

# Revisions Proposed to the UK Corporate Governance Code: An Overview and Comparison with Aspects of US Corporate Governance

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**In December 2017, the UK Financial Reporting Council (the “FRC”) proposed revisions to the UK Corporate Governance Code. These revisions will impact companies with a Premium Listing of equity shares in the UK, which are required under the Listing Rules to state in their annual report and accounts how they have applied the Code. The revisions are designed to achieve long-term company growth through enhanced corporate accountability mechanisms and are aimed at consolidating the UK’s reputation as a leading environment for transparent and efficient international business. Many of the proposed revisions, if enacted, would facilitate greater alignment between UK and US corporate governance law and regulations.**

## **I. Introduction**

In December 2017, the FRC published proposed revisions to the [UK Corporate Governance Code](#) (the “current Code”). The changes follow the August 2017 announcement by business secretary Greg Clark that the UK Government would be implementing wide-ranging corporate governance reforms in response to its [November 2016 Green Paper Consultation on Corporate Governance Reform](#), the subsequent [FRC report on corporate culture](#) and the [Business Enterprise and Industrial Strategy report on corporate governance](#).

The FRC’s proposed changes are intended to “shorten and sharpen” the current Code and are focused on changes in the areas of leadership, division of board and management responsibilities, board composition, succession and evaluation, audit, remuneration, risk and internal control. Many of the proposed new provisions (including with respect to remuneration, whistleblowers and director independence), if enacted, would facilitate greater alignment between UK and US corporate governance laws and regulations.

The consultation on the FRC’s proposed revisions is open until 28 February 2018. The final revised Code is set for publication in summer 2018 and to then enter into force for accounting periods

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beginning on or after 1 January 2019.

## **II. Key Revisions**

### *Structural Changes to the Code*

The revised Code has five sections:

1. Leadership and Purpose
2. Division of Responsibilities
3. Composition, Succession and Evaluation
4. Audit, Risk and Internal Control
5. Remuneration

### ***Leadership and Purpose***

The FRC's proposed revisions place significant emphasis on the need for company culture and wider stakeholder (including workforce) interests to be evaluated by the board as key drivers of long-term company sustainability. For example, the FRC's proposed Principle C provides "[i]n 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"<sup>[1]</sup> (i.e., stakeholders beyond shareholders). In addition, the FRC's proposed Provision 3 requires that "[t]he board should establish a method for gathering the views of the workforce"<sup>[2]</sup> through either (i) a director appointed from the workforce; (ii) formation of a formal workforce advisory council; or (iii) designating a specific non-executive director. In its report on the revised Code, the FRC stated that it deliberately adopted the term "workforce" to encourage "companies to consider how their actions impact on all, not only those with formal contracts of employment."<sup>[3]</sup>

The revised Code would maintain many of the principles and provisions of the current Code, reinforcing the importance of shareholder engagement and transparency in relation to shareholder voting practices. Several of the Provisions from Section E of the current Code are proposed to be contained within the first set of Principles and Provisions in the revised Code. For example, proposed Provision 5 incorporates:

- current Principle E.1, that the board should maintain an understanding of shareholder opinion;
- current Provision E.1.1, which requires that the chairman of the board ensures that the views of shareholders are communicated to the board and management and that strategy should be discussed with major shareholders;
- current Provision E.1.2, which provides that the board's annual report should contain the steps it has taken to maintain its understanding of the views of major shareholders about the company; and
- current Principle E.2, which establishes that the board should use general meetings to communicate with shareholders and encourage their participation.

The current Code was amended in 2014 in relation to voting practices, requiring boards to engage with shareholders if they receive significant votes against a resolution.<sup>[4]</sup> In order to improve transparency and provide greater certainty as to when the engagement obligation is triggered, the FRC proposes to revise the relevant Code Provision as follows:

"When more than 20 per cent of votes have been cast against a resolution, the company should

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explain, when announcing voting results, what actions it intends to take to consult with shareholders in order to understand the reasons behind the result.”<sup>[5]</sup>

In addition, the FRC proposes to include a new interim measure requiring that within six months after the vote, an update should be published before the final summary is provided in the next annual report. The FRC has stated that these revisions are “aimed at ensuring the company fully understands the reasons for shareholders voting against a resolution and that it can enter into dialogue with shareholders to discuss these matters further.”<sup>[6]</sup>

