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By email: codereview@frc.org.uk

28 February 2018

Dear Catherine,

Response to the FRC Consultation on Proposed Revisions to the UK Corporate Governance Code and Guidance on Board Effectiveness

We very much welcome the opportunity to respond to this consultation and set out our comments below.

We firmly believe that good corporate governance is not about full compliance with governance codes (albeit that loyalty to them can demonstrate good governance practice and increase transparency). It is therefore important that corporate governance does not become a box-ticking, compliance type exercise and, more fundamentally, that the "comply or explain" model continues to recognise that each company is different and gives boards the flexibility they need.

We are concerned that, despite the FRC's significant efforts, the proposed new Code and Guidance may still result in the formulaic and prescriptive approach to corporate governance that we understand the FRC would like to stop. This could further erode the value of the "comply or explain" model. If time permits we think there could be real benefit in the FRC considering whether there are alternative approaches which would help to encourage better governance practices. For example, we think that it would be helpful if the approach taken in the Guidance could be adjusted. The Guidance could instead take the form of a set of questions designed to help boards in their thinking on how they comply with the Code. Those questions would supplement the Code but, critically, be drafted in such a way as not to amount to prescriptive guidance. Rather the questions would be designed to help stimulate boards' thinking when framing and reporting on their own corporate governance practices. We believe the suggested approach would be more likely to lead to the desired cultural change in this area. It would also re-enforce the all important flexibility which the "comply or explain" approach should provide whilst at the same time still respecting the Principles and Provisions of the Code. We are happy to discuss this with you.

1. Do you have any concerns in relation to the proposed Code application date?

Yes. If the FRC proceeds with its proposals in relation to board composition and independence we believe that some companies will need a longer period to allow them to comply with proposed new Provisions 11 and 15. Please see our response to question 7 for more details on this.

2. Do you have any comments on the revised Guidance?

See above for our suggestions on the overall approach the Guidance might take.

(a) Paragraph 10 – In the context of section 172 this paragraph provides that at the heart of a director's duties *"lies a focus on generating and preserving value for shareholders for the long-term, taking account of the interests of the company's workforce and the impact on other stakeholders such as customers, suppliers, the community and the environment*".

Whilst we understand the benefits of taking a long-term, sustainable view and of considering the impact of decisions on stakeholders, in our view this wording, together with some other wording used in the proposed new Code is inconsistent with the section 172 duty. The section 172 duty is a duty to act in the way a director "*considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole*" and in doing so to "*have regard to*" a range of different factors including employees, stakeholders and the "*likely consequences of any decision in the long term*". We think it would be better if the FRC removed the first sentence in paragraph 10 and only included the statutory wording. This would help avoid any unnecessary confusion.

(b) Paragraph 12 – This paragraph suggests that the "*terms of reference and formal schedule of matters for board meetings should be made available*" on a company's website. As that schedule may include references to confidential matters we think that it would be better if this suggestion was removed.

(c) Paragraph 20 – We are concerned that this paragraph is overly prescriptive. Whilst we acknowledge that in some sectors, for example financial services, the regulatory backdrop means that more detailed minutes are often kept, we do not think that it is appropriate for the Guidance to create an expectation that all companies should keep such detailed minutes. We suggest that this paragraph is either removed, or that the wording in it is softened.

(d) Paragraph 21 – In this paragraph the FRC recommends that "*Once a decision has been made and implemented the board should review the effectiveness of the decision-making process, and the merits of the decision.*". Boards make many decisions and it seems inappropriate to expect them to carry out a review like this quite as often as the wording of this paragraph suggests. In our view the annual board evaluation process required under Provision 21 of the Code already gives boards a periodic opportunity to thoroughly review the effectiveness of their decision-making processes. We therefore think it would be better if this wording was either removed or, alternatively, amended such that this type of review only has to be made where the board considers it appropriate to do so.

(e) Paragraph 31 – We would welcome further clarification on the meaning of the term "workforce". Whilst we recognise that the FRC will be reluctant to adopt an inclusive definition of who is caught, it would be helpful if the FRC could give details of the categories of individuals who it does not believe would form part of the "workforce". For example, outsourced service providers and suppliers. More generally we observe that the term "workforce" is used in various different contexts and think that, on balance, it should not be used in the context of the proposed new oversight role for the remuneration committee (see also our comments below on Provision 33).

