KPMG LLP
15 Canada Square
London E14 5GL

Tel +44 (0) 44 (0)20 7311 5292
bill.michael@kpmg.co.uk

Bill Michael
UK Chairman and Senior Partner

Catherine Horton
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

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Dear Catherine

Proposed Revisions to the UK Corporate Governance Code

We welcome the opportunity to respond to the FRC's consultation Paper *Proposed Revisions to the 'UK Corporate Governance Code* and *Guidance on Board Effectiveness'*, and agree with the FRC's assertion that as governance within the largest companies is increasingly subject to heightened public scrutiny, now is the time to undertake a comprehensive review to ensure the Code remains fit for purpose.

At this critical time, and as the country faces up to Brexit, it is crucial that the revised Code plays its part in both ensuring trust in business and attracting investment. With this in mind, we are very supportive of the steps taken to make the Code shorter and sharper; the greater focus on the Principles and how they have been applied; and the emphasis on corporate purpose, values and ensuring the long-term success of companies for both shareholders and wider society. Engaging with and contributing to wider society must not be seen as a compliance exercise – rather it is fundamental to building confidence among stakeholders (ensuring trust) and in turn, the long-term success of a company.

Our responses to the specific questions raised in the Consultation Paper are set out in Appendix 1. We have not answered questions 21 to 24, and 26 to 27. Other detailed comments are included in Appendix 2. We hope that our comments prove to be useful and we would welcome an on-going dialogue with you on these initiatives. Please do not hesitate to contact me, or my colleague Tim Copnell (tim.copnell@kpmg.co.uk) should you wish to discuss any of the points raised in this response.

Yours sincerely

Bill Michael
UK Chairman

Appendix 1: Specific questions raised in the consultation
UK Corporate Governance Code

Q1. Do you have any concerns in relation to the proposed Code application date?

We have no concerns in relation to the proposed application date. The 'comply or explain' approach and the renewed focus on explaining how the Code principles have been applied provide sufficient latitude for companies to consider (and to the extent appropriate) address any non-compliance and their journey towards implementing the new recommendations.

Q2. Do you have any comments on the revised Guidance?

We are generally very supportive of the proposed *Guidance on Board Effectiveness*. We include a number of detailed comments in Appendix 2.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

We agree that boards should establish methods for gathering the views of the workforce and that – while not without their challenges – each of the three options outlined in Provision 3 may be part of the solution. However, notwithstanding paragraph 35 of the proposed *Guidance on Board Effectiveness*, of itself, the Code is not clear as to whether compliance with Provision 3 hinges on the adoption of one of the three methods or whether compliance can be achieved by adopting other means for gathering the views of the workforce.

With this in mind, we commend the ICSA: The Governance Institute and The Investment Association's guidance '*The Stakeholder Voice in Board Decision'* making which discusses the contribution of board composition, training on stakeholder-related matters, consideration of the board's decision making process and other matters relevant to understanding the views of stakeholders.

Notwithstanding the need to respond to the recommendation set out in the Government's Green Paper '*Consultation on Corporate Governance Reform'*, we also note that the inclusion of a specific provision directing boards to establish a method for gathering the views of the workforce, but no similar provision relating to the wider stakeholder body. We believe that a more principled approach would be one which addressed all significant stakeholders in the same way.

We note that Provision 3 also addresses whistle-blowing arrangements and the board's role in ensuring appropriate systems are in place for the workforce to raise concerns.

Consistent with the point we make above, we consider this provision to be construed too narrowly and that boards should ensure that appropriate systems are in place for *all* stakeholders to raise concerns about possible improprieties and other matters.

Q4. 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?

Responsible business requires business leaders who seek to direct organizations with a longer-term horizon in mind. Since the introduction of the ‘Business Review’ by the Companies Act 2006, the number of companies reporting on non-financial matters has increased substantially. However, arguably leadership on sustainability has not advanced significantly, which suggest that more reporting is not necessarily the answer.

Turning this trend around requires winning hearts and minds. Transparency must be reinforced by a governance culture that leads to company directors being responsible for the way a company is directed and controlled, explicitly covering the long-term direction of the company. In our opinion, corporate governance, in substance rather than form, is the means to encourage and enable companies to embed sustainability issues into its strategy and the decisions it makes.

With this in mind, we are supportive of the reference in Code of Principles A and C to a company’s role in contributing to wider society and the board’s responsibilities to both shareholders and other stakeholders. We also support Provision 4 and disclosure of how the board has engaged with stakeholders and how their interests have influenced the board’s decision making – though there is a danger that this might, over time, lead to boiler-plate reporting.

