

13 September 2023

Submitted via email: codereview@frc.org.uk

Public consultation on the FRC's proposed revision to the UK Corporate Governance Code

Dear Mr Styles,

EOS at Federated Hermes welcomes the opportunity to provide our comments on the FRC's Corporate Governance Code consultation.

EOS at Federated Hermes is a leading stewardship service provider advising on assets worth \$1.4 trillion as at 30 June 2023. Our engagement activities enable long-term institutional investors to be more active owners of their assets, through dialogue with companies on environmental, social and governance issues. We believe this is essential to build a global financial system that delivers improved long-term returns for investors, as well as better, more sustainable outcomes for society.

The views expressed in this communication are those of EOS at Federated Hermes and do not necessarily represent the views of all clients. Our response to this consultation is explicitly supported by Lothian Pension Fund (United Kingdom). EOS does not carry out regulated activities.

The Corporate Governance Code has been considered to be the bedrock of good governance for UK companies since its inception at the beginning of the millennium, and is globally perceived as providing best practices and guidance for corporate governance. As best practices and company cultures evolve over time, it is vital that the Code evolves to match. A principle at its heart is that of 'comply or explain' allowing companies and their boards to adapt and develop a governance structure which is optimal for its unique set of circumstances rather than simply blindly follow a set of box-ticking requirements.

As such, we welcome the opportunity to comment on the proposed amendments and improvements to the Code which have been outlined in the consultation document. We would like to take the opportunity to comment on each of the sections of the consultation in turn.

Board leadership and company purpose

The updated Code's emphasis on outcomes-based reporting is a positive intention, as outcomes of activity are a clear way of linking company activity with stated commitments and policy. However, stakeholders would likely benefit from guidance on what good outcomes-based reporting would look like. For example, it is broadly accepted that aligning climate-related disclosures with Task Force on Climate-related Financial Disclosures (TCFD) guidance provides a standardised methodology that ensures companies are reporting the right information that is relevant to stakeholders. The Code's wording should seek to provide similar guidance for relevant disclosures. However, companies should

be empowered to deliver reporting, which is tailored to their individual context, and as such we would not want the amendments to the Principle to promote standardised or boilerplate disclosure.

This belief extends to our view on whether the board should report on the company's climate ambitions and transition planning as part of its remit. Given the clear prominence of climate change and the need for transition planning in virtually every company's short- and long-term future, we believe that effective board oversight would include active coverage and reporting of a company's approach and planning for these topics. However, we would stress that the reporting should be additive and relevant to the company's individual approach, and should avoid using generic or boilerplate descriptions.

Division of responsibilities

We believe that the proposed updates focusing on significant external commitments for board members is a worthwhile element to highlight. Given the increasing complexity of companies and associated time demands, we believe board members are best able to function when they have a limited portfolio of responsibilities and can therefore dedicate more time to their companies. As such, we believe that highlighting the issue of significant external commitments in company reporting is a positive step.

However, simply reporting on time commitments may not be enough, as we are concerned that some firms may take the opportunity to simply report on why a significant amount of time commitments are appropriate, rather than encouraging board directors to reduce or limit them. As such, within the proviso of 'comply or explain', guidance towards an overall limit on external board commitments would likely be more impactful than additional reporting on the topic, or could be combined with such provisions.

For example, our current overboarding approach flags instances where directors have positions on more than five boards, with chair roles being equivalent to two board roles and executive roles being equivalent to three roles. We tailor this approach based on nuances such as company complexity (e.g. large financial institutions may have a stricter threshold) and subsidiary company relationships (e.g. a board member at a parent company taking a role at a subsidiary does not necessarily count as two separate roles).

Composition, succession and evaluation

We believe proposed amendments to capture a wide range of diversity characteristics is a positive development, as it should allow for broader reporting on important elements. The composition of the board should aim to use diversity to enhance its collective capability and function, rather than seek the broadest set of diversity for its own sake. For example, if to be effective a board's optimal size is seven or nine directors, it would not be appropriate to cater for every dimension of diversity.

In addition, the efforts to remove duplication and promote greater disclosure on succession planning as part of reporting are also positive changes which we would support. In keeping with our earlier comments, we would like to see companies adopting reporting, which is tailored to the company's specific circumstances, and would be against an increase in boilerplate reporting. We would also ask that any changes to reporting recommendations do not undermine the progress that has been made on important topics such as gender pay gap and ethnic diversity reporting.

Audit, risk and internal control

Consistent disclosure surrounding audit and assurance is a valuable input for stakeholders, particularly when it gives clear information about any external validation or verification processes which have been conducted. In addition, we support the proposal to refer to the Minimum Standard for audit committees which was recently published as a method for reducing duplication in reporting. We would like to better understand the circumstances by which a company could opt to not produce an Audit and Assurance Policy (AAP) based on the comply or explain principle, given the proposed breadth of topics it would cover and their importance to businesses of all sizes. There could perhaps be carve-outs for smaller companies (e.g. AIM listed or below FTSE 350), but we would expect to see the vast majority of larger companies complying with this form of reporting if introduced, in order for it to be effective at driving high standards.

We are supportive of further information on the audit committee's activity and role throughout the reporting year, and would encourage members of these committees to proactively reach out to investors to discuss their work. Our preference is that timelines related to reporting on activity are as strongly aligned as possible, and as such would like to see the board's declaration on its risk management system be based on the date of the balance sheet. This does not mean that continual reporting should not occur – rather, that the most comprehensive statements are made using the same time period to ensure consistency.

Remuneration

We are supportive of the proposed changes regarding the disclosure of malus and clawback provisions, and whether they have been used during the year under review. We would also not want to see a watering down or reduction on provisions for pay gap and pay ratio reporting, as we believe that there has been broad progress in reporting on these important topics and would not like to see the momentum regarding this lost.

We note that the amended Principle P includes a specific link between remuneration and "environmental, social and governance objectives." While we recognise the intention to highlight the importance of such objectives, we are conscious that this amendment creates the impression that E, S or G objectives are a separate component to be assessed as part of remuneration, rather than an integrated component which is incorporated into company strategy. We would recommend that the

FRC emphasises that specific E, S or G objectives should be integrated into the overall business strategy. In addition, we would suggest that the wording of the guidance is tailored such that it does not imply that all companies should have explicit E, S or G related targets as part of their remuneration, as this can result in the guidance being too prescriptive on companies' ability to set appropriate business performance and therefore remuneration objectives.

Conclusion

In conclusion, we are broadly supportive of the reforms being proposed by the FRC to improve the Corporate Governance Code. However, we would emphasise that these reforms and the Code overall should be recognised in the overarching principle of 'comply or explain' – that is, where a certain provision does not fit a company properly due to its context, that there is sufficient allowance for said company to explain why it does not comply. We would ask that the FRC continues to remind the investment community of this foundational principle, and that the reforms are enacted in the spirit of this approach.

Yours sincerely,

EOS at Federated Hermes