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FRC consults on changes to the remuneration section of the Corporate Governance Code

The Financial Reporting Council (FRC) has published a consultation document putting forward various changes to the Corporate Governance Code (the Code). This article looks at the proposed changes affecting executive remuneration.

Although the changes are not extensive, if implemented they will lead to a slight shift in emphasis in many companies' remuneration reports as well as increased disclosures on clawback policy and (if applied) actual operation of clawback.

Background

Premium-listed companies on the Main List of the London Stock Exchange are required in their annual report to explain how they have applied the Code in the financial year in question. In particular, they must explain how the Code's relevant general principles have been applied and then either confirm compliance with (or, if a company has not complied with a provision, set out the reasons for the company's non-compliance with) the more detailed provisions, the so-called "comply or explain approach".

The Code therefore has a significant impact on how companies approach their annual report as each Code provision must be individually addressed in turn, although many of the requirements require broader operational processes to be in place throughout the year. Many AIM companies instead apply the corporate governance code published by the Quoted Companies Alliance (QCA) which has fewer detailed requirements, but a review of the QCA code will presumably follow once the FRC has decided how the Code should be changed.

The majority of the proposals update the audit, risk and internal control section in light of the Government's White Paper in this area, including the establishment of new audit regulatory body, the Audit, Reporting and Governance Authority.

Remuneration changes

However, the FRC is also consulting on a number of changes in the Code's remuneration section – although none are as dramatic as in the last review when significant changes were made introducing the need for consultation with the workforce and the proposal for a remuneration committee chair to have at least 12 months experience on a remuneration committee. The main changes are.

- **Principles** – the relevant remuneration principles have been re-ordered, but the substantive change is to require director remuneration outcomes to take ESG objectives and workforce remuneration into account. In practice, this is already happening, with most companies already including ESG considerations in executive director pay and spending time justifying director pay in the context of the inflationary cost environment for employees.

- **Wider workforce considerations** – there is a proposed provision that a company should include in its annual report an explanation of the company's approach to investing in and rewarding its workforce.

- **Factors shaping the remuneration policy** – the FCA admits that the provision included in the 2018 version of the Code on "clarity, simplicity, risk, predictability, proportionality and alignment to culture" has not been a success and has led to boilerplate reporting, often parroting the relevant text. This has therefore been removed from the proposed version of the Code with a view to companies addressing these issues under more general requirements and producing bespoke individual responses on these issues.

- **Malus and clawback** – previous proposals in this area following corporate collapses over the last few

years have included requiring named specific events to lead to recovery of remuneration, but the FRC's proposals now appear quite modest in comparison. Shareholders' demands in this area have often been lower than Government and media proposals and so it is perhaps not surprising that this area, which gets much press profile, is more moderately addressed by the FRC, but the FRC's proposals will still require more disclosure than many companies currently supply.

This is because the company will need to include in its annual report a fuller description of its director malus and clawback terms (which should include consideration of all relevant documentation), including:

- the minimum circumstances in which malus and clawback could be used (note there is still no obligation to apply these provisions and companies may still retain the discretion to use them, unlike under parallel US developments).
- a description of the minimum period in which they can be operated and why that is appropriate for the company.
- whether the provisions have been used in the past year (and if so, the reason for using them) and also in the past five years.

Guidance will be produced by the FRC in its Guidance on Board Effectiveness once the relevant provision is settled.

Although this area is much debated and significant amounts of time are spent drafting for these eventualities, there is still little experience of applying it in the listed company arena. Nonetheless, companies have been significantly strengthening their malus and clawback provisions over the last few years anticipating these changes as well as in response to shareholder support for them and the good corporate governance it is believed that they represent. Most companies will already have these terms in place – it is now just a question of reporting them more fully. Of all the Code proposals, this is likely to be the one area of the Code where companies will need to undertake a review of all director remuneration so as to prepare appropriate disclosure in due course.

What next?

The FRC periodically reviews the Code but there has been a greater gap than normal since the last review. Changes to the Code are not made quickly. The deadline for comments on the revised version of the Code is 13 September 2023 with a revised version of the Code taking effect for financial years starting on or after 1 January 2025, some 7 years after the current version was published. Other than on points of detail, it is difficult to see these provisions not being introduced.

That said, companies are more likely to be taking a greater interest in the broader reviews the FCA is conducting to make it easier to operate as a listed company in London, although one of the consequences may be that companies with a current standard listing may have to start disclosing compliance with the Code if a single listing category emerges. The FCA is proposing very significant relaxations in these other reviews, supported by the Government (though so far not a removal of the need for shareholder approval of director long-term incentive arrangements or any change to company law requiring a shareholder binding vote on remuneration policy). In its other role as financial services industry regulator, the FCA is also supporting removal of the bonus cap and the reduction in the number of banks required to operate malus and clawback for "material risk takers".
Click here to read more.

In contrast, the Code sees no dilution in shareholder protection in the proposed new version. It will still say, for example, that no non-executive director should receive share options which is seen as a significant deterrent for some companies considering listing in London.
Click here for a link to the FRC's consultation.

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