In this area, the proposed Code diverges from prevailing corporate governance laws in the United States, which typically provide that officers and directors owe fiduciary duties to the corporation, its shareholders and, under certain circumstances involving financial distress, its creditors.<sup>[7]</sup> Officers and directors in the United States, however, do not owe any duty to employees of the corporation in carrying out their managerial roles.<sup>[8]</sup> Notwithstanding the prevailing law, certain large institutional shareholders lately have been advocating for companies and their directors to take into account a broader constituency than only stockholders and, at times, creditors.

In January 2018, BlackRock’s CEO and Chairman Laurence Fink delivered his [annual letter](#) to CEOs, titled “A Sense of Purpose,” describing what he called a “new model for corporate governance.” Tying ESG (environmental, social and governance) factors to long-term value creation, Mr. Fink wrote:

“The board is essential to helping a company articulate and pursue its purpose, as well as respond to the questions that are increasingly important to its investors, its consumers, and the communities in which it operates. In the current environment, these stakeholders are demanding that companies exercise leadership on a broader range of issues. And they are right to: a company’s ability to manage environmental, social, and governance matters demonstrates the leadership and good governance that is so essential to sustainable growth, which is why we are increasingly integrating these issues into our investment process.”

While it remains to be seen how, if at all, these views work their way into corporate governance practice or law, BlackRock’s influence as the largest money manager in the world, with over \$6 trillion under management, is hard to understate.

## ***Whistleblowing Provision***

The FRC revisions propose to amend the current Code Provision C.3.5 (the “whistleblowing provision”) which requires that the audit committee consider the measures through which staff are able to raise concerns about improprieties with respect to financial reporting or other matters. Provision 3 of the revised Code broadens the scope of the whistleblowing provision by removing the specific reference to “improprieties in matters of financial reporting or other matters,” thereby enabling a member of the workforce to raise concerns more broadly.<sup>[9]</sup> The FRC also seeks to make the revised whistleblowing provision a board responsibility, and not a responsibility solely of the audit committee (although the board may delegate this function to a sub-committee that would be tasked with reporting to the board).

The expanded whistleblower provision, if enacted, would, however, still not go as far as the whistleblower protection laws and regulations in the United States. In 2002, the United States Congress enacted the Sarbanes-Oxley Act, which requires public companies, in effect, to (1) adopt a written code of ethics applicable to its CEO and senior financial officers designed to deter wrongdoing

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and to promote ethical conduct, internal reporting procedures for violations of the code, and accountability for such violations; and (2) establish auditing procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls and auditing matters.<sup>[10]</sup> Both the New York Stock Exchange and NASDAQ require listed companies to implement compliance standards extending beyond the Sarbanes-Oxley's requirements, including establishing company-wide codes of conduct applicable to all directors, officers and employees,<sup>[11]</sup> making the code of ethics publicly available, and implementing enforcement mechanisms that ensure prompt and consistent enforcement of the code.

Sarbanes-Oxley and the Dodd-Frank Wall Street Reform and Consumer Protection Act also put in place anti-retaliation provisions that provide whistleblowing employees with protections in the event of perceived workplace retaliation tied to whistleblowing activities. And Dodd-Frank implemented a bounty program whereby a whistleblower can receive between 10% and 30% of sanctions above \$1 million recovered by the SEC based on information provided by the employee. Since the program was put in place through September 2017, the program has awarded approximately \$160 million to 46 individuals, and the Office of the Whistleblower receives over 3,000 tips each year. It is also worth noting, however, that on February 21, 2018, the US Supreme Court issued a decision that narrowed the definition of whistleblower for purposes of Dodd-Frank's anti-retaliation provisions. Now, to be protected under those provisions, an employee must first take the information to the SEC, as opposed to first reporting to management. See *Digital Realty Trust, Inc. v. Somers*, No. 16-1276 (Sup. Ct. Feb. 21, 2018).

