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City of London Law Society Company Law Committee response to the FRC Consultation on Proposed Revisions to the Corporate Governance Code (April 2014)

The City of London Law Society ("CLLS") represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response in respect of the Consultation Paper on **Proposed Revisions to the UK Corporate Governance Code** has been prepared by the CLLS Company Law Committee.

Question 1: Do you agree with the proposed changes in Section D of the Code?

Principle D1

We are surprised at the proposed change to Principle D1 and we question what effect it will have. All decisions of directors should have regard to the long term success of the company and requiring that in relation to remuneration will provide little guidance to remuneration committees on how to determine what remuneration is appropriate and how it should be structured. At the same time, the deletion of "recruit, retain and motivate" as the objective of executive remuneration is puzzling. That is, we think understood to be the objective of all remuneration policies and it is right that it should be. If it is thought important to make it clear that the desired motivation is to pursue long term success, that could be achieved with minimal redrafting, as follows:

"Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be stretching and rigorously applied. Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose."

In the press release at the time the consultation was launched the chief executive of the FRC was quoted as saying: "*The remuneration of executives on the Board must also incentivise them to put the company's well-being before their own*". We do not think the change to the Principle

achieves this and we disagree that this should be regarded as the objective of a remuneration policy. Remuneration structures should seek to align incentives, not to put the company first. Executive directors should be entitled to act self interestedly in negotiating a suitable remuneration package with the Company, whilst recognising that the remuneration committee will have responsibility for setting remuneration for executive directors and that committee and the Board as a whole will have to justify to shareholders that the remuneration package is appropriate and consistent with the remuneration policy. Directors are already subject to statutory duties not to put themselves in a position where their own interests conflict with those of the Company.

D2 Supporting Principle

The consultation paper does not explain why the opening words of the D2 Supporting Principle ("The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors") are to be deleted. While we do not object to the proposed warning that care needs to be taken regarding conflicts, the omission of these words may be taken actively to discourage such consultation. We think that consultation with the chairman and chief executive is appropriate and would therefore favour reinstatement of the previous wording.

Question 2: Do you agree with the proposed changes relating to clawback arrangements?

We agree that the statement in Schedule 1 which suggests that clawback should only be considered in exceptional circumstances of misstatement or misconduct is no longer appropriate and should be deleted but think that the proposed change will put strong pressure on companies to adopt clawback arrangements. We question whether it is appropriate for a Code which is about governance to be prescriptive in the manner suggested; we would prefer a requirement to disclose whether the company includes such provisions in its performance-related remuneration schemes and, if so, in what circumstances the provisions can apply.

If the existing wording in D.1.1 is retained, we think that the second sentence in D.1.1 should be redrafted to say " Schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum and specify the circumstances in which the company would be entitled to do so." We do not think it would be right for the Code to refer to "the committee" (rather than the company) taking action or to refer to what is "appropriate" (rather than the circumstances in which the company is entitled to take action). If it is intended that the company should give examples of circumstances in which the company considers it would be likely to exercise any discretion to withhold amounts, this should be set out more clearly, although we do not think that likely to lead to helpful disclosures.

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

We do not agree with the change. We think that it will lead to boilerplate disclosures indicating that the board will consult shareholders to understand the reasons for the vote against. We note that there was no consensus among those that responded to the FRC consultation that a change was necessary (even among investors) and do not understand why shareholders feel the need for a "hook" of this kind.

We think that the objective could better be met by adding the following to Section E.2 of the Code:

"When, in the opinion of the board, a significant proportion of shareholders have voted against a resolution at any general meeting, the company should take steps to understand shareholders' reasons for voting against."

In any event, as a matter of drafting we suggest that the disclosure that is sought is not the reason for the result of the vote. In almost all cases this will be an approval of the resolution and it would be rare for there to be any doubt regarding the reason for shareholders supporting the board, and we suggest the reference in our wording to the company understanding "shareholders' reasons for voting against" makes this clear.

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

We have no comment.

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

We urge the FRC to engage with the SEC to agree a practical approach that will facilitate companies' efforts to comply with both the Code and the US requirements. In our view the two sets of requirements can be reconciled because they have different objectives: the Code is concerned with governance and the purpose of the disclosures is to provide shareholders with the information to allow them to exercise stewardship, while the purpose of the US rules is to warn potential investors of the risks of an investment in the company. It would be helpful to companies if the regulators could acknowledge that difference of purpose and that the two sets of disclosures can therefore co-exist.

There is ambiguity in the term "robust assessment" as in the context of risk assessment "robust" can mean either "rigorous" or "not over-prudent". We also think it would be more appropriate to require the directors to take reasonable steps in the assessment of risk and therefore suggest that the reference in C.2.1 to the directors having "carried out a robust assessment" should be replaced by a statement that "the directors have taken reasonable steps to assess the principal risks facing the company".