(f) Paragraphs 50 & 60 – In paragraphs 50 and 60 the FRC gives a non-exhaustive description of the role of the Chair and the importance of the CEO's relationship with the Chair. We note that the description of the Chair's role is rightly very different to that of the non-executive directors and involves much more day-to-day interaction with the CEO. In our view the commentary given in these paragraphs is inconsistent with the FRC's new proposal that the independence of the Chair will need to be assessed on an ongoing basis. If the FRC proceeds to implement that proposal, we believe that the certain aspects of the description of the Chair's role will need to be modified. We believe that this (we think unintended) consequence would be an unfortunate development: in our view such a change has potential to negatively impact the pivotal role carried out by Chairs.

(g) Paragraph 109 – We think the Guidance should reflect the terms of the Code. We also think the Guidance (or Provision 36) should make it clear that holding periods should not prevent directors from being permitted to sell to cover tax arising on the vesting of awards.

3. **Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?**

Yes, provided that companies have the flexibility to use other methods of engagement should they wish to (whether in addition to, or instead of, one or more of the three specified mechanisms). We note that paragraph 35 of the Guidance suggests that companies have this flexibility and that the word "normally" in Provision 3 is designed to deal with this point. In our view, however, the flexibility inherent in the word "normally" could quickly become lost, which would make it harder for companies to choose a different approach. In addition, we think that the use of the word "normally" might in any case hamper innovation in workforce engagement as it could discourage companies from pro-actively considering other methods of engagement. Given that the underlying objective is to improve meaningful engagement and make sure that the views of the workforce are known, we think that this is an unintended consequence of the wording used.

We therefore suggest that the second sentence of Provision 3 is amended to make it clear that the mechanism for gathering the views of the workforce could be *"made up of one or a combination of different approaches"* and that as well as the three specified approaches it could also include *"another appropriate method"*.

Please note our comments in our response to question 2 about the scope of the term "workforce".

4. **Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?**

No. We do not think that there is any need for more specific references to be made to them.

5. **Do you agree that 20 per cent is "significant" and that an update should be published no later than six months after the vote?**

We have no comment on the appropriateness of 20 per cent. We do, however, think that it is important to recognise that where, for example, 20 per cent of the votes cast are cast against a resolution, this means that 80 per cent of votes cast have been cast in favour of the relevant resolution by what is typically a very large and diverse investor group.

We disagree with the proposal in Provision 6 that an update should be required within a six month period. We believe that Provision 6 should instead only provide that an update should be published in the next annual report or AGM notice, or at such earlier time as considered appropriate by the directors. This would be more likely to lead to meaningful and timely disclosure and avoid prejudicing any ongoing disclosures around the relevant point.

6. **Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.**

No comment.

7. **Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?**

No, we do not believe that this should automatically be the case. In our view, amongst other things, this can adversely affect the ability of companies to run balanced succession planning and discourage internal Chair appointments where, on all other grounds, it would be in the company's interests to make such an appointment.

We have concerns about the proposed changes in relation to board composition and the determination of independence. Specifically, we are concerned by the new requirement that the majority of a board, including the Chair, will need to be independent rather than at least half of the board, excluding the Chair, as is currently the case and the removal of the board's existing discretion to determine whether or not a director is independent.

Board Composition and Chair Independence

For many years the Code has recognised that there is a clear and important distinction between the role of the Chair and the role of the other non-executive directors. It has therefore only required a Chair's independence to be tested on his or her appointment. We believe that the proposed change fails to recognise this fundamental point and is inconsistent with the description of the Chair's role given in the Guidance. As mentioned above, this change has the potential to negatively impact on the ability of Chairs to carry out their pivotal role. We assume this is not intended, it is nevertheless a significant consequence.

In our view there is no logic for now requiring that the Chair be independent after appointment. We note that this view is not only shared by many listed companies and their legal advisers but that it is also supported by the findings of the Higgs Report which stated that: "*Once appointed, the Chair will have a much greater degree of involvement with the executive team than the non-executive directors. Applying a test of independence at this stage is neither appropriate nor necessary.*". If the FRC proceeds with this proposal it would be helpful if it could explain why it is now seeking to make this change.

In addition, we do not think that the change to the board composition requirement is justified. We note that following his extensive review into corporate governance following the financial crisis, Sir David Walker did not recommend any changes to board composition in the Code. In his view "*recent experience of cataclysmic outcomes encountered by boards on both sides of the Atlantic does not point to any particular board composition as consistently preferable.*".

For the reasons mentioned above, we believe that it is inappropriate to change the existing position on board composition and to require the Chair to be independent on an ongoing basis.

