28 February 2018

Financial Reporting Council Consultation on Proposed Revisions to the UK Corporate Governance Code — Aviva Response

Aviva provides life insurance, general insurance, health insurance and asset management to 33 million customers worldwide. In the UK we are the leading insurer, serving one in every four households. Our global asset management arm — Aviva Investors — is a major long-term institutional investor with a wealth of experience in corporate governance and investor stewardship. By serving our customers well, we are building a business which is strong and sustainable, which our people are proud to work for and which makes a positive contribution to society. This response represents the consolidated view of Aviva plc, including Aviva Investors.

1. General comments

1.1. Aviva welcomes the opportunity to contribute to the FRC's consultation on revisions to the UK Corporate Governance Code. We believe that the Code has contributed to making the UK an attractive place to invest and do business. Although it continues to raise governance standards in its current form, we recognise that the business landscape has evolved since it was conceived and that a comprehensive review is now due.

1.2. The ultimate objective of the Code —promoting the long-term success of UK businesses — must be upheld, especially given the importance of maintaining the competitiveness of the UK post-Brexit. We believe that the flexibility offered to businesses by the Code's 'comply or explain' model is one of the key strengths of our corporate governance system and is therefore central to preserving the UK's competitive edge. We are concerned that some of the proposed revisions risk making the Code too prescriptive, taking away the flexibility for businesses to decide how they apply the Code's fundamental principles in a way that is right for them. We do not wish to see the 'comply or explain' model eroded so that the Code and Guidance in effect become viewed as mandatory.

1.3. We are also concerned that by suggesting that directors are required to act in the long-term interests of the company (rather than for the benefit of its members as a whole), the proposed Code will effectively move to change the interpretation of Section 172 of the 2006 Companies Act. While we are wholly supportive of the intention to promote long-termism, it is a matter for Parliament to make changes to the law, therefore the FRC must make sure that the final wording of Principle A is consistent with current legislation

1.4. With this in mind, there needs to be careful consideration of all proposed changes, to ensure they support the Code's ultimate objective. The current practice for non-executive directors to have a nine year time limit to be considered independent works well. However we are not supportive of the independence criteria, and therefore the time limit, also applying to the chair given the nature of their role. Likewise, we are not supportive of the proposal to widen the remit of the remuneration committee to oversee pay and incentives across the wider workforce. Whilst we recognise that public trust in business is in part related to perceptions around executive pay, we do not think that the purpose or likely effect of this proposed amendment has been clearly articulated.

1.5. We must take this opportunity to ensure that the Code plays an even greater role in fostering long-term, sustainable business behaviour — something which is central to Aviva's own strategy and values. To support businesses in placing sustainability at the core of corporate decision-making and governance, Aviva would like to see the UN Sustainable Development Goals (SDGs) explicitly included within the Code's Guidance as best practice.

1.6. We believe that the Code can go further in encouraging a more integrated approach to good governance, so that the individual components of a robust and progressive framework — board effectiveness, diversity, stakeholder engagement and so on — are more clearly tied together. This would help to address the approach often taken by companies when considering these issues, which is to consider them in silos.

1.7. Our response sets out some broad comments on revisions to the Stewardship Code and we will respond to the detailed consultation when it is published later this year. The Corporate Governance Code and Stewardship Code are inextricably linked —investors play a key role in raising the standards of governance in listed companies— and we would like to have seen the timetable for review of the two Codes aligned. As with the Corporate Governance Code, review of the Stewardship Code offers an opportunity to make some important additions. For example, we believe that material environmental, social and governance (ESG) considerations within investment decisions should be part of an asset manager's fiduciary responsibility to clients, and we would like to see this incorporated into the Stewardship Code.

1.8. We would also like the FRC to review the role of proxy advisors, with a view to ensuring that they carry this out in a more responsible way. Proxy advisors are more likely to adopt a one-size-fits-all approach when advising investors on voting. This does not align with the FRC's efforts to promote issuer-investor engagement and will continue to compromise the integrity of voting decisions.

2. General approach

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

2.1. We believe that the proposed Code application date is reasonable, given that the substantive changes to the content of the Code have already been subject to significant debate prior to the formal publication of the draft revisions. We expect FTSE350 companies to be in a position to begin reporting against the revised Code during the 2019 reporting season.

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

2.2. In general the Guidance strikes a good balance between outlining the specific expectations of boards, whilst facilitating their thinking around what good governance to support the long-term success of the business looks like. Given their importance, we believe the UN SDGs should be included as best practice in the Guidance. Consideration could be given to the Business & Sustainable Development Commission's[1] recommendation that the Board is accountable for overseeing a company's alignment with the SDGs.

