GC 100

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By e-mail to: codereview@frc.org.uk

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Dear Ms Woods

Proposed revisions to the UK Corporate Governance Code (the 'Code')

I am writing on behalf of the GC100 in response to the above consultation paper. As you may be aware, GC100 is the association for the General Counsel and Company Secretaries of companies in the FTSE 100. There are currently 133 members of the group, with representatives from more than 80 companies in the FTSE 100.

The GC100 welcomes the opportunity to respond to this consultation and we set out below our comments on the specific questions in the Consultation.

Questions 1 and 2: Do you agree with the proposed changes in Section D of the Code? Do you agree with the proposed changes relating to claw back arrangements?

A significant concern for GC100 members is the description of both provisions ("withhold or retrieve") as "claw back" arrangements. This is inaccurate, may cause some confusion and goes further than the statutory requirements. The Code and the Financial Reporting Council's ("FRC's") associated documents should make clear the distinction between provisions enabling the withholding of unvested or unpaid deferred variable remuneration (normally called "malus" provisions) and the recovery of variable remuneration after it is paid or vested ("claw back").

We respond to these two questions together, since the "claw back" proposals are also in Section D of the proposed revised Code.

We have no comment on the proposed revisions to the "Main Principle" and "Supporting Principle" parts of Section D.1 of the Code. We are supportive of the principles expressed here. We are also content with the "conflict of interest" wording proposed for Section D.2.

The most significant proposal in the remuneration section is the one initially set out in the FRC's October 2013 consultation to introduce into the Code a "comply or explain" requirement in relation to what the Consultation calls "claw back" arrangements. The proposed revisions to paragraph D.1.1 require variable remuneration schemes for executive Directors to include "withhold or recover" provisions (i.e. both "malus" and "claw back" provisions).

The GC100 are generally supportive of the proposals in so far as "withholding the payment of any sum" is concerned (i.e. malus) but there is very real concern amongst companies about the recovery of sums

already paid (i.e. claw back) which are set out in more detail below.

The key difference between the requirements in the Large and Medium-sized Companies and Group (Accounts and Reports) (Amendment) Regulations 2013 ("the Regulations") on claw back (i.e. "recovery" of remuneration) and those in the FRC's proposals is that the Regulations (at Regulation 26(e)) require disclosure of "an explanation of whether there are any [such] provisions" while the proposed Code provision is that "Schemes should include provisions" (although for a more limited population, only executive Directors rather than all employees). We are not persuaded it is necessary for the Code to go further than the Government in respect of claw back – exceeding the statutory requirement to explain whether or not claw back provisions feature in companies' remuneration arrangements by requiring them to have such arrangements in place for executive Directors.

The following summary of issues arising from the introduction of claw back requirements into the Code demonstrates, in our view, that the FRC should consider this matter more fully before effectively requiring companies to introduce claw back provisions into executive Director remuneration arrangements.

- Withholding as yet unpaid or unvested remuneration ("malus") is more practical to operate in respect of deferred compensation than claw back, as it does not involve recovering something that an individual has already received and therefore does not require employee cooperation at the time of the malus reduction. Malus gives rise to far fewer and less complex legal issues than those associated with claw back.

- In some jurisdictions the legal ability to apply claw back provisions, as currently proposed, is unlikely to be enforceable, e.g. in Spain, Germany and France. Companies with executive Directors based overseas or international directors serving on UK boards may consequently have difficulty in complying with this provision. We would also note that in practice companies would likely apply these provisions more widely than just Executive Directors.

- A requirement in the Code to operate claw back provisions will create competitive disadvantage for UK companies competing outside the UK where such requirements do not exist Claw back could have the effect of creating upward pressure on fixed pay and potentially reducing the proportion of variable pay to which the more practical malus / withholding form of adjustment can be applied. This is because claw back provisions will reduce the value employees perceive in deferred remuneration. An increase in fixed pay and a reduction in variable pay to which risk and other adjustments can be made could be an unintended consequence of the FRC's proposals and would not promote sound risk management.

- Numerous tax issues arise from claw back proposals in the UK and other jurisdictions, including questions as to whether claw back would be applicable to net or gross amounts and the interaction with HMRC (and other tax authorities') rules on individual reclaims and corporate deductibility. Taking these complexities into account it is our view that the application of claw back to the gross value of variable remuneration will be impractical and, therefore, any Code requirements in relation to claw back should clarify that the operation of those provisions should relate only to net of tax values.

GC100 recognises the potential role claw back could play as part of the broader structure of variable remuneration, but only as a last resort risk adjustment where reductions in in-year remuneration decisions and the application of malus/withholding provisions cannot adequately reflect the circumstances requiring remuneration to be reduced. However, given the issues raised above, GC100 recommend that this proposal solely focus on malus given the many challenges in implementing claw back and that, in respect of banks, the Prudential Regulation Authority are currently consulting on the detailed implications of implementing claw back.

