

February 2018

RESPONSE TO FINANCIAL REPORTING COUNCIL'S CONSULTATION TO REVISE THE UK CORPORATE GOVERNANCE CODE

The world is changing and the UK faces a number of challenges ahead, from shaping our global future to building an industrial strategy that unlocks growth and prosperity across the UK. In this context, it has never been more important that government, business and society work together to set out a shared vision for delivering prosperity. For that vision to be genuinely shared, it must be underpinned by trust and understanding.

Good corporate governance is a vital part of this trust agenda – helping to create an environment where businesses are appropriately held to account and are focused on long term value creation and effective decision making. It is right that corporate governance approaches continue to evolve to build a successful, modern economy and business must engage constructively in this ongoing conversation about reputation.

Building trust and understanding about the role business plays in society goes far beyond corporate governance alone – that's why the CBI is campaigning to better position the business community to seize the opportunity to help shape an economy that works for everyone.

When used properly the UK corporate governance system is world leading and is a vital part of the UK's reputation as an attractive place to invest and do business. The Financial Reporting Council's (FRC) revisions to the Code provides an opportunity to build on these strengths and help improve UK competitiveness and global reputation before we leave the EU.

To this end, the CBI shares the FRC's view that prescriptive regulation, which does not consider individual company circumstances, can turn disclosure into a simple box-ticking exercise. Relative to the initial proposals considered as part of the government's Green Paper review and Business Select Committee consultation last year, the CBI broadly welcomes the FRC's latest round of revisions. We are also grateful for the open and engaging dialogue which the FRC has facilitated with the CBI and its member companies throughout this consultation.

In this formal response the CBI seeks to highlight two elements of the revised Code which should be amended to enhance company reporting. The CBI strongly supports the essential governance principles of director independence and stakeholder engagement. However, the CBI believes there are better ways for the FRC to present and promote these governance principles within the Code.

The CBI's response outlines the following key points:

- The CBI strongly supports the principle of director independence, but the approach that the FRC has adopted within the revised code will pose significant challenges for companies. The CBI therefore recommends that the FRC should continue to use the 2016 Code provisions which provide a better standard of independence for the Chair.
- Effective engagement with stakeholders is an essential part of good corporate governance, and companies should start by defining their most important stakeholders and work out how to engage them.
- Executive remuneration should be set in the context of wider company pay. Additional clarity about the role of the Remuneration Committee will help companies to do this.
- For these reforms to work in practice, the Stewardship Code must mirror and enhance Director responsibilities, as set out in this new style Corporate Governance Code.
- Aligning company purpose, strategy, values and culture is critical to a company's long-term success, and should be supported via best practice guidance.
- Fostering a culture that allows diverse views to be heard right across firms is a necessary challenge and should be prioritised within the UK governance framework.
- The new Code's structure and simplification will help companies concentrate on best practice governance principles and behaviour.

The CBI strongly supports the principle of director independence, but the approach that the FRC has adopted within the revised code will pose significant challenges for companies. The CBI therefore proposes that the FRC should continue to use the 2016 Code provisions which provide a better standard of independence for the Chair.

1. In the revised Code the company Chair is regarded as independent after appointment, and the required majority of independent directors must now include the Chair. This significantly alters the application of the independence principle and as a result is likely to have serious implications for the effective functioning of company boards.
2. The rationale for this change in approach by the FRC is not clear or persuasive. In the CBI's view, the ongoing requirement for the Chair to be independent, coupled with the mechanistic application of the independence criteria is too rigid for well-functioning boards.
3. It is right that company Chairs are independent on appointment. Company Chairs must also be independently minded throughout the period of their tenure, and this will be reflected in the way that they Chair the board and invite constructive challenge.

