# GOVERNMENT PUBLISHES WATERED-DOWN CORPORATE GOVERNANCE REFORMS

On 29 August 2017, the UK Government published a package of corporate governance reforms, intended to enhance the public's trust in business. Whilst the Government is not pressing ahead with a number of the initial proposals set out in its November 2016 Green Paper on Corporate Governance reform, companies can expect to see (i) new legislation requiring all large listed companies to reveal the pay ratio between their CEO and their average UK worker; (ii) the establishment of a public register naming all listed companies where over 20% of investors have voted against the company's annual shareholder vote on its directors' remuneration report; (iii) new proposals to strengthen the voice of employees in the boardroom; and (iv) the introduction of a new voluntary corporate governance code for large private companies. No longer on the agenda however are the most radical proposals which contemplated putting workers on company boards and the introduction of an annual binding vote on executive pay.

Whilst some commentators such as the TUC have been strongly critical of what they see as a greatly watered-down set of proposals, others regard the proposed reforms as being a pragmatic approach.

Further details of the key proposals are set out below.

**Key issues**

- New legislation requiring all large listed companies to reveal the pay ratio between their CEO and their average UK worker
- The establishment of a public register naming all listed companies where there is significant shareholder opposition to the annual vote on executive pay
- New proposals to strengthen the voice of employees in the boardroom
- The introduction of a new voluntary corporate governance code for large private companies
- These reforms are intended to come into effect by June 2018, for financial years starting on or after that date

### *Executive Pay*

- Secondary legislation will be introduced to require quoted companies to report annually the ratio of CEO pay to the average pay of a UK worker, along with a narrative explaining changes to the ratio from year to year and how the ratio relates to pay and conditions across the wider workforce. This proposal has been controversial and was strongly opposed by the majority of quoted companies that responded to the Green Paper. Undoubtedly, this disclosure, if taken in isolation and without recourse to the accompanying narrative, is likely to generate some eye watering headlines when published. Any such disclosure will, however, only offer a crude measure by which to compare pay between listed companies given that, in industries such as investment banking, where there are a significant number of employees on very high salaries, the ratio is likely to be significantly lower than, say, a manufacturing company, with a much higher number of relatively low paid employees. Whilst the Government will give further consideration to the methodology for calculating the ratio, at present, it proposes that it should be calculated based on the CEO's total annual remuneration (as set out in the existing "single figure" in the directors' remuneration report) relative to the average total remuneration of the UK workforce.

- The Investment Association is to be invited to establish and maintain a public register to "name and shame" those listed companies that receive a shareholder vote of 20% or more against their annual directors' remuneration report, along with a record of what these companies have said about the steps they are taking to address shareholder concerns. The Government argues that this will increase accountability and transparency but, given this information is already in the public domain, critics have already queried whether this proposal has any real teeth. The FRC is also to be asked to revise the Corporate Governance Code (**Code**) to be more specific about the steps premium listed companies should take where they encounter significant shareholder opposition to executive pay policies and awards.
- The FRC will be asked to extend the recommended minimum vesting and post-vesting holding period for executive share awards from three to five years to encourage a focus on longer-term outcomes when setting pay.
- The FRC will be asked to revise the Code to give remuneration committees greater responsibility for pay and incentive oversight, requiring them to engage with the workforce to explain how executive pay is aligned with the wider company pay policy. The chair of the remuneration committee will also be expected to have at least 12 months' prior experience of serving on the remuneration committee.
- The Government will announce details shortly of a review to examine the use of share buy backs to ensure they cannot be used to artificially hit performance targets and inflate executive pay.
- Proposals mooted in the Green Paper such as the introduction of an annual binding vote on executive pay (or some of the variable parts of the pay package), a cap on total executive pay and more frequent binding votes on the remuneration policy are not being progressed.

## *Strengthening the employee and wider stakeholder voice*

- The initial proposal to require that an employee representative be appointed to the board is not being taken forward. Instead, the FRC is being asked to consult on a new Code provision requiring premium listed companies to adopt, on a comply or explain basis, one of three employee engagement mechanisms: (i) designate a non-executive director to represent employees, (ii) create a formal employee advisory council, or (iii) nominate a director from the work force. ICSA and the Investment Association are to be asked to publish joint guidance on practical ways in which companies can better engage with their employees and other stakeholders at board level.

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- Secondary legislation is to be introduced to require all large companies (both public and private) to explain how their directors comply with the requirements of section 172 Companies Act 2006 (duty to promote the success of the company for the benefit of the members, having regard to various factors, including the interests of certain other stakeholders (including employees) and the likely long-term consequences of any decision). The Government's initial view is that this requirement should apply to companies with more than 1,000 employees, although this is subject to further consultation.
- The GC100 is to be asked to publish new advice and guidance on the practical interpretation of the section 172 directors' duty.

## *Corporate governance in large private companies*

- The FRC will be invited to work with the Institute of Directors, the CBI, the British Venture Capital Association and others to develop a voluntary set of corporate governance principles for large private companies. This work is expected to commence in Autumn 2017.
- In addition to the new section 172 reporting requirement set out above, secondary legislation will be introduced to require large private companies to disclose their corporate governance arrangements in their directors' report and on their website, including information about whether they follow any formal governance code. The Government's initial view is that these requirements should apply to companies with more than 2,000 employees, unless they are already subject to an existing corporate governance reporting requirement. The Government is considering whether this proposal will be extended to limited liability partnerships (LLPs) of equivalent size.

## *Boardroom diversity*

Whilst the Green Paper did not specifically consult on the issue of boardroom diversity, this was an issue raised during the course of the consultation, not least by the BEIS Select Committee report published in April 2017, which recommended that the FRC should have the issue of board diversity as a key priority in its revised version of the Code. It was suggested that this should include embedding the promotion of ethnic diversity in the Code and requiring a detailed narrative on board diversity in the annual report.

The Select Committee also recommended that the Government set a target that, from May 2020, at least half of all new appointments to senior and executive management positions in the FTSE350 and all listed companies should be women. Whilst the Government agrees more progress is needed, it does not intend to set higher targets than those already recommended by the Davis Review (by 2020, 30% of FTSE board members as well as 33% of executive committees and their direct reports should be women). Instead, it would prefer to focus its efforts on ensuring existing targets are met, rather than setting new targets.

The FRC is expected to take forward a number of the Select Committee's other recommendations on diversity reporting as part of its ongoing review of the Code.

## *Next steps*

The FRC is expected to consult on proposed amendments to the Code in Autumn 2017. The Government intends to bring forward the secondary legislation referred to above by March 2018. The current intention is to bring the reforms into effect by June 2018 and for them to apply to company reporting years beginning on or after that date.

You can access the Government's response to its Green Paper consultation here.

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