2.3. We would also like to see certain elements of the new Code moved over into the Guidance, such as the three options set out for employee engagement. As set out in our comments in Section 1 with regards preserving the 'comply or explain' model, the Code should allow companies to identify the engagement practice which is best for them, instead of encouraging a 'tick box' approach against narrowly prescribed options. Whilst the three options could be provided in the Guidance, we would like the Code wording to make clear that these are not compulsory.

2.4. We suggest that the FRC also considers the following amendments to the Guidance:

- **Future industry trends and opportunities.** The ability of boards to understand and navigate industry macro trends as central to a business's long-term success. Therefore we would like to see the Guidance place greater emphasis on the subject of long-term strategy and explicitly outline how matters such as board composition, culture and diversity can support the delivery of this.

- **Stakeholder engagement.** The ICSA, The Governance Institute and The Investment Association have published joint guidance[2] to help company boards consider the interests of their key stakeholders when taking strategic decisions. Aviva is very supportive of the ten core principles set out in this guidance to guide a board's approach on this issue. The Corporate Governance Code Guidance references this document but we would encourage the FRC to consider including these core principles within the Guidance text.

- **Long-term investment plans.** We are concerned that companies have become overly short-term in their investment planning. We believe that boards should play a more active role in shaping long-term plans, which underpins the effective delivery of strategy and value creation. We would encourage the FRC to consider how this could be reflected more strongly in the Guidance.

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[1] BSDC, *Better Business, Better World*, January 2017

[2] ICSA: The Governance Institute & The Investment Association (2017), *The Stakeholder Voice in Board Decision-Making: Strengthening the business, promoting long-term success.*

3. Code Section 1: Leadership and Purpose

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

3.1. We welcome workforce engagement having an increased focus in the new Code. However as set out in our answer to Q2, we do not think the Code itself should be prescriptive about this. What is important is that the chosen mechanism supports the Code principle of effective and meaningful engagement.

3.2. Indeed as the consultation document states, the Government's Green Paper on Corporate Governance Reform recognised that 'there was no consensus on which of the three proposed options would work best' and that there should be flexibility for individual companies to choose the right mechanism for them. Companies should be allowed to determine this based on their specific circumstances, such as size, industry and geographical footprint. Aviva's model is the establishment of a workforce advisory council with a suitably wide, robust and transparent mandate.

3.3. As set out above, we are supportive of the ICSA and ISA's existing ten core principles for board stakeholder engagement and would also like to see these included in the Guidance. An important element of any engagement approach will be ensuring that employees receive appropriate training to enable them to fulfil their responsibilities in an effective and appropriate manner. It would be useful for the FRC or other relevant bodies to provide guidance on this.

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?

3.4. The UN SDGs have the potential to be an era defining multi-national agreement and offer a key opportunity to restore trust in business. It is an agenda that Aviva is extremely supportive of and we welcome the FRC's move to reflect the SDGs within the corporate governance framework. It is important that the SDGs are not viewed exclusively through a narrow financial lens, but within the broader context of stakeholder expectations, trust and social licence to operate.

3.5. Aviva Investors are founding signatories of the World Benchmarking Alliance, a powerful and potentially transformative set of corporate sustainability benchmarks that aim to measure and compare the performance of companies against the SDGs. Such benchmarks provide stakeholders with information they can use to inform investment and other economic decisions, increase transparency and facilitate trust between sectors, as well as creating a race to the top in corporate sustainability performance.

3.6. We recommend that the SDGs are included in the Code's Guidance. This would explicitly direct boards to consider how best to align corporate practices with the SGDs —and underlying benchmarks— whilst maintaining the principle of flexibility for businesses in the

Code itself. As referenced in Section 2, consideration could be given to the proposal that the Board is accountable for implementing a company's strategic alignment with the SDGs.

3.7. We further believe that implementation of the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations will enhance the UK's corporate governance framework and encourage long-term thinking throughout the investment chain. TCFD recommendations should be integrated and referenced within the Code, with companies reporting on a 'comply or explain' basis.

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?

3.8. We are supportive of this addition to the Code, with regards to both the 20 per cent threshold and six month timeframe.

4. Code Section 2: Division of responsibilities

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.

4.1. We are supportive of the removal of this exemption as we believe it is important to encourage best practice in companies of all sizes. The cost of external evaluations is only likely to be disproportionate for companies at the very lower end of the FTSE All Share. These tend to have a smaller number of large shareholders and will be reasonably well placed to communicate and justify any departures from the Code.

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

4.2. It is established practice for non-executive directors to have a nine year time limit to be considered independent and therefore we do not have an issue with this proposal. However, we are not supportive of the independence criteria, and therefore the time limit, also applying to the chair. The current code provision A.3.1 deals with this much better than the proposed change. We are not sure that a chair could be considered independent post-appointment due to the time commitment, nature of the role and the salary chairs are paid.

