RYDER COURT, 14 RYDER STREET, LONDON, SW1Y6QB UK
T.44 (0) 20 7024 9000 WWW.KORNFERRY.COM

Financial Reporting Council (FRC) Consultation

Proposed Revisions to the UK Corporate Governance Code

Response from Korn Ferry Hay Group

Introduction

We set out in this document our response to the FRC consultation on revisions to the UK Corporate Governance Code.

As a general comment, we believe that the Code as revised is a sensible, well-structured document which (particularly when read in conjunction with the revised Guidance on Board Effectiveness) provides a robust framework for companies wishing to follow good corporate governance practice. The updates to the Code to take into account developments in market expectations are timely.

However, one potential issue we wish to highlight relates to the removal from the revised Code of the current exemptions for companies outside the FTSE 350. While we understand the FRC's desire to encourage smaller companies to strive towards the highest standards of corporate governance, we believe that the exemptions on board and committee composition have been useful in recognising the reality that smaller listed companies can be very different beasts to those in the FTSE 350. For example:

1. The existing Code permits the boards of companies outside of the FTSE 350 to include only two independent non-executive directors. Under Provision 11 of the revised Code, independent non-executive directors should constitute the majority of the board. Even if the board chair is considered one of the independent non-executives (a change from current practice), there are many smaller companies which will need to appoint additional non-executives to ensure ongoing compliance with the Code, or instead explain non-compliance.
2. The existing Code accepts that the board chair of a smaller company can serve on the audit committee (if he/she was independent on appointment), and that is a useful option for small boards where the chair has specific financial expertise. With this exemption now removed, and reflecting the need for audit committees to include three members as a minimum (Provision 24), a board in this position will need to appoint another non-executive director in order to ensure ongoing compliance or instead explain non-compliance.

The common concern with explaining rather than complying is that such explanations are sometimes not taken into account sufficiently by investors and proxy agencies, which instead have been accused in some instances of following a 'comply or else' mantra. We recommend that the FRC considers retaining the smaller company exemptions on board and committee composition.

Response to specific consultation questions

Q1	**Do you have any concerns in relation to the proposed Code application date?**
	No.
Q2	**Do you have any comments on the revised Guidance?**
	The revised Guidance is an extremely useful starting point for boards considering how to address the issues raised in the revised Code. The inclusion of questions is a good way to prompt boards and committees to think about implementing the new Principles and Provisions. Our only fear is that the inevitable focus on the Code may mean that the Guidance will be overlooked. We encourage the FRC to do its best to ensure that companies and other interested parties are aware of the Guidance.
Q3	**Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?**
	The proposed methods are useful ways in which boards can gather the views of the workforce. However, in order for the engagement to be meaningful, boards will need to carefully consider which method is likely to work best in the specific circumstances of their company. Time will also need to be taken to ensure that the practicalities of the chosen approach lend themselves to meaningful engagement: for example, a designated non-executive director needs to understand precisely how he/she is expected to gather the views of the workforce and reflect these to the board. This is a particular issue at companies with a large, diversified workforce spread over multiple geographies. As mentioned in the Guidance, boards should also be aware that the proposed methods are not mutually exclusive: an approach which uses more than one of the methods is valid. As also noted in the Guidance, boards should be free to use an alternative method of engaging with the workforce if one would be more effective in their specific circumstances.
Q4	**Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?**
	Referring to the UN SDGs or other NGO principles would be more suitable within the context of the Guidance than the Code. Under the framework of the Code, it is more appropriate that companies should have flexibility to report on how they contribute to wider society how they see fit, rather than be required to focus on the UN SDGs or other external guidelines.
Q5	**Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?**
	20 per cent is indeed considered 'significant' and has the benefit of being aligned with the threshold used by the Investment Association to determine which companies appear on its Public Register of shareholder votes. When interpreting voting results, however, observers should be alive to company-specific issues. For example, a company with a disgruntled single major shareholder which frequently votes against management is in a