## ***Board Independence***

The FRC proposes several measures which would strengthen the independence of company boards. The current Code Provision B.1.1 contains criteria which should be accounted for by the board when determining whether non-executive directors and the chair are independent. The revised Code shifts the emphasis so that where non-executive directors, including the chair, do not meet the stated criteria, they should *prima facie* not be considered independent, including where they have a current or a previous relationship with the company.<sup>[12]</sup> This focus on independence is in line with the importance the Code places on the role of independent non-executive directors and the need for boards to be exposed to challenges, new ideas and expertise from individuals without links to the company.

One of the more notable changes to the current Code is contained in Provision 15, which effectively imposes a time limit on board service so that where an individual has served on the board for more than nine years, he or she is no longer considered independent. The FRC report provides that this amendment is consistent with the revised Code's approach to succession planning and the importance of board refreshment. This includes time spent in previous non-executive director roles. The tenure proposal should be of particular concern to company chairs who have cumulatively served nine years in their current role together with non-executive director positions held in previous roles.

Although rules and regulations in the United States do not impose specific time limits on board service, much of the revised Code's criteria for determining whether a director is independent is on par with the requirements for independence under rules promulgated by the New York Stock Exchange and NASDAQ which, themselves, are substantially similar. In order to qualify as an independent director under these guidelines, the director must not be, or have been within the previous three years, an executive officer or employee of the company,<sup>[13]</sup> or an immediate family member of an executive officer or employee.

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The director also may not have any “material relationship” with the company “either directly or as a partner, shareholder or officer of an organization that has a relationship with the company,”<sup>[14]</sup> or have any relationship that would “interfere with the exercise of independent judgment” in carrying out director responsibilities.<sup>[15]</sup> Such relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships.<sup>[16]</sup> For example, a director may be disqualified as “independent” if the director or an immediate family member is currently, or has been within the previous three years, a partner or employee of the company’s external auditor.

While not part of the formal NYSE or NASDAQ independent requirements, courts in Delaware also have considered length of board service in assessing director independence. These decisions do not adopt any bright line rules, but look to length of board service as one factor in determining whether a long-serving director is sufficiently close to an interested director such that his or her independence is compromised. See *Friedman v. Dolan*, C.A. No. 9425-VCN, 2015 WL 4040806, at \*6 (Del. Ch. June 30, 2015); *In re BJ’s Wholesale Club S’holders Litig.*, C.A. No. 6623-VCN, 2013 WL 396202, at \*6 n. 63 (Del. Ch. Jan. 31, 2013).

### ***Division of Responsibilities: Board Composition***

FRC-proposed Provision 9 requires that the chair and chief executive should not be the same person. It also provides that:

“...The responsibilities of the chair, chief executive, senior independent director, board, committees and management should be clear, set out in writing, agreed by the board and made publicly available. The annual report should set out the number of meetings of the board and its committees, and the individual attendance by directors.”<sup>[17]</sup>

Proposed Provision 10<sup>[18]</sup> provides that the chief executive is responsible for proposing and delivering strategy, reflecting the importance placed by the FRC revisions on linking strategy with company culture and values. Provision 10 also requires that the chief executive be responsible for ensuring that the board receives the necessary information required to inform its decision-making and should be read alongside Principle H and the important role of the company secretary.<sup>[19]</sup>

These revisions have left the permissible composition of the board broadly the same as under the current Code. However, because the revised Code provides for the chair to be independent at all times, the requirement has been amended from “...at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent”<sup>[20]</sup> to “[i]ndependent non-executive directors, including the chair, should constitute the majority of the board.”<sup>[21]</sup>

In the United States, the recent trend has been a movement toward separating the roles of CEO and chair of the board. According to the 2017 Spencer Stuart U.S. Board Index, for the first time in 2017, more than half (51%) of S&P 500 boards have a separate chair and CEO.<sup>[22]</sup> In theory, separation of the two roles has the potential to improve stockholder returns because the company will be able to increase efficiency by: (1) more effectively differentiating between the roles of the directors and management, including by allowing the CEO to focus exclusively on strategy, operations, and organizational issues while the chairman may focus on management oversight, board leadership, and governance-related matters; (2) giving one director authority to speak on behalf of the board and to run board meetings; and (3) eliminating conflicts in the areas of performance evaluation, executive compensation, succession planning, and the recruitment of new directors.