4. Yet the Chair has a hybrid role¹ and must be able to act as an ambassador for their company in public. Over time they will inevitably gain an intimate understanding of the company's business, so that they can provide the correct level of supervision, support and challenge.
5. Requiring the Chair to be independent after appointment is therefore unrealistic. Enforcing this approach could have harmful consequences for the leadership of UK listed companies.
6. The CBI acknowledges that the FRC has said that companies can explain how their Chair's behaviour and approach aligns with the principle of independence, without meeting the strict independence criteria set out in Provision 15. Yet companies that fail to be compliant with this provision are likely to face discrimination from shareholders and regulators. This is not a desirable outcome.
7. Furthermore, the intent of Principle F is not reflected in the Code's Provisions 11 and 15. Independence means ensuring a division of responsibilities between the executive and non-executive functions of the board. Companies are alert to the risk of a Chair who inadvertently becomes too close to the management of the company over time and they recognise the implications for objective decision making. But this fundamental aspect of independence is demonstrated through the behaviour of company leaders and is not determined by their compliance with the criteria of Provision 15.
8. Chairs, who engage extensively with shareholders, are currently subject to annual re-election which sufficiently incentivises companies to ensure their Chairs are performing effectively with appropriate independent judgement.
9. Whilst the board should identify in the annual report each director considered to be independent an outline of the correct behaviours, which typify true independence is now lacking within the revised Code. Based on these revisions a Chair could easily be deemed to be compliant based on the prescriptive criteria for independence without demonstrating the right behaviours, whilst a Chair who behaves in accordance with the principles of this Code, but does not meet the criteria of Provision 15 could be deemed non-compliant. This creates the wrong incentives for companies and could result in misaligned outcomes for shareholders.
10. The CBI's strong recommendation is for the FRC to better reflect the fine line which effective company Chairs must walk, between support and challenge. The 2016 Code sets out a standard for Chair independence which is logical, well intentioned and works in practice. This more nuanced approach is better suited to the practical running of most large premium listed businesses. The CBI therefore urges the FRC to revert to the requirements for Chair independence set out in the 2016 Code to support effective, well-functioning boards.
11. The proposed change in emphasis on independence generally from that in B.1.1 of the 2016 Code, to Provision 15 adds to the CBI's concern. Many premium listed companies outside the FTSE 350 will now need to recruit additional independent directors, to achieve 'a majority' of independent directors. This will be challenging given the investment companies put into finding suitable candidates and bringing them on-board.

¹ As set out in paragraphs 50 and 60 of the Guidance on Board Effectiveness

Effective engagement with stakeholders is an essential part of good corporate governance, and companies should start by defining their most important stakeholders and how to engage them.

12. CBI members recognise that poor stakeholder engagement risks fuelling the disconnect between business and society². The best businesses have long recognised that engaging with their customers, employees, suppliers and communities is crucial to their success.
13. Although UK company law already recognises the importance of stakeholder groups in corporate governance, encouraging firms to demonstrate that directors are taking their duties seriously is welcome. Companies should be required to report how they are engaging with their stakeholders.
14. The CBI agrees with the FRC that the most effective approach to strengthening the stakeholder voice at board level is to build on existing best practice approaches taking place across the business community, rather than mandating specific models.
15. Every business is different and it's no surprise that companies have adopted a range of different models to suit their form and culture, based on an assessment of who the key stakeholders to the business are.
16. The starting point for any company should be to define who their key stakeholders are. Then boards should set out how they engage with these stakeholders. Getting these steps right will enable companies to adopt the best methods of engagement to suit both their business needs, and the needs of their main stakeholders.
17. For many companies, their employees will be the most important stakeholders but that revised Code should not prejudge that or lead to a bias on employee engagement to the detriment of other stakeholders.
18. Principles C and D are well worded and capture all stakeholders. Setting out three specific models as the 'norm', in Provision 3 risks stifling the credible, bespoke vehicles businesses can use to deliver a genuine feedback loop for their key stakeholders. The importance of employee voice comes through strongly in the Guidance on Board Effectiveness which includes the government's preferred options for employee engagement. The CBI believes the Guidance provides sufficiently clear direction for companies, and the three preferred models could therefore be taken out of the Code.
19. Companies should not be judged harshly if they iterate and continue to adapt their formal processes of engagement over time. Achieving effective engagement with wide ranging stakeholder groups is likely to be complex and challenging – particularly for companies who wish to engage meaningfully with their extended contracted or agency-based workforce. Asking companies to report on engagement with workers who are not employed directly by the company in question is ambitious and potentially sets a compliance standard which many companies are not empowered to meet because of their commercial relationships with suppliers.