	different position to a company with a widely dispersed ownership base which faces opposition from a number of its investors. In terms of following up a significant vote against, we believe that providing a summary of consequent board actions in the next annual report should suffice for reporting purposes and we question the necessity of an update at the six-month stage. This recommendation for an interim update should perhaps apply only for those companies where a resolution was defeated.
Q6	**Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.**
	We support the removal of this exemption for smaller companies. Undergoing an external board evaluation exercise is recognised as good practice, and for this to be done only once every three years should not be viewed as an onerous burden for most companies outside of the FTSE 350.
Q7	**Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?**
	As noted in the consultation document, nine years has become the *de facto* period used by many companies and investors when determining non-executive director independence on the basis of tenure. As such, making this explicit in the Code is an appropriate recognition of reality (on the understanding that a company may always choose to explain rather than comply). The area where we can foresee difficulties under the revised Code relates to the specific position of the board chair. Under the existing Code, a chair's independence is assessed only on appointment and he/she subsequently has special status on the board in view of the chair's unique role as neither conventionally executive nor non-executive. As a result, in practice there has been less focus on the tenure of board chairs than for other non-executives, and there are a significant number of chairs at UK companies who have served for more than nine years. Under the revised Code, the chair has a more explicit non-executive status and the independence of the chair will be assessed on an ongoing basis in the same manner as the other non-executives. This means that, in effect, the 'nine year-rule' will apply to board chairs. This could cause some problems for existing chairs. If a board chair who has served for longer than nine years believes that compliance with the Code is important, then he/she may feel obliged to step down as the revised Code is implemented, causing some disruption to the board and its succession planning. Companies will hope that this process will not be further complicated by over-zealous application of the nine-year rule in respect of board chairs by investors and proxy agencies. For other companies, a nine-year cut-off applying to board chairs could mean a reluctance to appoint from the ranks of the existing non-executives, despite prior experience as a non-executive on the board being a valuable quality in a new chair. Under the revised Code, situations may develop whereby a non-executive who has served for, say, four years on the board may not be considered for the chair role. Although this individual could be an excellent candidate, the board may take the view that he/she is effectively time-limited to only five years as chair and therefore not proceed with the appointment.

	To help address this issue, we recommend consideration of an additional statement in the Code of a "carve-out" which permits board chairs to serve for up to 12 years without their independence being compromised. This would recognise existing realities while also setting a limit on expected tenure for board chairs.
Q8	**Do you agree that it is not necessary to provide for a maximum period of tenure?**
	We agree. Boards which wish to retain the services of a non-executive director beyond nine years should be able to explain why this is appropriate in their specific circumstances.
Q9	**Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?**
	The diversity of UK boards has increased in recent years and we expect this to continue, not least due to the latest targets set by the Hampton-Alexander Review and increasing pressure from investors on this issue. The changes proposed in the revised Code will also have an impact, in part as a result of the enhanced expectations on nomination committee reporting. Companies which believe in the benefits of diversity at board level and across the senior executive population will be able to demonstrate this, while the spotlight will be shone on those companies which have made less progress.
Q10	**Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.**
	The information required is not difficult to assemble and therefore we support extending this recommendation beyond the FTSE 350. Companies which wish to explain rather than comply have the ability to do so.
Q11	**What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.**
	Encouraging companies to report on levels of ethnicity in executive pipelines will help ensure that nomination committees focus on this important issue when considering board diversity. Principle J of the revised Code is clear that diversity needs to be viewed in a wide sense, including consideration of ethnic backgrounds. If the Code were to go further and require companies to provide data on levels of ethnicity in executive pipelines (in a standardised format for ease of comparison), this would shed considerable light on current practice and would help identify leaders and laggards in this area.
Q12	**Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?**
	Yes (subject to reviews on a regular basis to ensure this remains relevant). The Code works well as a standalone document and serves as a template of good practice in the UK

