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Dear Catherine,

Response to FRC's consultation on UK Corporate Governance Code

I am pleased to share with you Grant Thornton UK LLP's response to the consultation on a revised UK Corporate Governance Code.

For the last fifteen years, the Grant Thornton Governance Institute has conducted an annual, comprehensive analysis of FTSE 350 annual reporting. We measure compliance with the UK Corporate Governance Code and narrative reporting requirements of the Companies Act, and assess the quality of reporting. Drawing on our unique data set and expertise in corporate governance, we provide responses to the consultation questions.

The Code continues to evolve through continued experience – as it has done in recent years. We trust that the Code and reporting requirements, if revised, will contribute to the overall strengthening of governance practices and UK board effectiveness. Through greater transparency assisted by regulatory oversight, and peer pressure for the application of best practice guidance, accountability and engagement we believe that trust can be restored in and between UK business, government and society.

Good, effective corporate governance is integral to ensuring integrity in markets and unlocking sustainable growth in dynamic businesses. We therefore welcome the opportunity to help shape thinking on this important topic and to put in place the foundations for a vibrant economy in the UK.

We have pleasure in enclosing our response.

Yours faithfully

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Who we are

Grant Thornton UK LLP is part of Grant Thornton, one of the world's leading organisations of independent advisory, tax and audit firms. We help dynamic organisations unlock their potential for growth by providing meaningful, forward-looking advice.

Our underlying purpose is to build a vibrant economy, based on trust and integrity in markets, dynamic businesses, and communities where businesses and people thrive. We work with banks, regulators and government to rebuild trust through corporate renewal reviews, advice on corporate governance, and remediation in financial services. We work with dynamic organisations to help them grow, and we work with the public sector to build a business environment that supports growth, including national and local public services.

In the UK, we are led by more than 200 partners and employ 4,500 of the profession's brightest minds. We provide assurance, tax and specialist advisory services to over 40,000 privately held businesses, public interest entities and individuals nationwide.

The Grant Thornton Governance Institute is a dedicated team within Grant Thornton UK LLP that specialises in governance research and analysis.

Our annual publication – The Corporate Governance Review (www.grantthornton.co.uk/cgr2017) – is an in-depth and thorough piece of mixed methods (qualitative and quantitative) research. We conduct this annual review of governance of all FTSE 350 companies by assessing the annual reports of these companies using our in-house methodology. We assess the quality of reporting and the compliance of FTSE 350 with the provisions of the UK Corporate Governance Code and certain disclosure regulations of the Companies Act. We have been conducting this review since 2002, and are the only organisation – professional or academic – that reviews all FTSE 350 companies that follow the Code (our analysis excludes investment trusts).

Our Response

At Grant Thornton, we believe that the health and prosperity of the UK is dependent on the creation of a vibrant economy. For such an economy to work efficiently there has to be trust: trust between governments, communities and business, and between businesses and their stakeholders. Without this, regulation increases, risk premiums rise, decision making lengthens, investments stall, and cash circulation declines, all adding to the cost of capital. Ultimately, society pays in one way or another. Good governance is a fundamental enabler of trust and at its heart is promotion of transparency and accountability between all of society's constituencies. Corporate governance reform is one contribution that can help restore trust and improve business performance.

The UK promotes good governance practices through the Code that establishes a set of principles distilled from experience. Its strength lies in placing emphasis on encouraging engagement and buy-in rather than rigid, perfunctory or legal compliance. The guidance provides a flexible framework that recognises that companies' needs and circumstances differ, while using the compass of experience to set a true north against which the direction of travel can be measured.

We believe that the UK's corporate governance framework is a great example of how increasingly high standards of governance can be achieved without excessive burden, through a set of evolving principals and provisions underpinned by a requirement to comply or explain. Our overall findings highlight that the majority of companies take the Code seriously:

- 95% of the FTSE 350 comply with all but one or two of the provisions of the Code.
- 55% of non-compliant companies provide good quality explanations for not complying.