Determination of Independence

We believe that it is inappropriate for the Code to anticipate all circumstances that could impact on a director's actual independence and to mandate when a director should not be considered to be independent. In our view it is more appropriate to continue to permit the board, as the body best placed to assess all factors relevant to a director, to exercise its judgement in making an overall assessment of independence. Furthermore we do not believe that this change is necessary given, amongst other things, the existing requirement for a board to state why it considers a director to be independent notwithstanding the existence of any of the circumstances specified in the Code; the ultimate right of a shareholder to vote against the re-election of a director on an annual basis should he or she disagree with that analysis, and the recent introduction of the public register for significant votes against. In addition, we believe that, given the pressure from investors and their proxy advisors for companies to be fully compliant with the Code, unfortunately this change will promote a box-ticking type approach to independence rather than the desired considered and balanced judgements.

We are also concerned that the proposal to remove a board's discretion to determine that one or more non-executive directors has a number of unintended, negative consequences. We would ask the FRC to consider those consequences before reaching a final decision on this proposal. The problem is particularly acute in industries where there has been consolidation over the years and in specialist sectors where people tend to move around a relatively small number of key players. By way of illustration:

- Pensions – where a non-executive director as a result of a previous employment (whether in the appointing company or a company which it has acquired) is a member of a company's pension scheme this could mean that he or she could never be treated as independent. This could be the case even where, on all other considerations including the individual's overall financial position and the value of that pension, that would be the entirely wrong conclusion to reach.

- Cross-Directorships – if two directors sit on the board of X plc and Y plc, under the FRC's proposals that would by definition compromise their independence even where the board does not believe that to be the case.

If the existing position is retained it would be possible for boards to take a considered view on these points (as is currently the case).

For the reasons given above we believe that the existing approach should be maintained. It should remain a question of judgement for the board as to whether the test of independence is met, whether after nine years on the board or when one of the other indicators listed in Provision 15 is present.

Finally, we would welcome clarification from the FRC on how the various factors in Provision 15 are expected to work in practice including:

- whether in relation to promotions to the Chair, the "tenure clock" recommences upon the Chair's first election to that role so that he or she can potentially serve as Chair for nine years? We believe that it should work like this; and

- the meaning of a number of the factors listed in Provision 15. For example, what is meant by "material business relationship", "significant links" and "close family ties"? The need for certainty becomes much more acute when a director to whom one of these factors applies is automatically non-independent.

8. Do you agree that it is not necessary to provide for a maximum period of tenure?

Yes, in our view it is not appropriate to impose a maximum tenure of nine years. Please see our response to question 7.

9. Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

On balance, yes, the changes proposed in Section 3 should lead to more action to build diversity, although many companies are already very active in this area so this will not necessarily lead to more action from them.

10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

Yes, but we have no view on the potential costs and other burdens involved.

11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

We welcome greater ethnic diversity but unfortunately see a number of issues with collecting and reporting ethnic data. The categorisation of an individual's "ethnicity" and who should determine it is not straightforward. By way of illustration, should ethnicity determined by reference to race, birth or association? How should second and third generations be classified? Should this be for the individual company to determine (and report on how they define it) or should it be more clearly defined in the Code? Furthermore, even if there was a clear definition of ethnicity, it will be difficult and potentially misleading to compare data as some companies may have incomplete data sets. Examples of where this would be the case include where local law prevents that data being collected, or the subjects do not wish to provide it.

12. Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?

No. We think it would be better to remove all duplication.

We note your reference to the Government's plans to introduce secondary legislation to require all companies of a significant size to explain how their directors comply with section 172 and, as a result, your intention to keep the wording of Provision 4 under review. If the proposed Provision 4 remains, we believe that it should simply take the form of a sign-post to the relevant legislation. Our concern is that companies may otherwise have to comply with two similar, but quite possibly slightly different, sets of rules which each have the same underlying objective.

13. Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.

Yes.

14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

We agree that, when setting the policy for director remuneration, the remuneration committee should be asked to take into account remuneration and workforce policies and practices within their company. Provision 33, however, goes further than the Government's request to the FRC for change in this area and makes the remuneration committee responsible for the oversight of workforce remuneration and workforce policies. In our view the use of the word "oversee" in Provision 33 implies an expanded remit for the remuneration committee potentially amounting to an HR supervisory role and may require non-executive directors to encroach on what should be executive responsibilities.

We therefore believe that the FRC should recast Provision 33 so that it instead reiterates best practice by requiring remuneration committees to have an understanding of pay practices across the workforce when determining executive remuneration. Regardless of the final position adopted in relation to "oversight", it would be helpful if the final versions of the Code and the Guidance could be more clearly aligned on the question of delegation.

Please note our comments on the meaning of "workforce" in our response to question 2.

15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

No. In our view it is key that the Code is not too prescriptive and gives remuneration committees the flexibility they need to adopt principles of remuneration that properly reflect the needs and culture of the relevant company.

16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

We believe that investor engagement gives the most meaningful impetus.