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

4.3. We agree that it is not necessary to set a maximum period of director tenure. However, this should be caveated with a responsibility for boards to communicate a clear succession plan which includes ensuring a balance of new, medium and long-tenured directors. High quality decision-making relies on a mix of institutional knowledge, experience, expertise and fresh thinking. Board refreshment and succession planning must be a strategic process, not simply triggered by an individual director reaching their nine year independence limit.

4.4. The Provisions could be updated to require companies to report on average tenure of the board as a whole, as well as for the non-executive directors. This will provide investors with a clearer view of a companies approach towards board refreshment.

5. Code Section 3: Composition, succession and evaluation

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?

5.1. We welcome the revised Code asking boards to intensify their efforts on diversity, both in terms of board composition and the executive pipeline. Linking diversity to a company's strategic objectives is a positive addition to the Code's Provisions. Aviva sees becoming a more inclusive and diverse organisation at every level as a business imperative. We believe that diversity makes commercial sense: it improves innovation, decision-making and the way we deliver for our customers. Indicative of this is the fact that in 2016 Mark Wilson, Aviva Group CEO, was the first FTSE 100 Chief Executive to sign up to the Executive Committee commitment to increase female representation on boards outlined by the 30% Club.[3]

5.2. We are supportive of the desire in the revised Code to ensure that boards also consider diversity not only in terms of gender but also social background and ethnicity. As in relation to gender diversity, targets, focused initiatives, transparency and accountability will help to catalyse change in terms of broader diversity. However, cultural factors have traditionally hindered diversity programs and this hurdle remains. We recommend that the Code and Guidance makes the case for the business benefits of diversity, such as better performance and decision-making, more strongly.

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.

5.3. The importance placed on diversity should not be determined by the size of a company and we agree with extending requirements beyond the FTSE 350. However it is understandable if smaller companies have less developed data and more limited resources to support new diversity initiatives. Therefore we would support phased reporting requirements for smaller 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.

[3] https://30percentclub.org/press-releases/view/aviva-commits-to-new-30-club-target

5.4. We know that increased transparency and reporting around gender diversity is helping to achieve progress. So the same approach in relation to ethnicity will be important in shifting deep-rooted and long-standing cultural employment biases. The FRC should explore how this could be addressed in an appropriate way, joining up with the work that the Government is doing to consider greater reporting around diversity.

6. Code Section 4: Audit, risk and internal control

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?

6.1. We agree that the current approach should be maintained, provided updates and revisions flow through in a timely and consistent manner.

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.

6.2. We have no objection to the requirement for the terms of reference of the Audit Committee to be moved from the Code to the Guidance document.

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?

6.3. Pay and wider workforce policies are of course critical to any business's long-term strategy and success. However we believe that responsibility for this sits firmly with the chief executive, executive team and HR functions. As such, we do not consider it appropriate for the remit of the board and remuneration committee to be extended to such matters, over and above their general oversight of the management of the business as a whole. This already includes ensuring that pay arrangements are consistent with corporate values and do not encourage excessive risk.

6.4. The role of the remuneration committee was established to manage the conflicts associated with the executive determining their own pay arrangements and we do not believe there is strong justification to fundamentally change the scope of its remit. However, we do think that remuneration committees need to ensure that the approach to executive pay and reward takes into account that of the general workforce. This requires a greater level of internal transparency and engagement in justifying pay and reward structures.

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

6.5. We acknowledge the challenge of balancing average executive tenure with long-term incentive plans. However, the board should use the full period of the business's strategic plan to define tangible and meaningful long-term milestones, which could then be aligned more closely with executive pay and reward.

6.6. We agree with the revision to the Code to make clear that in normal circumstances, shares granted or other forms of long-term incentives should be subject to a vesting and holding period of at least five years. We believe that five years should be considered the minimum. We still consider there to often be a gap between the business and capex cycle and the periods in which management teams are evaluated and rewarded. A sector where this is often a challenge is the oil and gas sector for example, where capital allocation decisions can only genuinely be assessed on a 10 to 15 year period.

6.7. Due to the plethora of variables that can impact a firm, there needs to be a much greater emphasis on the application of discretion and judgement by remuneration committees when retrospectively assessing performance. We welcome the additional language to this effect in the Code. We also recommend that:

- Remuneration committees determine a maximum level of absolute quantum that would be considered reasonable. This is particularly important for value creation plans.

- Sustainability factors become a more prominent part of variable pay, when these are material to the prospects of the business. Remuneration committees should spend more time in determining meaningful, measurable and externally verifiable indicators of success.

- Remuneration committees should broaden their approach to recruiting and retaining senior executives beyond simply pay. This is increasingly apparent in HR strategies for the wider workforce and there is no reason that it should not also be reflected at the most senior level.