² CBI Everyone's Business report, 2017

20. The best outcomes are likely to be achieved through regular dialogue, not one-off annual meetings, and this will require a significant commitment from company directors and managers. It will take time for some companies to get the best results from new engagement activities, and we would encourage companies to reflect what they learn from this process in their reporting.
21. The revised Code also addresses shareholder engagement, following a significant vote against a general meeting resolution. Greater transparency on shareholder voting will help to improve understanding between the board and shareholders. The proposals set out in the Code are reasonable and will mean companies must demonstrate how they are responding to shareholder concerns.
22. It is the responsibility of the company to initiate productive engagement with shareholders, but this requires effort from both sides to be successful. Future changes to the Stewardship Code should aim to improve understanding of the joint obligations which are framed by this revised Code, and must encourage sustained engagement among shareholders beyond the AGM.

Executive remuneration should be set in the context of wider company pay. Additional clarity about the role of the Remuneration Committee will help companies to do this.

23. Businesses recognise that the ongoing debate on executive pay is intrinsically linked to public trust in business and CBI members support action to address the public's concerns that executive pay has become disconnected from employee salaries. Transparency about executive pay levels can help to improve business reputation³.
24. It is right that remuneration committees should have a sound understanding of wider company pay policies. It is also important that executive remuneration should be rewarded fairly and should reflect the structure of pay within the wider company. The most important consideration however remains the principle that executive pay should be determined solely based on company performance. This means that remuneration committees must be empowered to apply discretion where pay rewards are unduly influenced by external factors, beyond the Board's control.
25. The provisions set out in the revised Code reflect these core principles. However, discussion with CBI members suggests that the wording of the provisions related to the remit of remuneration committees could be clearer. The wording of the provisions suggests remuneration committees should 'set' wider pay policies rather than 'oversee' remuneration policies for staff. This language blurs the line between the board's remit and management accountability.
26. The CBI therefore suggests that the FRC should instead emphasise that the role of the remuneration committee, is to have a comprehensive view of all company pay policies, and to supervise the application of these policies to ensure fair outcomes which promote the long-term success of the company, and are aligned with company strategy and values.

³ CBI Everyone's Business report, 2017

27. High levels of executive pay can only ever be justified by outstanding performance. Reward for mediocre performance, or reward for failure is unacceptable. Investors are holding companies to account over exceptional pay for ordinary or poor performance and this is to be welcomed and encouraged.
28. The 'say on pay' and associated more detailed remuneration disclosure requirements have begun to have a positive impact on the remuneration process, including underpinning tougher performance conditions.
29. On balance, the CBI supports proposals to encourage firms to extend the holding period for share awards or shares acquired on the vesting of awards or exercise of options. The CBI recognises that incentives which distract from long-term value creation and encourage short term behaviour are still a problem in some areas. There is growing recognition that because all firms are different, boards need the flexibility to design incentive schemes that genuinely align with long term performance for their individual businesses.
30. The chairs of remuneration committees do require detailed company knowledge and understanding to be effective in their role. Requiring them to have served for at least 12 months on a committee before taking up the role may add an additional barrier to recruiting for a position that can be challenging to fill.

For these reforms to work in practice the Stewardship Code must mirror and enhance director responsibilities as set out in the revised Code

31. The responsibility of the company is to initiate productive engagement with Shareholders. Effective shareholder dialogue is a two-way process and requires full participation from both sides.
32. The aims of this revised Code, which places greater emphasis on the outcomes of decision-making, and less on strict compliance with provisions, need to be understood and appreciated by the shareholding community, and their advisors. The CBI's members have already shown great interest and willingness to assist the FRC with its consultation on future changes to the Stewardship Code.
33. Governance reform will only result in improved outcomes if these two Codes meet in the middle and both communities are able to comprehend their responsibilities to one another. Without this common understanding Principles will not work in practice.
34. If the FRC adopts its proposal on independence, the CBI recommends that enforcement of the Stewardship Code should be strengthened in parallel with amendments to the Code. This will ensure investors and proxy advisors are discouraged from using a tick-box approach.
35. A company's explanation, if reasonable and evidenced, should be sufficient to avoid an automatic vote against the company for non-compliance. The FRC's assurance that companies can comply either by following the provisions or by providing an explanation should be reflected in the pre-amble to the Code, to ensure that both companies and shareholders understand the true intent and nature of this corporate governance framework.

