation and Directive. It is proposed to amend Provision C.3.1 to require the audit committee as a whole to

8 Regulation EU/537/2014 covering specific requirements regarding statutory audit of public interest entities and Directive 2014/56/EU covering the statutory audit of annual accounts and consolidated accounts.

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have competence relevant to the sector in which the company operates and Provision C.3.8 to require the audit committee to provide notice of audit retendering plans.

Changes to FRC Guidance on Audit Committees: Key proposals include expanding on the audit committee composition to include the sectoral competence requirement, the removal of references to audit retendering (as this is already covered in separate legislation (see page 2)) and changes to reflect the new rules restricting the provision of non-audit services by auditors.

As part of the consultation, the FRC is also seeking views on whether there should be a separate advisory vote on the audit committee report at the AGM. This follows a recommendation of the Competition and Markets Authority in its 2013 report into the audit services market. The FRC believes that shareholders already have sufficient opportunity to express their opinion on the audit committee report by voting against the annual re-election of directors or tabling a specific resolution. Companies and investors have also indicated they do not think such a vote is necessary but the FRC has sought market views.

It is not clear when the proposed changes to the Code and FRC Guidance on Audit Committees would take effect (although it would make sense for it to coincide with the Regulation and Directive taking effect on 17 June 2016).

The FRC consultation closed in December 2015. Once the final changes are published, companies will need to give thought to the composition of their audit committees to ensure they meet the requirement to achieve "sectoral competence" and will also want to review their audit committee terms of reference to ensure that they are consistent with the updated Guidance on Audit Committees.

Contacts

Robert Crothers
Partner – Corporate
T: +44 20 7006 1427
E: robert.crothers@cliffordchance.com

Isabelle Hessell-Tiltman
Senior Associate – Corporate
T: +44 20 7006 1681
E: isabelle.hessell-tiltman@cliffordchance.com

Kath Roberts
Senior Professional Support Lawyer – Corporate
T: +44 20 7006 1308
E: kathryn.roberts@cliffordchance.com

Katharine Peacock
Professional Support Lawyer – Corporate
T: +44 20 7006 3605
E: katharine.peacock@cliffordchance.com

Liz Pierson
Senior Associate – Incentives
T: +44 20 7006 2817
E: liz.pierson@cliffordchance.com

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