We also suggest that the statement in the second sentence of C.2.2 that "The directors should state whether they have a reasonable expectation" should be replaced by "The directors should state whether they expect that the company will be able to continue…". What is a "reasonable expectation" may be judged differently in the future with the benefit of hindsight and a statement of the directors' expectation at the time of reporting should be sufficient given that the disclosure required by C.2.1 (amended as we have suggested) would provide the necessary assurance that the directors have acted reasonably.

As a matter of drafting we suggest that C2.2 should be amended as follows:

"Taking account of the company's current position and the principal risks that it faces , the directors should explain in the annual report…..

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?

We agree that there should be two separate statements and we think the wording makes the distinction between the two statements clear.

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?

Subject as mentioned in the answer to Question 5, we agree with the drafting of Provision C.2.2.

One aspect of this new requirement that has not been addressed is its interaction with the working capital statement required to be included in a prospectus complying with the Prospectus Regulation or in a Class 1 circular required under the Listing Rules. The FCA does not currently permit companies to qualify the working capital statement in any way. That precludes disclosure of assumptions and explanations of the impact of risk of the kind the new Provision calls for and we foresee problems for a company which is required to incorporate disclosures from its annual report in a prospectus or circular (it will almost always be the case that a detailed discussion of the ability of the company to continue in operation will be material information required to be included in a prospectus). We would encourage the FRC to discuss this issue with the FCA to ensure the two requirements can be reconciled and the FCA's position does not operate as a constraint on the disclosures made by companies to comply with C.2.2 and to request the FCA to set out its position on how the requirements interact.

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?

Going concern basis

The third paragraph of Appendix B in relation to "Going concern basis of accounting" states that directors should consider "all available information about the future". This is not an accurate reflection of paragraph 26 of IAS 1, which qualifies and provides guidance as to the degree of consideration required. We do not think the provisions should extend what is required to comply with accounting standards, and this should be made clear.

Our comments in relation to C2.2 are also relevant (see the answer to Question 5).

We question whether it is appropriate to adopt in the guidance as the test for materiality: "Uncertainties relating to such events or conditions should be considered material, and therefore disclosed, if their disclosure could reasonably be expected to affect the economic decisions of shareholders and other users of the financial statements." We have significant reservations regarding this guidance. Whilst we recognise that this formulation appears in the Final Report of the Sharman Panel (Paragraph 100), it is there in the context of a reference to auditing standards and is followed by a discussion of the threshold for disclosure that is helpful in understanding what should be regarded as "material uncertainty". We note that the test is not dissimilar to the test for when information is material for inclusion in the strategic report under FRC guidance, which provides: "Information is material if its omission from or misrepresentation in the strategic report might reasonably be expected to influence the economic decisions shareholders make on the basis of the annual report as a whole" (although it expands the scope to include non-shareholder "users"). However, we think the disclosure standard for strategic reports should be different to the test for disclosing material uncertainties. This is recognised in the comment in the draft guidance that an uncertainty that is remote is not to be considered material. We think that the word "usually"

should be omitted from this sentence in the draft guidance, because “usually” suggests that there are in fact circumstances in which remote possibilities have to be disclosed and we do not think this is appropriate. The viability statement will provide detailed information regarding the ability of the company to continue in operation and it should be made clear that a higher standard of materiality should apply to the disclosure of going concern uncertainties.

In the draft Guidance, the third paragraph under “Determining whether to adopt the going concern basis of accounting” , the words: ”and in identifying” should be: “and identify”..

Viability statement

Our comments under Question 5 above are also relevant here.

The words “The statement should be based on a robust assessment of those risks….” should be replaced by “The directors should take reasonable steps to assess the risks….”.

We think the guidance on the viability statement should allow more flexibility for the company to decide on the period of the statement. There is a balance to be struck between the benefits to shareholders of more detailed disclosures and the potential damage to the company from disclosures of uncertainties regarding future viability in the longer term. It is not helpful to create unreasonable expectations regarding the period that should be covered and it should be acceptable for companies to choose a shorter period where it considers that is appropriate, so long as it explains why that period has been chosen.

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

We do not think it necessary or desirable for the FRC to provide guidance on the location of the viability statement. Companies should have flexibility to decide on where the statement best sits in its annual report.

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?

We do not agree with this recommendation. We do not think it will be in the interests of companies (or their shareholders) to provide details of the failings or weaknesses or the remedial actions it is taking. The proposed guidance will create expectations regarding the information that will be disclosed that will not be fulfilled in practice. A company that discloses that it has identified failings or weaknesses will almost inevitably also disclose that it is taking action to address those problems, without providing details.

If the recommendation is retained we think the guidance should emphasise that a company is not required to disclose where that would prejudice its interests.

Question 11: Should the option of giving companies the possibility of putting the full corporate governance statement on their website be considered further? If so, are there any elements of the corporate governance statement that should always be included in the annual report?

We can see advantages in companies having the flexibility allowed by the Listing Rules to include the full corporate governance statement on a website and therefore would be in favour of further consideration of that option.

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

We have no comment.

If you have any questions on this submission please contact William Underhill (william.underhill@slaughterandmay.com; 0207 090 3060).

June 2014