We reiterate the view we expressed in our 6 December 2013 submission:

> "Under the new remuneration regulations, companies are required to disclose what, if any, provisions exist in the company's incentive plan rules in relation to recovering and/or withholding variable pay, and whether those provisions were used during the year. These are new disclosure requirements. While we believe the new requirements, complemented by the recent GC100 and Investor Group guidance on their implementation, are appropriate, we also believe they are, at this stage, sufficient. Their application by companies should be monitored over several reporting periods before developing any proposals about whether there is a case for requiring companies to report on a comply or explain presumption. It is premature at this stage to introduce a presumption into the UK Corporate Governance Code."

Question 3: Do you agree with the proposed change relating to AGM results? Is the intention of the proposed wording sufficiently clear?

GC100 understands the FRC's intention in making its proposal and agrees that on-going and effective engagement between companies and their investors is crucial given their shared responsibility for the stewardship of companies. Accordingly, many GC100 companies have formal programmes of engagement and allocate significant resources to ensure the success of those engagements, chief of which are the dialogues with investors prior to the annual general meeting (AGM).

However, from a practical perspective, listed companies are required to publish their AGM voting outcomes as soon as practically possible after the meeting. The FRC itself, in the introduction to this consultation, accepts that it is not realistically possible for any engagement to occur so soon after the AGM and yet the words "the company should explain when announcing the results of voting what action it intends to take to understand the reasons behind the vote result" remain in the proposed new provision in section E.2 of the Code. We are concerned that hasty announcements made by companies to meet an imposed reporting deadline, even if "only" to understand the reasons behind the vote will not meet the FRC's objectives. It is therefore difficult to see what meaningful disclosure could be made at the point of publication of AGM voting results and any requirement to publish an explanation on the day of the AGM will almost certainly lead to generic boiler plate disclosures.

We would ask the FRC to reconsider the need for this new provision and suggest instead that the FRC consider introducing a new provision which mirrors and extends the provisions in the Directors' remuneration regulations whereby a significant adverse vote against any AGM proposal triggers a requirement to include in the annual report a summary of the reasons for the adverse vote and a description of the Company's actions taken to address them. Such a measure, covering all resolutions put to shareholders, would be more likely to produce a meaningful and positive result.

If the proposed wording in E.2.2 is to be implemented we suggest the wording be changed to "significant proportion of the votes cast" rather than proportion of shareholders.

It would be helpful to have clarity on whether the intention is for this to be applied to all General Meetings and not just AGMs.

Question 4: Do you agree with the proposed amendments to the Schedule?

Subject to one detailed comment we are supportive of and content with the proposed revisions to Schedule A to the Code, as long as they remain guidance rather than prescriptive requirements.

The intention behind the addition of the words "of an option" in the revisions to the fourth paragraph of

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Schedule A is unclear. It appears to limit the consideration of shareholding requirements to shares acquired following the vesting and exercise of options only, and not other forms of share-based variable remuneration. We suspect this is not the intention. We would suggest the wording should be "…and to hold shares for a further period after vesting or exercise of share-based variable remuneration plans…"

Additionally, as we have previously indicated, we believe that specifying that Directors should hold shares after retirement or leaving the company is very specific and prescriptive. Prescribing this for all Directors in all industries cannot be the right answer. If (as we believe) the objective is continued alignment with shareholders post departure, we note that this can be achieved in other ways. For example:

- under a common feature of long term incentive plans, a good leaver's unvested awards are reduced pro rata on departure, but remain on foot and subject to the original performance hurdles and original vesting period (and subject to malus provisions during that period); and

- under a common feature of short term incentive plans, a good leaver's unvested Deferred Shares remain on foot and subject to the original vesting period (and subject to malus provisions during that period).

Also, a requirement to continue holding shares is not something that companies can have any control over once a Director has left a Company in respect of shares that have already vested and their contractual obligations to their companies have expired.

Question 5: Do you agree with the proposed changes to the Code relating to principal risks and monitoring the risk management system?

The GC100 support the proposed enhanced approach to the monitoring and management of risks as set out in the proposed provisions C.2.1 and C.2.3 and believe that most enlightened companies are already broadly operating on this basis.

The wording in C.2.1 could be seen to imply that the Directors themselves must undertake the robust assessment of the principal risks facing the company whereas in practice they will be reviewing the outputs of management's assessment and satisfying themselves that it is robust. The FRC may wish to clarify the wording in this respect. Guidance on what would amount to "robust assessment" would also be helpful to companies.

Question 6: Do you agree that companies should make two separate statements? If so, does the proposed wording make the distinction between the two statements sufficiently clear?

The GC100 notes the consultation that has already been undertaken in respect of Lord Sharman's proposals on going concern and has no objection to companies being asked to make two separate statements. However, the accounting going concern statement is mandated by the Listing Rules whilst International Financial Reporting Standards (IFRS) require disclosure if the accounts are not prepared on a going concern basis and we question therefore whether it needs in addition to be enshrined in the Code.

The GC100 agrees that by removing the current provision C.1.3, the proposed wording in the new provision C.2.2. relating to the future viability of the company is clearly distinguished from the going concern basis of preparation of financial statements and meets the objectives of the Sharman Panel's recommendations on going concern and particularly the desire for a broader assessment of risks and on-going viability. The GC100 feels that it is vital that the period of assessment of the forward looking statement of viability should be a matter for each company to decide according to the industry in which it operates and its own individual

circumstances.