We feel these changes bring the UK back into line with other jurisdictions that have already made changes to their corporate governance arrangements to extend the role of the board to focus on the sustainable success over the longer term such as the International Corporate Governance Network’s *Global Governance Principles* which state that:

“The board of directors is accountable to investors and relevant stakeholders and responsible for protecting and generating sustainable value over the long term.”

Or, the King *Code of Corporate Governance* (South Africa) which includes the principle:

“Ethical Leadership and Corporate Citizenship: the need to direct strategy and operations to build a sustainable business and *consider short- and long-term impacts of the strategy on the economy, society, and the environment*.”

Q5. 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 agree. 20 percent or more votes against is the threshold adopted by both the Investment Association in determining what significant shareholder opposition to proposed resolutions should be included in their Public Register, and the 2016 GC100 and Investor Group Directors' Remuneration Reporting Guidance as a guideline for what should be treated as significant. Using a different threshold in the Code would be impractical.

Q6. 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.

We agree with the removal of all the exemptions for companies below the FTSE 350 - we have always argued that these are an anomaly in a 'comply or explain' framework.

We note that while many smaller boards could use the 'comply or explain' framework to rationalise non-compliance with the Code, many will feel compelled – if only by the perception that some proxy voting agencies and institutional investors are unwilling to engage constructively around areas of non-compliance – to hire additional non-executive directors. There will be a financial cost to this, but equally it could act as a catalyst for increased board diversity – which we consider to be positive.

With regard to externally facilitated triennial board evaluations, we believe the benefits of such a process can far outweigh the costs – which in any event should be proportionate to board size and the complexity of the governance arrangements.

The 2012 report by Keeldeep Associates (sponsored by Ashridge Business School) *Research into the effectiveness of UK board evaluations* concludes that the fees paid to external evaluators by those FTSE300 companies whose turnover is typically between £400m to £1bn – ranges from £20,000 to £75,000, with an average of a little over £42,000. This equates to £14,000 p.a. and presumably a little less for companies outside the FTSE350 if only because the average board size will be marginally smaller. We do not consider this to be excessive given the potential benefits of externally facilitated board evaluation.

Finally, we think the FRC should encourage disclosure of the fee paid to the independent evaluator - which could be significant for some providers and therefore provide a threat to their independence and objectivity. Similarly, disclosure of the fee paid would discourage boards from entering into cursory engagements with little value in terms of improved board performance.

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

We believe the concept of 'independence' cannot be encapsulated by a simple list of criteria. Individuals might cease to be independent well before they have served for nine years while others may remain independent well beyond nine years. We also note that all directors – whether executive or non-executive – are required by law to exercise independent judgment. Nevertheless, we do accept that the existing provision is not well understood and may companies and investors already refer to a 'nine-year rule'. With that in mind we welcome the clarity provided by paragraph 15.

Chair of the board

All previous versions of the Code have stated that while "*the chairman should, on appointment, meet the independence criteria... thereafter the test of independence is not appropriate*". Our understanding is that this is because the breadth of the role and the necessary relationship between the chairman and CEO, create relationships and circumstances which are likely to affect, or could appear to affect, the chair's judgement. However, section 2 of the proposed Code (Provision 11 and the wording of this question) suggests that the chair should be independent and by implication that the breadth of the role and the necessary relationship between the chairman and CEO, *do not necessarily* create relationships and circumstances which are likely to affect the chair's judgement.

However, the implication of the new Provision is that in order to comply chair's would need to stand down after nine years (notwithstanding that there is not, we believe, any correlation linking long chair tenure to poor governance). In practical terms, if companies were to comply (rather than explain) we understand that around 20% of FTSE 350 Chairs would fall foul of this new test, and while we accept that the comply or explain regime could be used to rationalise non-compliance with the Code, the reality is that this change will drive board leadership churn at unprecedented levels. This might be desirable if shareholders were voting in large numbers against the reappointment of long-tenure chairs, but we are not aware that this is the case.

The new Provision will also make internal appointments (non-executive director to Chair) challenging as most such appointments will normally not be considered until an individual has served a number of years as a non-executive director – and therefore the possible tenure as chair will be relatively short.