We believe that the further strengthening of governance practice and reporting requirements would contribute to the overall effectiveness of the boards of UK publicly listed companies. Further evolution of the existing code is to be encouraged to reflect learnt experience and the changing expectations of society but we believe the greatest improvements in governance practice can be achieved through the promotion of greater transparency. However, this can only be achieved through the provision of better quality, more insightful explanations, regardless of whether a company has complied, encouraged through regulatory oversight and investor pressure.

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

- For the Code to be effective it will require concerted effort from all interested parties but particularly the investor community in holding the companies to account. It is therefore important that requirements of the Code are co-ordinated with those that are to be incorporated into the Stewardship Code. Consideration therefore needs to be given to whether the Stewardship Code development will be sufficiently advanced at the time the Code is finalised.

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

- In general, we support the changes made to the revised Guidance and the addition of areas such as Culture and Stakeholder Engagement, showing a significant development from the 2011 guidance.
- It is expected that an organisation's culture and tone is set from the top, with the board responsible for both setting and monitoring the values and behaviours that determine a company's culture. This year, 56% of FTSE 350 chairs (2016: 39%; 2015: 22%), discuss culture and values in their annual report, either in their primary statement or in their introduction to the governance report. The biggest increase is in the latter, with 28% of chairs now mentioning culture in their introduction to the governance report, up from 17% in 2016 and 10% in 2015. However, this improvement should not overshadow the finding that 43.6% of company chairs still make no reference to culture. Thus, we propose that further emphasis be given to the chair's role in relation to culture including the provision of recommendations within the chair's role description in Provision 50.
- Currently the Guidance states that the chief executive has primary responsibility for setting an example to the company's employees and communicating to them the expectations of the board in relation to the company's culture: its values, attitudes and behaviours. Our research indicates that the number of FTSE 350 CEOs who discuss culture in their opening review has increased – up from 21% in 2016 to 29%. This increase is encouraging as a direction of travel but disappointing given the CEO is the primary setter of culture. Therefore, we suggest to put more emphasis on this in Provision 61 and recommend the CEOs to discuss how they act at embedding company's values at every level of the organisation.

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

- Broadly we agree with the proposed methods in provision 3, but we believe some further clarification is required to achieve meaningful engagement.
- This year our research assessed how many companies discuss employee engagement. Seventy seven FTSE 350 companies mention employee surveys in their annual report, with many doing so in the context of how they measure or address their organisational culture. Twelve companies state that they engage with employees, but do not explain

how. As disclosed in the annual reports, only one FTSE 350 company has an employee representative on the board, one has an employee council, and one has a non-executive director with responsibility for engaging with employees.

- Overall, we believe that the proposed methods are suitable for many companies to improve their employee engagement. However, we note that it will represent a significant change to existing practice.
- We also believe that if a director is nominated with responsibility for employee engagement the guidance could recommend that this be the SID. As a person who supports the chair in the delivery of their objectives and helps to maintain board and company stability, they are de facto next in line to the chair and have a high level of respect of the board. Their involvement would emphasise the importance of employee engagement and ensure sufficient attention is given to the matter by the board.
- Provision 3 requires the board to establish a method for "gathering the views of the workforce". We believe that this should be broader than just gathering the views. In order to achieve meaningful engagement, the board should not only collect employees' feedback but also review this information, respond, incorporate in their decisions or take necessary actions and communicate their response back to the workforce. Thus, we propose the role of the SID or another nominated person should expressly cover all these aspects.
- In relation to having an employee representation on the board, we are concerned that such a role on the board would present too many areas of conflict with their role as employee representative and their legal position as member of a unitary board. As all directors have the same responsibilities under the Companies Act 2006, the duty to promote the overall success of the company for the benefit of the shareholders would restrict the principal objective of advancing the interests of employees. Further, some tensions may arise between workforce representatives and other directors, regarding the motivation behind certain decisions, especially those on remuneration, site closures or employment disputes.
- We would suggest that if this is included as a recommended option, then the Guidance needs to include greater clarification about the role, responsibilities, skills and experience requirements.

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?