Aligning company purpose, strategy, values and culture is critical to a company's long-term success and should be supported via best practice guidance

36. Good corporate governance is a vital part of this trust agenda – helping to create an environment where businesses are appropriately held to account and are focused on long term value creation and effective decision making.
37. Businesses must demonstrate the right corporate behaviours to sustain success⁴. Aligning company purpose and culture with governance practices is essential. The changes to the Code put the emphasise on the application of good governance principles within a company. The CBI fully supports this approach and agrees it is right to ask companies to set out how their governance has had an impact on decision making and corporate behaviour.
38. This Code offers a best practice standard, to stimulate boards' thinking, and can encourage them to focus on continually improving their effectiveness. It is up to individual boards to decide on the governance arrangements which are most appropriate to their company's circumstances, and to use the best practice set out in the Code as guidance. Ensuring companies have sufficient support to make this transition towards reporting on 'behaviour and impact' will be important.
39. A less prescriptive approach within Provision 23 would be helpful. Companies should conduct formal and rigorous annual evaluations on the performance of the board, the Chair and individual directors. Boards should also retain the discretion to determine how they undertake evaluations and the level of detail they disclose when reporting the outcomes. This will incentivise candid and effective appraisals.

Fostering a culture that allows diverse views to be heard right across firms is a necessary challenge and should be prioritised within the UK governance framework

40. Improving diversity is one key aspect of this. CBI believes there is a strong business case for improving diversity at every level of business, including the very top. Not only does diversity of thought and experience lead to better decision making and stronger business performance, but increasing diversity in the boardroom is also fundamental to a positive corporate image as a visible reflection of the culture of a company and of wider society.
41. Businesses accept that more can be done to improve the diversity amongst senior business leaders, and the CBI supports the voluntary approaches outlined by the Hampton-Alexander, Parker and McGregor-Smith reviews.
42. Becoming more inclusive will improve diversity in leadership at every level of a business. The CBI believes that voluntary targets have a role to play in improving diversity at all levels of business and that they are best set by individual businesses. These can be supported by national targets set by business-led reviews.

⁴ CBI Everyone's Business report, 2017

43. Every business faces its own mix of strengths and challenges, so there is no 'one-size fits-all' plan for becoming more inclusive. Each business must first identify the challenges facing their organisation related to diversity and inclusion and then take appropriate action in response.

The revised structure and simplification of the Code will help companies concentrate on best practice governance principles and behaviour

44. The move to publish a refined Code which highlights the most important elements of good governance - the unitary board, strong shareholder rights and aligning purpose and practice - is sensible.
45. Moving provisions which have become standard practice for large companies to the supporting guidance shows confidence in UK company reporting.
46. It is also good to see the preservation of necessary flexibility for companies which comes from the 'Comply and Explain' model of provisions. It is important to find the right balance between keeping requirements simple and flexible, and ensuring that they lead to useful disclosure of meaningful information.
47. The CBI agrees with the FRC that regulations which are too prescriptive and do not account for individual company circumstances turn disclosure into simple box-ticking exercises, which are of little use for company management, boards or their stakeholders.
48. On balance the quality and scope of the Guidance on Board Effectiveness is satisfactory and is rightly aimed at providing best practice suggestions for meeting the Principles and Provisions of the Code.
49. We note that this guidance is not intended to be prescriptive and raise one concern about the wording of paragraph 10. This paragraph unhelpfully expands the legal requirement for directors through interpretation of S.172 of the Companies Act. Retaining only the exact legal wording will ensure company directors are clear about the duties they must follow.