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Proposed Revisions to the UK Corporate Governance Code
Financial Reporting Council
December 2017

We welcome the opportunity to respond to consultation on the Financial Reporting Council's proposed revisions to the UK Corporate Governance Code. Ten years since it was established, University of Exeter Business School is now one of the UK's leading institutions, with world class research and TEF Gold in teaching. Our students come from over 80 countries and go on to successful careers around the globe. We are accredited by both EQUIS and AMBA for the quality of our teaching and educational experience. Our flagship Exeter MBA programme was recently ranked number one in the world in sustainability by Corporate Knights. Alongside the MBA, we have research centres in Circular Economy, Leadership, Tax Administration and Simulation Analytics and Modelling.

This response is led by Professor Ruth Sealy, Director of the *Exeter Centre for Leadership*, in collaboration with the *Department of Accounting* of the University of Exeter Business School. Professor Sealy has been working in the field of diversity and leadership for over 10 years, at Cranfield and City University. A recognised expert in the field, she has contributed to the Davies Review, Hampton-Alexander Review, has authored the Female FTSE report for Cranfield for a decade and the FRC's reports on diversity in Annual Reports in 2012-2014. Professor Sealy has recently been commissioned by FRC to conduct a benchmark survey of diversity with FTSE 350 Annual Reports. That research will be completed in early summer 2018.

This response is the joint contribution of the following members of Faculty:

Exeter Centre for Leadership:
Ruth Sealy, *Associate Professor of Organisation Studies and Director of the Exeter Centre for Leadership*
Louise Tilbury, *Practitioner Research Fellow*

Department of Accounting:
Mark Billings, *Senior Lecture in Accounting and Business History*
Prof Gilad Livne, *Professor of Accounting*
Prof Giovanna Michelon, *Professor of Accounting, Director of Research (Accounting)*
Dr Maria Tsipouridou, *Lecturer in Accounting*

Response to Questions

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

No concerns.

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

Our specific comments on the Guidance are included in the consultation responses below.

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

We support the effort to include workforce engagement activities within the Code. We also note that the three suggested methods bear different weights in terms of how they may affect key board decisions. The proposed revised Code makes no attempt to define responsibilities for these directors, should a company adopt either of the methods "director appointed by the workforce" or "designated non-executive director". It is not clear what are his/her specific responsibilities (Section 2), whether he/she would be involved in the nomination and succession activities (Section 3), play a role in the audit oversight (Section 4) or remuneration setting (Section 5). The Guidance is also unclear on how the formal workforce advisory panel should work and how it should be composed.

The first part of Provision 3 requires companies to gather the views of the workforce, but it does not explain why this is desirable, what the purpose is, or why the workforce would be a preferred stakeholder to engage with, vis á vis wider stakeholders mentioned in Principle C. In other words, Provision 3 seems to lack clarity with respect to "what" views of the workforce are being gathered, i.e. whether the gathering of views relates to the engagement practice (Principle C) or the means of raising concerns (Principle D).

The Guidance reports that these methods are not the only possible, but this is not clear in the Provision. Whether the proposed or other methods are sufficient to achieve meaningful engagement is per se a question that would need to be investigated. However, research provides encouraging evidence. For example, our own archival study on a sample of US companies documents a positive association between the stakeholder orientation of the board and companies' social performance ranking (Mallin, Michelon and Raggi, 2013).

We acknowledge the legal issue raised in earlier consultation; UK company law does not distinguish between executive and non-executive directors or make any other distinction in terms of the responsibilities of directors; so, unless the law is changed, all directors, including these, have equivalent legal responsibilities.

Finally, we note that although Paragraph 33 mentions that "the term workforce is widely applicable" it is not defined here. However, we note the use of "for example" in this paragraph 33 suggests that the term includes suppliers, as long as they are individuals (i.e. self-employed contractors).

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?

Section 172 of the Companies Act 2006 is broadly drawn. It is therefore useful for companies to articulate how they comply with this section. Specific reference in the Guidance to the UN SDGs and other NGO principles would encourage companies to report in relation to such goals. The Guidance should also encourage companies to align recommended disclosures with the content of the Strategic Report as required by the Companies Act 2006 [Chapter 4A].

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 that 20 per cent is 'significant' although this figure is arbitrary. The threshold of 20 per cent of votes against a resolution does not consider abstain votes. It is possible that choosing to abstain is a soft form of shareholder skepticism/dissent vis á vis the board (Sauerwald, Van Oosterhout and Van Essen, 2016). Manifest itself calculates the dissent to management proposals as (Against + Abstain) votes. We therefore suggest that the threshold should be set considering also abstain votes, which may eventually lead to stronger opposition to management/board resolutions. As an update should be expected before the next annual report and AGM, six months is appropriate.

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.

In 2017 we conducted a research project on board evaluation, interviewing key board evaluators who between them conduct the majority of FTSE350 reviews. Our findings, published in Cranfield's Female FTSE Report (2017), strongly endorse the role of external evaluation in providing challenge and support to Chairmen, in response to individual company culture and dynamics. Therefore, we support the extension of the expectation that ***all*** *listed boards should have external evaluation every three years.*

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 agree. Tenure is considered one of the criteria to assess independence of individual directors. Whilst it does not necessarily equate to independence, we agree that as a general rule, tenures of longer than nine years should be the exception.