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In practice, however, studies have shown that the independence of the chair “is not a material indicator of firm performance or governance quality” and, in fact, separation “can lead to duplication of leadership, impair decision making, and create internal confusion, particularly in times of crisis.”<sup>[23]</sup> One recent study found that “forced separation due to shareholder pressure is associated with a decrease in market valuation and lower future operating performance, suggesting that mandatory separation can actually be harmful.”<sup>[24]</sup>

## ***Exemptions for Non-FTSE 350 Companies***

The FRC has proposed the removal of certain exemptions for smaller non-FTSE 350 companies which are contained in the current Code. The FRC has justified this change on the basis that the purpose of the revised Code is to set good practice even for smaller companies and that “although a company might be outside the FTSE 350 it may be of a similar size and structure. Equally, these companies may also have significant impacts on their workforce and wider stakeholders and as such they should be subject to the same levels of corporate governance.”<sup>[25]</sup> The FRC has noted in its report, however, that independent board evaluation for smaller companies could create disproportionate costs and other difficulties and, therefore, it seeks input about the potential impact of this proposal.

## ***Remuneration***

The revised Code strengthens the role of the board in its exercise of independent judgement and discretion with respect to remuneration.<sup>[26]</sup> For example, new Provision 37 requires certain allowances for boards to have the ability to overrule remuneration outcomes made by management. The FRC report provides the following example for when this situation may arise: “where the measurement of any performance condition does not reflect the actual performance of the company over the period or the performance of the individual director.”<sup>[27]</sup>

Remuneration committees would have expanded remit under proposed Provision 33 with the new responsibility for oversight of company remuneration and broader workforce policies, including a new reporting requirement regarding an explanation of what workforce engagement has taken place and how executive remuneration aligns with the broader company policy on remuneration.<sup>[28]</sup> New Provision 32 also includes a requirement that the remuneration committee chair must have served for at least twelve months on a remuneration committee before taking on the role as chair. The FRC has foreshadowed that guidance will be issued on the role of the remuneration committee and its new responsibilities. It also noted in its report that this enhanced remit will likely result in an increased workload for remuneration committees.

The FRC’s proposed remuneration provisions closely align with the deference that courts in the United States give in reviewing decisions of a corporation’s compensation committee. Generally, US courts have been reluctant to second-guess the decisions of the compensation committee in approving a compensation package as long as the committee acts in good faith, on an informed basis, and not for a self-interested purpose.<sup>[29]</sup>

In *In re Walt Disney Co. Derivative Litigation*, shareholders brought suit against Disney’s directors for breach of their fiduciary duties in connection with the hiring and termination of Michael Ovitz as President of The Walt Disney Company. Shareholders alleged, *inter alia*, that members of Disney’s compensation committee had acted in bad faith by approving Ovitz’s employment and termination agreements—which consisted of approximately \$25 million in yearly salary, \$50 million option appreciation guarantee, and \$130 million severance package—without informing themselves of the full

magnitude of the potential payout. In affirming the Court of Chancery's dismissal of the claim, the Delaware Supreme Court held that although the compensation committee had failed to follow "best practices"—e., the aspirational goals of ideal corporate governance—the compensation committee had not breached their fiduciary duty to shareholders in approving Ovitz's compensation package because the record showed that the committee had adequately informed itself of all material information reasonably available.

Similarly, the Delaware Court of Chancery in *Friedman v. Dolan*<sup>[30]</sup> dismissed a shareholder suit for breach of fiduciary duty and waste, holding that the deferential business judgement rule standard of review, instead of the more exacting entire fairness standard, applied to executive compensation decisions made by an independent committee of a controlled company. In *Friedman*, the compensation committee, which comprised three independent directors, approved a compensation package and stock option grants for the chairman and CEO whose family accounted for ten of the sixteen-member board, held approximately 73% of the company's voting power, and was a party to a block voting agreement that classified the company as a "controlled company" under New York Stock Exchange rules. The court rejected the plaintiff's assertion of bad faith by the committee, concluding that the mere fact that the CEO had consulted with the committee's independent directors regarding the compensation did not establish any manipulation or utter failure to fulfill responsibilities. According to the court, "compensation decisions are not the expertise of trial judges, and the Court should not second-guess an independent compensation committee's business decisions that are not irrational."