We also note some potential inconsistencies which the FRC may wish to address. For example, whilst Provision 11 includes the chair within the cadre of independent directors that should constitute the majority of the board, Provision 24 asserts that the audit committee should comprise a minimum of three independent NEDs – but the board chair should not be a member, suggesting they are not regarded as independent. To complicate matters further, Provision 32 stipulates that the remuneration committee should comprise a minimum of three independent NEDs – and while the board chair can be a member, they cannot chair the committee. If these 'qualifications' are simply to avoid the chair being over committed, then this should be made clear.

We support the status quo, but if the chair of the board is to be independent not just on appointment, but thereafter, then the Code should be consistent as to board and board committee composition.

Q8. Do you agree that it is not necessary to provide for a maximum period of tenure?

We agree that it not necessary to provide a maximum period of tenure. Notwithstanding the 'comply or explain' regime and that shareholders are encouraged to engage constructively on any departures from the Code, the independence criteria in paragraph 15 provide a *de facto* maximum tenure period.

Q9. Do you agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

We agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, the executive pipeline and in the company as a whole – especially in those companies that already embrace the merits of diversity.

We are particularly supportive of Principle J and the reference to both appointments and succession plans that promote diversity of gender and social and ethnic backgrounds. However, we note that Provision 23 encourages only the disclosure of gender balance (in the [board], senior management and their direct reports). We would encourage the FRC to explore best practice reporting of different forms of diversity, particularly socio-economic background of the board, senior management team and the workforce more generally.

At the end of 2016 KPMG became the first UK business to publish comprehensive data on the socio-economic background of our workforce. We did this to provide an evidence base for change and as a baseline to measure our future progress.

Public disclosure of a broader spectrum of diversity measures – such as socio-economic backgrounds – would help hold companies to account for their actions and provide an even more powerful driver for change than the current proposal to disclose the actions taken to oversee the development of a diverse pipeline for future succession to the board and senior management positions – which we also support.

Q10. 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.

We believe that companies that focus on increasing diversity in the boardroom, in their executive teams and across the workforce as a whole, can expect a positive impact on performance. We are therefore supportive of extending the Hampton-Alexander recommendations relating to the disclosure of gender balance (of those in senior management and their direct reports) beyond the FTSE 350. The merits of diverse leadership are not limited to large companies.

Q11. 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.

As discussed in our response to question 9 above, we would like the Code to encourage reporting on a broader spectrum of diversity measures – including ethnicity and socio-economic background.

While the comparable data would clearly be preferable, we are conscious of the challenges involved in determining what data should be collected, measured and disclosed. Nevertheless, we believe that this is not a precise science and companies should be encouraged to disclose such information – within the 'comply or explain' framework – rather than waiting for formal reporting standards to be developed.

Q12. 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?

We agree with retaining the audit, risk and internal control concepts contained within the existing Code notwithstanding that there is some duplication with the FCA's Disclosure and Transparency Rules. The area is well understood and altering the status quo will distract from the important Code changes made elsewhere

Q13. 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.

We are supportive of removing the requirement to make available the audit committee terms of reference in favour of inclusion in the revised board effectiveness guidance for directors.

Q14. 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 with the Government's response to the Green Paper *Consultation on Corporate Governance Reform* that boards should better demonstrate how pay and incentives align across the company, and to explain to the workforce (and other stakeholders) each year how decisions on executive pay reflect wider pay policy. Consequently we are supportive of the proposed expanded remit for remuneration committees to oversee remuneration and workforce policies and practices, and take these into account when recommending to the board the policy for director remuneration.

As we have commented in our responses to previous iterations of the UK Corporate Governance Code, we are troubled by the current and proposed drafting that recommends that remuneration committees should have delegated responsibility for determining the remuneration policy for director remuneration and setting remuneration for the board and senior management as *prima facie* this moves away from the fundamental concept of a unitary board. As Sir Adrian Cadbury set out clearly in his seminal 1992 report, "remuneration committees should recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary. Executive directors should play no part in decisions on their own remuneration." Paragraph 51 of the proposed *Guidance on Board Effectiveness* – and the assertion that the board retains responsibility and makes final decisions on [remuneration] - would appear to support this point.

We think the principles of board (or board committee) oversight are well understood and therefore further guidance on how to exercise oversight over the remuneration of the wider workforce and associated policies and practices is unnecessary. If further guidance is deemed necessary, then perhaps the FRC could look to (say) its *Guidance on Audit Committees*, with a view to preparing something proportionate.