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

6.8. The primary mechanism for holding directors accountable for their performance is through the annual re-election cycle. Shareholders should be encouraged to communicate concerns regarding the judgements exercised by the remuneration committee, and board more generally, through this mechanism.

6.9. There should not be a separation between the assessment of pay decisions and the competence of the individuals involved in the decision-making process. Should investors begin voting against directors more frequently for sub-optimal outcomes on pay, boards will be empowered and incentivised to provide a more robust assessment of performance and exercise discretion accordingly.

7. Future direction of the UK Stewardship Code

7.1. We have set out some broad comments on the Stewardship Code in this response, with the intention of providing more detailed comments when the separate consultation on this Code is published later this year. In our view, detailed review of the Corporate Governance Code and Stewardship Code should have been run on the same timetable, to be considered together.

7.2. For the Stewardship Code to have a meaningful impact on investment behaviour, there needs to be an equal focus on both the demand and supply of stewardship activities. Investment management is a service industry and ultimately its products and activities are shaped by the needs and requirements of clients. Therefore, we would strongly support initiatives to better embed stewardship principles along the whole investment value chain, from pension fund trustees, investment consultants, sell-side brokers and ultimately to the clients.

7.3. In light of the imminent implementation of the Shareholder Rights Directive, coupled with the on-going proliferation of global Codes, we would not support the development of multiple variations of the UK Stewardship Code. The existing Code can be revised to include an annex outlining specific principles and expectations for different categories of actors.

7.4. The Stewardship Code was originally designed to focus on the disclosure of policy and as such there has been less attention on investment behaviours and outcomes. We think there are two key opportunities to deliver higher quality reporting on behaviour and value delivered to clients:

- Firstly, we welcome the creation of a Responsible Investment Kitemark, akin to a 'fairtrade for finance' standard. The investment industry has made significant progress in improving its approach to stewardship, but commitments to principles are in themselves inadequate in creating the behavioural change required to build a thriving market that supports responsible business. The work to establish a credible and auditable industry 'kitemark', certifying robust and effective responsible investment standards, will help to create a competitive market and channel significant investment into responsible business.

- Secondly, more client focus on the relationship between engagement, outcomes, voting, and portfolio construction. This should result from efforts to instil Stewardship Code principles within manager selection and mandate monitoring. Again, we would caution against prescriptive reporting requirements, as this will more likely result in 'tick box' reporting. However, connecting stewardship reporting to commercial obligations to clients will lead to innovative, meaningful disclosures and enable qualitative differentiation.

7.5. There is strong academic and empirical evidence showing that environmental, social and governance (ESG) factors can have a material impact on investment outcomes in terms of downside protection and long-term value creation. Therefore we believe that the incorporation of material ESG considerations within investment decisions should be part of an asset manager's fiduciary responsibility to clients. We recommend that the Stewardship Code be revised to include language to this effect and require investment managers to report on their policies, approach and activities accordingly. This should be reflected in reporting against Principles 1, 3, 5, 6 and 7 of the Code.

7.6. Similarly, we support the recommendations of the EU High Level Expert Group on Sustainable Finance in respect of clarifying investor duties, so that long term sustainability is considered throughout the investment chain. We encourage the FRC to consider how these duties can be integrated within the Code.

7.7. Efforts to better align long-term liabilities with investment strategies has resulted in an increased focus on private markets and 'real assets'. Given the increased illiquidity within portfolios and direct ownership of physical assets, it is arguable that investment managers' commitment to responsible stewardship is of greater importance within these asset classes. We would encourage the FRC to consider how best to expand the scope of the Stewardship Code beyond equities and listed securities.

7.8. The Stewardship Code should not be amended to include specific reference to voting on pooled funds. We are supportive of the intentions behind the 'Red Line Initiative' as we consider the engagement of underlying beneficiaries of assets to be critical. However, there are a number of technical, operational and legal challenges involved in split voting on pooled accounts. We recommend that the FRC initiate a working group in collaboration with the Investment Association and other interested stakeholders to explore these challenges and identify practical solutions that can be implemented by the investment industry as a whole.

7.9. Judgements on materiality should be the primary determinant of which, and to what extent, ESG factors are considered as part of investors' stewardship responsibilities. Consequently, in general we do not consider it appropriate for the Stewardship Code to be amended to make specific reference to particular ESG risks and opportunities in policies or reporting. However, we would make one exception related to climate risks, which we consider to be the most significant systemic business risk and market failure of our time. We would encourage the FRC to explicitly reference climate risks within the Stewardship Code and encourage reporting on how climate-related considerations impact on capital allocation, engagement and voting decisions.

7.10. As well as being incorporated into the UK Governance Code, we would like to see TCFD recommendations also incorporated into the Stewardship Code.

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