Question 7: Do you agree with the way proposed Provision C.2.2 addresses the issues of the basis of the assessment, the time period it covers and the degree of certainty attached?

The new proposals relating to Provision C.2.2 are an improvement over the original proposals as there is a clearer distinction from the accounting assessment and the responsibility placed on directors is more realistic. However, we have residual concerns that the legal risks from these statements for Directors, will lead to the utilisation of heavily caveated statements from which investors will derive limited value. The further a company looks ahead, the increasingly uncertain the future becomes as economic, regulatory and political uncertainty means it is not feasible for Directors to anticipate events and impacts on companies' future in the long-term. Directors may therefore be increasingly reluctant to make categorical statements past the foreseeable future.

The FRC may, therefore, want to consider whether the proposed provision will create the insights it seeks.

Question 8: Do you have any comments on the draft guidance in Appendix B on the going concern basis of accounting and / or the viability statement?

For the reasons set out above we do not believe that the going concern statement needs to be a requirement of the code, and therefore the guidance in regard to this statement could also be removed. There is also a real danger that by issuing guidance on how to apply IFRS, the FRC creates a different approach to going concern assessments in the UK compared to other countries where IFRS are used. This would be extremely damaging for international comparability and could even harm the international competiveness of UK companies.

Question 9: Should the FRC provide further guidance on the location of the viability statement?

No, we suggest this should be a matter of choice and that market practice develop over time.

Question 10: Should the recommendation that companies report on actions being taken to address significant failings or weaknesses be retained? If so, would further guidance be helpful?

Yes, GC100 believes this is an important element of corporate governance and disclosures relating to significant failings or weaknesses would be valued by investors and likely to influence their perspective.

We would, however, suggest that the scope of the statement should be a focus on failings or weaknesses which have not been addressed, or are not capable of being remedied, in the interests of avoiding disclosures which are long on detail and short on insight. We see no value in disclosing failings and weaknesses which have been addressed or are well-managed therefore avoiding negative financial or reputational impacts. Indeed, an excessive volume of disclosure is likely to be counter-productive in that it might lead investors to conclude that companies have a weaker control environment than is the case.

We also suggest, in the interests of avoiding duplicative disclosures, that "significant failings or weaknesses" should have the same definition as significant control issues under the existing obligation of Audit Committees to review and assess significant control issues. We believe this measure would ensure consistency of interpretation and clarify how companies should think about and report on significant failings or weaknesses in the risk management framework.

Question 11: Should the option of giving companies the possibility of putting the full corporate governance statement on their website be considered further?

Yes. GC100 welcomes any measure which encourages investors to seek information online. In our view additional flexibility regarding the media used for reporting is beneficial. The advantages of giving companies this option include:

- the savings available from reduced printing and fulfilment costs;
- the removal of static information which would result in the annual report being more engaging;
- capitalising on corporate governance information which companies already provide on their websites; and
- the option represents a natural progression from the electronic communications regime under the Companies Act 2006 and investors deemed to have consented to the regime already obtain information on companies' corporate governance practices from their websites.

We also support the optionality of the proposed measure as we recognise that the shareholder profile changes from company to company and those with a majority of private investors, as opposed to institutional investors accustomed to obtaining corporate information online, may prefer to maintain the status quo and offer their shareholders printed annual reports.

A further important consideration is whether the FRC intends that the corporate governance statement should be correct at the point on which it is published as opposed to real-time reporting. Our view is that the former is appropriate as real-time reporting would require companies to increase resources to enable companies to keep their disclosures up-to-date and may also introduce legal and audit consistency issues given that all other areas are approved at a point in time.

We would also encourage the FRC to consider whether there are other financial reporting disclosure areas in the Annual Report which are heavily comprised of static data which could and should instead be disclosed on-line.

ii) If so, are there any elements of the corporate governance statement that should always be included in the annual report?

Ideally, the entire corporate governance statement would be removed to the website. However, it is likely that pressure may be brought to bear to include the Directors' Remuneration Report and certain Board Committee reports. That being the case, we suggest that the disclosures by the Board and its committees in printed reports focus on highlights such as the significant judgements and decisions made, with the full reports available online.

Question 12: Are there any disclosure requirements in the Code that could be dropped entirely?

We believe that the FRC should consider emphasising and explaining the nature of 'comply or explain' as contemplated under DTR 7.2.2R and DTR 7.2.3R to clarify that the requirement does not expect companies to provide disclosures on every provision of the Code, whereas practice has become one of complying and explaining.

In terms of specific disclosures which might be dropped entirely from the Code, these include items which are already covered by separate legislation or for which the purpose is unclear:

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- going concern statement by Directors;
- changes to other significant commitments of the Chairman during the year (as these would be announced);
- Directors' insurance and/or indemnities (already covered by the Companies Act 2006);

Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

If you would like to discuss any of these points further, we would be happy to do so.

Yours faithfully

Mary Mullally
Secretary, GC100

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