	and more broadly. This may be weakened by removing these requirements.
Q13	**Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.**
	The removal of C.3.3 makes sense given that there is no reference in the revised Code to the terms of reference of *any* of the board committees being made publicly available. It is important that boards are reminded that the Guidance requires the terms of reference of *all* committees to be made available on the company's website.
Q14	**Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?**
	In principle we agree with the remuneration committee's remit being extended in the manner suggested in the revised Code. However, thought needs to be given as to how committees should operate under this extended remit, for example in respect of being more explicitly responsible for ensuring that executive remuneration is aligned with wider company policy. In this regard, the suggestion in the Guidance on Board Effectiveness to focus on headline pay principles is sound: in large, diversified companies with a global footprint it may be difficult for remuneration committees to take a more granular approach. A focus on principles also reduces the risk of the remuneration committee taking responsibility for matters which more properly fall under management's remit. Attention also needs to be given to the best way the committee should engage with the wider workforce. Intuitively, this is a role that the remuneration committee chair should perform. There is potential overlap with the wider engagement the board may undertake with employees (Provision 3), and in some cases it may therefore make sense for the remuneration committee chair to be the 'designated non-executive director' for those companies which take up this option. However, care needs to be taken not to overburden the committee chair given the already considerable responsibilities of this position, and for some companies another board member (for example the senior independent director) may be the better conduit to the employee base. In order to be successful, engagement with the wider workforce on pay will need to be a two-way process: the committee will need to explain its approach carefully while also taking on board feedback from employees. This also needs to be reported on in a manner which is informative and less likely to be open to criticism of 'boilerplate'. The revised Code also extends the remuneration committee's remit to setting (as opposed to recommending and monitoring) the remuneration for senior management, i.e. the senior executives at the layer below board level. We have no fundamental concerns with this development, but it is essential that the committee works closely with the chief executive to ensure that his/her perspective is taken fully into account. In some cases, the CEO may be reluctant to relinquish the responsibility for setting pay for his/her direct reports.
Q15	**Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?**
	In general, the revised Code provides a sufficient framework for remuneration

	committees to put in place policies and practices which help drive long-term sustainable performance. Of particular importance is the emphasis on executive directors developing long-term shareholdings (Provision 36). One way this could be enhanced is to state within the Code that meaningful shareholding requirements should be put in place; this would reflect a common practice that ensures a significant proportion of an executive's wealth is retained in company shares. The inclusion within the revised Code of a reference to a minimum five-year vesting and holding period for share schemes was expected. Many companies already operate their incentive schemes in this fashion. For those that don't, and which wish to explain rather than comply with this provision, it is to be hoped that investors and proxy agencies will give the explanations due consideration. That said, we caution against the Code being overly prescriptive regarding the detailed structure of executive remuneration. Companies should have sufficient flexibility to design and operate remuneration policies that reflect their particular circumstances and challenges. Prescriptive recommendations in the Code could limit innovation, notwithstanding the principle of 'comply or explain.' The key way in which remuneration is linked to long-term sustainable performance is through the choice of performance conditions for long-term incentive schemes. The revised Code states that incentives should be aligned with company purpose, strategy and values but does not prescribe specific performance metrics, which we believe is the correct approach. However, the Code could emphasise that the use of non-financial strategic measures is valid for a long-term scheme, provided they are transparent and capable of robust measurement. Such measures can provide a clear link with company strategy and, potentially, with company culture.
Q16	**Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?**
	In our experience, boards and remuneration committees are aware of the need to exercise discretion where appropriate, taking into account incentive scheme outcomes and the correlation with wider company performance. Such discretion is explicit within the way in which some companies operate incentive schemes and is important in ensuring that a link between performance and pay is maintained. Writing this into the revised Code in Principle Q and Provision 37 will help ensure that this good practice is followed by other companies, although in some cases it will also require revision to scheme rules and remuneration policies. Boards and remuneration committees will need to ensure that participants in incentive schemes are fully aware of this overriding discretion, and should not accept a participant arguing that the resulting increased uncertainty over the ultimate vesting justifies a higher award size. Discretion could, after all, be exercised in either direction. Companies would also appreciate having a sensible dialogue with investors on the exercise of discretion in specific circumstances. At present, the perception is that investors will only support discretion being operated one way – downwards – whereas in practice there are circumstances where a fair outcome would require the use of upwards discretion. A greater willingness from investors and proxy agencies to consider this in the context of specific company situations and explanations would be welcome. On a separate but related issue, we do foresee some challenges to remuneration committees in determining – as set out in Provision 40 – how 'total awards available should not be excessive.' Answering the question of 'how much is "too much"?' has been fraught with difficulty, and we have some concerns that committees may seek to find the

	answer in benchmarking outcomes against what has happened at other companies without the benefit of a detailed assessment of the companies' performance. Investors have been vocal in their criticism of benchmarking when it has been used to set pay levels, and would be unlikely to accept its use in the determination of an appropriate range of outcomes. Further guidance from the FRC on how it expects boards and remuneration committees to define excessiveness would be helpful.
	UK Stewardship Code
Q17-Q31	We have no specific comments to make in response to these questions.

Korn Ferry Hay Group
28 February 2018