- Overall, we are in favour of the Guidance including reference to the SDGs and other principles, while making it flexible for companies to adopt and prioritise those that are most relevant to them. We do not believe establishing a specific set of principles should be the role of the Code, but that guidance should recommend that companies refer to the SDGs or similar principles, reference whichever of these principals is most appropriate to the organisation, and recommend the company explain why they are adopted.
- We would recommend that there should be a reference to them in relation to wider stakeholder responsibilities, with emphasis being placed on them being guidance rather than prescriptive.
- The importance of these goals and principles is also a key consideration when reviewing the Stewardship Code, as investors are a key driver. To an extent, market forces will determine that if investors deem a recognised set of principles important, then a particular reporting protocol will evolve as companies begin to adopt what is seen to attract investment. However, this should be taken into account when reviewing the Stewardship Code, to ensure the two Codes (and the Guidance) work together.

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?

- Based on typical voting patterns, 20 per cent would seem to represent significant dissent, and that an update should be published no later than six months after the vote.
- We noticed that Provision 6 proposes to publish a final summary in the annual report **or** in the explanatory notes to resolutions at the next meeting. We believe that it should be both: the board should provide the detailed final summary in the explanatory notes and a high-level explanation in the annual report. This would provide the shareholders with sufficient detail, while also giving an overview to all stakeholders.
- We have found in our research that shareholder engagement is an area of reporting that requires greater focus: over the last five years it has consistently decreased in quality and detail. The high level overview would improve reporting in this area, while preventing the annual report being made even lengthier with detail on voting.

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 intention of the change that an externally facilitated review is good practice given the stewardship role of the board and smaller companies should be encouraged to do so (or at least, should not be exempt simply because of their size).

- Key consideration should be given to the potential impact this has on independent board effectiveness providers, in particular their ability to add value to the board. Our data finds that the external evaluations of the FTSE 350 were led by 34 independent evaluators. For the last three years there has been a potentially unhealthy concentration in the market, with 60% of all externally-facilitated evaluations conducted by just four firms. This year the market narrowed even further, with 50% completed by the top three firms, and 39% of all reviews undertaken by just two. The majority of the remaining evaluators typically work with one or two companies. This is a difficult market for new boards to know how to choose from; we therefore feel that guidance should be provided to boards on what to look for when engaging an independent review to ensure that they get a fresh perspective, which adds value to their future effectiveness.
- We also observe from our research that reviews tend to be process based, and less frequently address the issue of behaviours. Given that smaller companies are likely to rely more heavily on methods such as questionnaires which are limited both in their scope and the value they can deliver, we are concerned that the requirement may not have the desired outcome of improving a board's effectiveness. We would suggest that the Code recommend that any evaluation should include a review of both board processes and behaviours and the need for behaviours assessment should be referenced within Section 3 (95) of the Guidance. This could be expanded in the Guidance to outline the need for a behavioural assessment to address capacity and capabilities, as well as behavioural dynamics. There should also be guidance to outline what is expected of reviews, and how these might vary between different kinds of organisation – if different reviews and outcomes are required for a premium listed for a smaller company review.
- Our research also shows that the quality of explanations around the outcomes arising from the board evaluation needs to be improved, as less half (47%) of the FTSE 350 provide any helpful insight around the outputs and actions arising from their board evaluations. We do support Provision 23 of the proposed Code, which requires the annual report to include a description of how the board evaluation has been conducted, detailing the outcomes, actions taken and how it has influenced board composition. The requirement could be clarified by inserting "actions taken *on previous evaluation*" and *"a timescale or plan for implementing changes following the most recent evaluation*".

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

- Yes – we believe 9 years is the maximum any director should be considered as independent.
- We believe independence is most important in relation to the independence of thought and challenge that an independent director brings to decision making. Although nine years is a good proxy for this, more emphasis should be given to independence as a valuable part of board effectiveness (in part to ensure the question of independence is not seen as a checklist). The Code could be strengthened through the inclusion of more explicit reference to such attributes Principle G could for example make reference to the need for independent, constructive challenge (separate from the reference in Provision 15 to what constitutes an independent director).