17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes

or enhanced separate guidance for different categories of the investment chain help drive best practice?

In our experience the expectations of different participants in the investment chain can both vary and conflict. This can be as a result not only of the views of the ultimate beneficiary and the terms of the relevant investment mandate, but also as a result of differing business models and investment and performance horizons. For example, the expectations of an investor which takes a wider view of responsible investment may be very different to one that does not. Subject to our comments below on the role of proxy advisors, whilst a basic statement around this may be helpful to some market participants we do not think that it should be more prescriptive than that. In our view even if the FRC could create a basic statement around expectations it might not have the impact that the FRC would like it to have given the relatively low level of UK equity held by UK based institutional investors.

We believe that the FRC should look at the role played by proxy advisors in the stewardship process. We acknowledge that the Stewardship Code currently states that it applies by extension to proxy advisors but our clients' experiences suggest this should be strengthened.

Often the size of institutional investors' portfolios means that they cannot evaluate every one of companies they invest in, or make informed decisions on how to vote on every resolution. Proxy advisors therefore step in and provide this important service to them. Based on the experiences of our clients, we are concerned that proxy advisors can be unwilling to engage with companies in a meaningful and timely way. For example, proxy advisors often only allow for limited engagement to happen very late on in the AGM process and then only to see the relevant report and to correct factual errors. The time given to respond is generally not long enough to allow for proper engagement and the potential revision of any voting recommendations. In our view this has the potential to make both the government's and the FRC's work on promoting stewardship and issuer-investor engagement significantly less effective than it might otherwise be. There may be merit in requiring investors who are subject to the Stewardship Code and use proxy advisors to report on how those proxy advisors have engaged with their investee companies.

18. Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

We support the existing "comply or explain" regime. We believe that it is important to give sufficient flexibility to investors to accommodate the fact that individual situations and circumstances will vary. As is the case for listed companies it is key that "comply or explain" does not in effect become "comply or else" so any changes in this area should not be overly prescriptive.

19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

In our view the tiering exercise might have helped some asset owners and other market participants to assess stewardship performance. For example, in the selection processes they run when awarding investment mandates. The FRC might also want to consider publishing a periodic report highlighting the best reporting practices that the FRC sees in this area.

20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

No comment.

21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

The FRC could give greater emphasis to investors considering the long-term success of a company but in our view the wording used should recognise the fact that investors' perspectives on this may, for valid reasons, vary. Equally, even where the investor and ultimate beneficiary want to hold for the long-term, market practices can place some short term pressures on investors. For example, the perceived tendency for the market to define their performance relative to benchmark indices (even in the case of active managers); the basis on which asset managers are monitored by asset owners and advisers; and the actual asset manager selection process.

We understand the benefits and increased emphasis on taking a long-term view. We do, however, note that the section 172 duty of directors to promote the success of the company is not a duty to promote the long-term success of the company. Under section 172 a director can consider the long-term impact of a decision but can take action on the basis of short-term considerations if he or she thinks that is most likely to promote the company's success for its members. Please see our answer to question 2 for further details on this.

22. Would it be appropriate to incorporate "wider stakeholders" into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

We support the promotion of ESG factors and note the role that investors can, and which many investors already do, play in making sure that their importance is recognised. We, however, accept that the individual position of investors on this area can be constrained by, amongst other things, the objectives and perspectives of their underlying beneficiaries and investment mandates.

23. How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC

or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

The FRC might like to consider periodically sharing best practice or using an FRC Financial Reporting Lab type approach in this area. It is important that wherever the FRC puts this "guidance" it does not impose overly prescriptive obligations and gives investors the flexibility to report in the way that works best for their own stakeholders.

24. **How could the Stewardship Code take account of some investors' wider view of responsible investment?**

    No comment.

25. **Are there elements of international stewardship codes that should be included in the Stewardship Code?**

    In our view the most significant international stewardship codes have been introduced too recently to allow us to have a clear view on the impact of any different provisions included in them.

26. **What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?**

    No comment.

27. **Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?**

    No comment.

28. **Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?**

    Please refer to our answer to question 22 for details of our views in this area.

29. **Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?**

    Please refer to our answer to question 22 for details of our view in this area.

30. **Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?**

    We generally agree that this might be a useful development and give the relevant organisation the opportunity to put their report in context. In our view it would be helpful if the signatories could provide details of the person designated as a contact point for stewardship related matters and who will direct the way in which the investor's vote is cast at AGMs.

31. Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

Funds can be established for different purposes. To the extent that this would, for example, allow asset owners, beneficiaries and listed companies to easily determine the approach and purpose of a fund that might be helpful but we do not have a clear view on this.

Yours sincerely,

[redacted]

Stephanie Maguire