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

There is no silver bullet in this area. However, more meaningful shareholder engagement is the starting point. It should focus on the strategic rationale for remuneration structures and the consultation process should be aimed at understanding investors' views – albeit many of which are different and sometimes contradictory. Undertaking a process of consultation will not lead to blanket investor support nor should we expect it to.

Clarity and simplicity

We welcome Provision 40 and the emphasis on clarity and simplicity. There has been some simplification of executive pay structures over recent years but the current approach to executive remuneration, while intended to link pay to performance, remains a complicated system with many examples of poor correlation between company performance and remuneration outcomes. Not only is executive pay failing to act as the tool to incentivise performance, we believe the complexity of the system is creating a growing reputational risk for companies and arguably investors too.

A move towards metrics more directly linked to the achievement of business strategy

Similarly we are supportive of Principle O which now clearly aligns remuneration (and associated policies and practices) with strategy, values and the promotion of long-term success. As noted in our response to the BEIS Green Paper *Consultation on Corporate Governance Reform*, we are wary of metrics such as total shareholder return (common in many existing schemes) or any other performance measure influenced by capital market conditions and other generic factors rather than solely on company specific performance. Instead, and notwithstanding the inherent difficulties in doing so, we encourage remuneration committees and the investor community to focus on measures more directly linked to the achievement of business strategy (and the executive's contribution to that outcome) and ***relative*** rather than absolute performance.

The balance between fixed and performance related pay

Thinking more broadly, we question the perceived wisdom around the balance between fixed and performance related pay. Should variable pay be a fraction of fixed pay rather than a multiple – as it is for most employees including other highly paid individuals considered to be in scarce supply such as premier league footballers? While fixed pay would necessarily rise, greater transparency around a larger proportion of pay would address the impact of complex LTIPs which have contributed to both the widening pay gap and poor correlation between company performance and remuneration. Could the Code encourage consideration of pay structures where variable pay is a fraction of basic pay rather than a multiple?

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

We are supportive of the new Provision recommending that boards have discretion to override formulaic outcomes – though there is always the risk that some remuneration committees might seek to exercise discretion in an inappropriate way. As discussed in our response to Question 15 above, more meaningful shareholder engagement is key.

Stewardship Code

Q17. 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?

We have no strong opinion as to whether separate codes or guidance would be helpful – that is best answered by those subject to the Stewardship Code. What is clear is that the expectations of the Stewardship Code are either not clear, or the enforcement mechanism is insufficient.

Q18. 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?

The strength of the 'comply or explain' framework is that investors (and those that purport to act for investors) hold each company to account. It is not clear what body would hold signatories to the Stewardship Code to account under a similar 'comply or explain' framework.

Q19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

We are supportive of the tiering exercise as a mechanism for driving best practice. However, anecdotally we hear that too many entities were included in the top category.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

Careful analysis will be required to determine what parts of the UK Corporate Governance Code could be reflected in the Stewardship Code? Nevertheless, we would be supportive of greater emphasis being placed on purpose, values and the contribution to wider society.

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

We are not, at this time, aware of specific elements of other stewardship codes that should be included in the Stewardship Code. However, if the FRC are reviewing the Stewardship Code with a view to driving further improvements in best practice, then international best practice should be factored into any proposed changes.

Q28: Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

Yes. Board and executive pipeline diversity should be included as an explicit expectation of investor engagement.

Q29: Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

Yes. The Stewardship Code should explicitly request that investors give consideration to company performance and reporting on adapting to climate change

Q30: 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?

Yes. 'Purpose' is the bedrock upon which corporate governance is built. Signatories to the Stewardship Code should define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities.

Q31: 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?

We agree that there are strong arguments for promoting greater transparency for asset owners by encouraging reporting against the Stewardship Code at a fund level – in particular the fund's purpose and its specific approach to stewardship. However, this needs to be done in a proportionate way that encourages meaningful reporting rather than boiler-plate disclosure.

Appendix 2: Other matters

Revised UK Corporate Governance Code

Section 1 – Leadership and purpose

Principle C: To avoid any ambiguity as to whether this Principle extends directors' duties to stakeholders beyond section 172, the FRC might consider making direct reference to section 172 within the principle itself.

Section 2 – Division of responsibilities

Principle E: As drafted, Principle E underscores the chair's role in ensuring the effective contribution of all non-executive directors. Shouldn't the chair be equally concerned to ensure the effective contribution of executive directors too? As part of a unitary board, executive directors' duties extend to the whole of the business and not just the part of it covered by their individual executive roles. It is important that the chair encourages executive directors to understand the wider remit of their role and help them resist the trap of seeing themselves only as members of the CEO's team.