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

- We do not feel there is a need to set a maximum tenure for a director. Common practice tends to use nine years as a reasonable benchmark to judge tenure against, and in the majority of cases is an effective catalyst for refreshing the director pool. Comply or explain also allows companies to have exceptions while bringing it to the attention of the shareholders. Of greater concern would be if more than one of the independent non-executive directors (including the chair, under the suggested new Code) were to exceed the nine year term. The FRC may want to consider including this in the guidance.

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?

Overall we agree with the proposed changes in Section 3.

- Our 2017 Corporate Governance Review shows that 87% of FTSE 350 companies mention board diversity (apart from gender) in their annual reports, up from 42% in 2014 – though this area still requires more work. We welcome the proposed changes aiming at building diversity in companies overall and in the boardrooms as this can bring a level of challenge that will inevitably improve their effectiveness.
- We also found that in the years that the Davies' Review was being conducted (2011- 2015) there was an upswing in focus on gender diversity in annual reporting that has since been in decline. This suggests that companies were focused on this issue primarily to fulfil the target, rather than it being wholly reflective of a belief in the value of gender diversity or in long term systemic change. We therefore fully support greater emphasis being put on the need to explain how diversity supports the company in meeting its strategic objectives. We find that few companies sufficiently demonstrate the link between strategic objectives and board composition in their annual reports. An example is in the area of technology, which for decades has been considered an operational matter. Our research

shows that more than half of the FTSE 350 who report IT and technology as a key risk to their business (73%), do not disclose having technology expertise represented on their board.
- Looking at international best practices, we find that the most effective disclosures use for example, a skills matrix which incorporates an organisation's strategic priorities and links these to the skills available to the board. Others explain how they take into account their principal risks and strategic objectives when considering board composition. Further guidance including examples of good practice might help avoid the tendency to boiler-plating.
- We have some concerns regarding the use of the word "lead" in Provision 17. While the nomination committee may oversee and challenge the process for appointments and succession planning to senior management, being a committee consisting of non-executive directors, it is not appropriate for them to lead on operational matters below board level.

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 agree with extending the Hampton-Alexander recommendations beyond the FTSE 350 as they relate to reporting on the gender split of senior management and their direct reports. Given that gender pay reporting and gender split reporting is likely to overlap with this we do not believe it will increase costs or reporting.
- Our research shows that 21% of the FTSE 350 provided their definition of the senior management in the annual report, but there is a lack of consistency about what that entails. We therefore support the clarification of first layer of management below board level and direct reports.
- We are conscious however that this reporting requirement being located within the nomination committee report may lead to duplication of information in the strategic and governance report, which may contribute to the increase of the pages /words in the annual reports and the use boiler plate statements.

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.

- We are supportive of all actions that seek to promote greater diversity in UK companies as a means of increasing the pool of talent available in the executive pipeline. The role of the nomination committee is to address the availability of talent to address the company's strategic objectives, be it nurtured internally or recruited in and to explain its activities throughout the year in pursuit of this goal. The Parker Review has set out the challenge to UK FTSE 100 to introduce greater ethnic diversity. It would be remiss of nomination committees not to explain all areas of diversity that they are seeking to achieve.
- We are broadly in favour of encouraging companies to report on levels of ethnicity in executive pipelines, provided this is also put in the broader context of the organisation. This could be more effective if included as wider ethnicity reporting, rather than focusing solely on the executive pipeline. We do not have specific costings related to this;, however, there are a number of implications: as organisations are not required to hold details on employee ethnicity there is a risk that this could result in additional burden and incomplete data.

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 do not see any issue with keeping requirements in the current Code and duplicating with other areas, provided it is giving companies greater guidance as to what they should include. If it is direct duplication – for instance reference made to specific principles – it may be worth considering deleting duplications. The primary goal in any changes should be simplifying reporting requirements, while at the same time ensuring reports preparers and boards have sufficient guidance.

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.

- At least 97% of the FTSE 350 disclose that the terms of reference for the audit, remuneration and nomination committees are available for inspection. As this has become best practice, we agree with this change.