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

We agree, with annual election of the board of directors, it seems superfluous to provide a maximum period of tenure for directors.

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 strongly agree that overall these changes will lead to more diversity in the boardroom. The success of the Davies review demonstrates that with sustained action, progress can be achieved for women on boards. We particularly welcome the shift in focus to the executive pipeline, in line with the Hampton Alexander recommendations, and the use of a specific definition of senior management as Executive Committee and their direct reports, consistent with Hampton Alexander.

We also welcome the inclusivity of Principle J, with reference to the Equalities Act 2010 and protected characteristics. We are concerned that the inclusion of social, cognitive and personal strengths in this list dilutes the emphasis on equality and conflates the issue of constructing a team (cognitive and personal strengths) with other diverse characteristics. We note that social background is not a protected characteristic. Para 76 of the guidance might be a more suitable place for mentioning social, cognitive and personal strengths. Alternatively, the second sentence of Principle J could be split into two to give greater clarity to the intention here.

Our Board Evaluators Project (2017) included a recommendation for the Code to require companies to report on how the board evaluation has been conducted. This recommendation built on the analysis in the Walker Report (2009) which stopped short of a formal recommendation in this area:

"where an external facilitator is used, some form of attestation should be provided along lines that the board evaluation statement appropriately describes the evaluation process that was undertaken and that the terms of the evaluation statement are consistent with the outcomes from that process." (Walker, 2009: 66)

We are delighted that this has now been included in the Code at Para 23 Bullet 1. We suggest it might be helpful for the accompanying Guidance to include reference to observation of the board in Para 93. Our study found observation of the board to be the most important criteria for a quality behavioural board evaluation. Whilst we absolutely believe that the content of the board evaluation should remain confidential if it is to be honest and useful to the Chair, we believe there may be value in sharing what actions have been taken following the evaluation

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 strongly agree that transparency and reporting on the gender balance of the senior management and their direct reports will provide greater visibility and accountability for the board and investors on progress in this area. Many businesses now have targets for gender diversity in senior management. This should also be encouraged. We do not recognize costs of collecting data as a barrier to all listed businesses reporting on the gender balance of their senior management team and direct reports. From a research perspective, this step greatly increases the available data to track and hold listed companies to account for their gender diversity in senior management.

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 strongly supportive of the adoption the Parker Review (2017) recommendations into the Code. Learning the lessons of definitional problems for 'senior management' for this data to be useful in terms of monitoring and comparison, detailed best practice guidance will be needed on the collection and reporting of data on ethnicity. Following our response to Q.9, greater clarity to Principle J will aid the reporting against Para 23 bullets on pipeline and succession.

Based on the Parker Review methodology, we recommend that the Guidance refer to the process of self-identification as the recognized process for collection ethnic data. Where companies do not hold this data, we anticipate this requirement to report will lead to action. The rationale for reporting this data is exactly the same as gender, therefore reporting requirements should be aligned.

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. Although there is some duplication (e.g. on the main role and responsibilities of the audit committee in C.3.2 of the Code and Chapter 2, Part 16 of the Companies Act 2006), they complement each other. It is also helpful that they include footnotes where they clarify that.

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 do not agree. We believe that this information is of primary importance given the enhanced role of audit committees and their involvement in the financial reporting and auditing process. These disclosures improve transparency and help investors understand how audit committees operate. As boards are not required to follow the Guidance, we think this should remain in the Code.

The revision of the Code should consider the oversight of the audit committee (AC) over the external auditor's (EA) work. The governance role of the AC over the EA stems from the 2012 revision of the Code, influenced by the failure of auditors to warn of bank failures during the financial crisis of 2007-2009. The Code states that it is the responsibility of the AC "to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements." In addition, since 2012 "[t]he audit committee section of the annual report should include an explanation of how the committee has assessed the effectiveness of the external audit process" (FRC 2012 - Guidance on Audit Committees). The current proposal does not feature any changes to the AC's responsibilities. However, the recent failure of Carillion PLC without a warning from its auditors raises concerns about the efficacy of the existing regime and suggests a review may needed.

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 principle of the wider remit. It may pose practical difficulties, but in the absence of alternative mechanisms it is worth pursuing.

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

Paragraph 79 refers to the Culture Report and need for incentives "… to be aligned with the company's purpose, strategy and values …". Provision 41 of the proposed revised Code should therefore require remuneration committees to report explicitly on such alignment.

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

The changes would be unlikely to give impetus if a board is already minded to exercise discretion. But these proposed changes reinforce the point that there may be circumstances when it is acceptable to exercise discretion.

Response to the INITIAL CONSULTATION ON FUTURE DIRECTION OF UK STEWARDSHIP CODE

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.

The preceding paragraph (13) suggests "… it may be appropriate to highlight a select group of signatories … rather than individually assessing every statement". This appears to imply that best practice can be identified using some form of sampling, selection or classification. It is not clear to us how "best" practice can be established with confidence if using such an approach.

References

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