Provision 12: The senior independent director is given a formal role as an intermediary for the other directors and shareholders. Consistent with Principles A and C, why would it not be 'shareholders and other stakeholders".

Provision 13: Expecting non-executive directors to be responsible for appointing/removing executive directors *et al*, is not only contrary to the unitary board concept (as encapsulated in paragraph 51 of the proposed *Guidance on Board Effectiveness*), but inconsistent with Provision 17 which specifies that only a majority of nomination committee members need be independent non-executive directors and that such committees should lead the appointment process – and by inference, not be responsible for it.

Section 3 – Composition, succession and evaluation, risk and internal control

Provision 19: It is proposed that major shareholders should be consulted ahead of appointment if, exceptionally, it is proposed that a chief executive should go on to chair the same company. We would expect major shareholders to be consulted ahead of time whenever a new chair is proposed, irrespective of their prior employment.

Section 4 – Audit, risk and internal control

Principle M: We strongly believe that the board should satisfy itself as to the integrity of all reported information, not just the integrity of financial information.

Section 5 – Remuneration

Provision 32: We note that this new provision recommends that an individual should not chair the remuneration committee unless they have served on 'a' remuneration committee for at least 12 months. We believe that this provision should be tightened such that a prospective remuneration committee chair should serve on the remuneration committee in question for at least 12 months, not any remuneration committee. Remuneration committee chairs need to have extensive knowledge of the company, the contribution of the executives, the shareholder base and the current senior executive remuneration landscape in order to be truly effective.

Furthermore, we consider this to be a matter of good governance and equally applicable to the chairs of all board committees – particularly the audit committee.

We recognise that there may well be situations where the best course of action is for the board to ask a newly appointed, and appropriately skilled, non-executive director to chair a board committee rather than an individual with greater tenure but less relevant experience. This we believe, can be adequately addressed by the 'comply or explain framework'.

Provision 34: Given that the first sentence refers to "the chair and all non-executive directors" while the second sentence refers only to "all non-executive directors", it appears that there is an expectation that chairs be remunerated via share options and other forms of performance related pay. We do not believe this is appropriate or - given that the Code now considers chairs to be 'independent' – the FRC's intention.

Revised Guidance on Board Effectiveness

Paragraph 30: To ensure consistency with section 172, we suggest replacing "*have taken account of the interests of different stakeholders*" with "*have had regard for the interests of different stakeholders*".

Paragraph 32: As discussed in our response to question 3 below, we believe the recommendation on whistle-blowing arrangements is applicable to all stakeholders, not just the workforce. *All* stakeholders should be able to raise concerns about possible improprieties and other matters.

Paragraph 35: We welcome the clarity as to whether compliance with Provision 3 hinges on the adoption of one of the three methods or whether compliance can be achieved by adopting other means for gathering the views of the workforce – though we would encourage the FRC to make this point clear in the Code itself.

We note that this paragraph refers to *"the Code requirement"*. It is difficult to discourage proxy voting agencies and others from taking a 'tick box' approach to Code compliance when the FRC refers to its own Code provisions as requirements.

We also note that compliance with Provision 3 will be achieved if the chosen method for gathering the views of the workforce delivers "*meaningful, regular two-way dialogue*". This is introducing a qualitative test that isn't in Provision 3 itself – an employee director, for example, will not necessarily deliver meaningful, regular two-way dialogue – whether or not that is the objective.

Paragraph 37: It is not just investors and potential investors that can focus on short term returns. We suggest inserting "and other stakeholders" after "potential investors".

Paragraph 40 (Figure 2): We suggest inserting "*meaningful*" before "*engagement between leadership and employees*". Furthermore, we question why hierarchical attitudes are considered a sign of a cultural problem. There are many successful organisations, such as our armed forces, for whom a strong hierarchical culture is considered a good thing and not an inhibitor of organisational effectiveness or sustainability.

Paragraph 83: As this paragraph concerns 'skills and knowledge', might it be better placed immediately after paragraph 79?

Paragraph 96: We are very supportive of the first sentence which clarifies the role of the audit (and risk) committee within the unitary board structure. We think it would be useful to start the sections on nomination and remuneration committees with a similar reminder about the role of the committee vis-à-vis the board.

While the guidance on viability statements is important, its inclusion here feels a little incongruous – especially as so many other important audit, risk and control issues are excluded. Perhaps its more natural home would be the FRC's *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*.