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 are concerned with the expansion of the remit for the remuneration committee, as taking on responsibility for the pay of the entire workforce is far too wide – particularly for the largest companies and those that are multinationals - and would be a distraction from the key remit of linking executive directors and management's reward to the achievement of strategy over the medium to long term. Further, the proposal runs the risk of the remuneration committee losing its independence by taking on a more operational remit of setting policy, rather than providing the appropriate level of independent challenge. We also question how in practice, such a remit could be achieved in a cost effective manner.

- Similarly, we are concerned that the responsibility for explaining how they have invested in and developed the workforce should remain the management's responsibility, rather than the remuneration committee's. Instead, the remuneration committee should have responsibility for making sure that such activities are clearly articulated and happen in practice.
- Our preference therefore would be for the remuneration committee responsibility to be restricted to taking into account the remuneration of the wider company and wider workforce policies.
- From a reporting perspective, such a wide extension of the remit for the remuneration committee is likely to lead to a significant increase in the size of the remuneration report already on average 20 pages. This could risk losing the focus on understanding managements' remuneration (an area that has been raised as a concern by the FRC and the Government alike).

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

- We believe this is an opportunity for the Code to specify that the remuneration committee should consider and report on how remuneration is connected to measures of success beyond financial means. Pay should be connected to for example, culture, strategy, longer term KPIs, non-financial ESG factors. Our research has found that while 96% of the FTSES 350 discuss connection between executive remuneration and company strategy, 37% discuss only financial metrics for performance-based remuneration. Only 20% discuss the link between strategy and remuneration in the strategic report, showing clearly how reward is linked directly to the achievement of its strategic objectives with clear, measurable KPIs.

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

No response

Other points

We would make the following additional comments not specifically addressed by the questions raised above:

- Principle A (Section 1) – We welcome the changes to Section 1 that expand the role of leadership to account for Section 172 director requirements as well as foregrounding purpose, strategy, values and culture. We also However we believe that the inclusion of the wording 'generate value for shareholders and contribute to wider society' after 'promote the long term sustainable success of the company' could be removed. By elaborating, this may it seems an attempt to specify what a measure of company success is. This could result in a company who has different priorities (for instance one which has a specific purpose apart from benefit to its shareholders) being non-compliant with the principle if it does not prioritise value for shareholders.
- Provision 11- we would like to bring your attention to Provision 11 which does not include any longer an exemption for companies outside the FTSE 350 and requires INEDs, including the chair, to constitute the majority of the board. We propose the FRC to clarify their intention here as current wording does not make it clear if a company is non-compliant when the majority of the board, excluding the chair, consists of INEDs.
- Provision 29 – it is unclear from the working of provision 29 how often this assessment should be taken: it is implied that the review happen annually, but this is not made explicit. We would suggest that the provision that a robust assessment of principal risks should be undertaken requires more clarification to reinforce the need to constantly assess and refresh a company's assessment of its principal risks.
- Provision 40 – A drafting point, but we feel that the alignment to culture is the most important of the points listed and so should be very much first in the list to emphasise its relative importance.

UK Stewardship Code Questions

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 principal of comply or explain has brought about gradual but sustained improvements in governance disclosures and we would suggest standards of practice. Further, our research has found over the last 16 years that good quality guidance tends to lead to better disclosure and, we believe, to better practice. We would therefore suggest that a Code which seeks to apply the same approach of distilling best practice gathered from within the investor community and promoting it within a code framework, underpinned by the principle of comply (or possibly apply) or explain, would ensure over time the evolution of stronger practice.

Q21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

- For the Code to be effective, the investors have to play their role in engaging with and holding companies to account for both their operational performance and governance practices. Transparency is therefore key to effective engagement. Equally, if investors are to be effective in this relationship, their own expectations and activities need to be framed within a code of practice that mirrors or at least reflects common goals and practices. It is therefore important that any code for investors is prepared in recognition that the goal of preserving and creating shareholder value is common to both. Further, any codes should acknowledge the common objective responsibility under S172 to consider the interests of wider stakeholders.

Q22. 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?

- As well as our response for Q21 (above), we would recommend that the Stewardship Code consultation explicitly consult on this area, and investors be encouraged to demonstrate what they are already doing in this area. Many of the major fund managers are looking to run some of their funds taking ESG into account, and the Stewardship Code should reflect this.

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?

Yes