### **III. Conclusion and Timing**

The FRC's revisions are designed to promote strong corporate governance as the primary means to achieve sustainable company growth. As was the case in the United States after the financial crisis, the new provisions demonstrate the importance of director independence and protections for self-policing with respect to financial and other improprieties. The revisions mark the beginning of wider corporate governance reforms. The consultation also includes questions regarding future revisions to the UK Stewardship Code (a Code designed to enhance the quality of engagement between investors and companies and to improve long-term risk-adjusted returns to shareholders) which will be published for consultation in late 2018.

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[1] Pg. 3, Section I, Appendix A – Revised UK Corporate Governance Code, 5 December 2017.

[2] *Ibid.*

[3] Paragraph 33, Proposed Revisions to the UK Corporate Governance Code, 5 December 2017.

[4] Pg. 23, Code Provision E.2.2, Section E: Relations with shareholders, The UK Corporate Governance Code, April 2016.

[5] Pg. 3, Provision 6, Section I, Appendix A – Revised UK Corporate Governance Code, 5 December 2017.

[6] Paragraph 38, Proposed Revisions to the UK Corporate Governance Code, 5 December 2017.

[7] See, e.g., *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 543-44 (Del. Ch. 2015) (quoting *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101) (Del. 2007)) ("[T]he creditors of an insolvent corporation have standing to maintain derivative claims

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against directors on behalf of the corporation for breaches of fiduciary duties.”).

[8] See, e.g., *Cutler v. Ensage, Inc.*, 2007 WL 4372919, \*7 (Sup. Ct. N.Y. Cnty. Nov. 30, 2007) (dismissing employee’s claim for breach of fiduciary duty against employer because employers do not owe employees a fiduciary duty).

[9] Pg. 3, Section I, Appendix A – Revised UK Corporate Governance Code, 5 December 2017.

[10] Sarbanes-Oxley Act of 2002, 15 U.S.C. §§ 78f(m)(4), 7264.

[11] See NYSE Listed Company Manual Section 303A.07(b)(iii); Nasdaq Equity Rule 5605(c)(3).

[12] In the alternative, the FRC proposes preserving the board’s right to offer an explanation if it considers that an individual is still independent, notwithstanding that he or she does not meet the stated criteria.

[13] NASDAQ Listing Rule 5605(a)(2).

[14] NYSE Listed Company Manual Section 303A.02.

[15] NASDAQ Listing Rule 5605(a)(2).

[16] NYSE Listed Company Manual Section 303A.02.

[17] Pg. 5, Provision 9, Section 2, Appendix A – Revised UK Corporate Governance Code, 5 December 2017.

[18] Pg. 5, Provision 10, Section 2, Appendix A – Revised UK Corporate Governance Code, 5 December 2017.

[19] See *also* Provision 16 of the Revised UK Corporate Governance Code.

[20] Pg. 11, Code Provision B.1.2, Section B: Effectiveness, The UK Corporate Governance Code, April 2016.

[21] Pg. 5, Provision 11, Section 2, Appendix A – Revised UK Corporate Governance Code, 5 December 2017.

[22] Spencer Stuart Board Index (2017).

[23] David F. Larcker and Brian Tayan, Chairman and CEO: The Controversy over Board Leadership Structure, Stanford Closer Look Series (June 24, 2016), <https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-closer-look-58-independent-chair.pdf>.

[24] *Id.* (citing Aiysha Dey, Ellen Engel, and Xiaohui Liu, “CEO and Board Chair Roles; To Split or Not to Split?” *Journal of Corporate Finance* (2011)).

[25] Paragraph 38, Proposed Revisions to the UK Corporate Governance Code, 5 December 2017.

[26] Pg. 12, Principle Q, Section 5, Appendix A – Revised UK Corporate Governance Code, 5

December 2017.

[27] Paragraph 84, Proposed Revisions to the UK Corporate Governance Code, 5 December 2017.

[28] Pg. 13, Provisions 40 and 41, Section 5, Appendix A – Revised UK Corporate Governance Code, 5 December 2017.

[29] *In re Walt Disney Derivative Litigation*, 907 A.2d 693 (2005).

[30] *Friedman v. Dolan*, C.A. No. 9425-VCN (Del. Ch. June 30, 2015) (Noble, V.C.).

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