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Response to the Consultation on the UK Corporate Governance Code and the initial Consultation on the future direction of the UK Stewardship Code

Dear Catherine,

Institutional Shareholder Services ("ISS") is pleased to have the opportunity to provide feedback on the proposed changes to the UK Corporate Governance Code (the "Governance Code") and also to provide views on the Stewardship Code (the "Stewardship Code") to which we are a signatory.

ISS is a leading provider of corporate governance solutions to the global financial community, including corporate governance research and voting recommendations for institutional investors (also referred to as proxy advisory services). More than 1,700 institutional clients globally rely on ISS' expertise in providing background research and voting recommendations to help them make more informed voting decisions. In the UK, ISS operates through its wholly-owned subsidiary, Institutional Shareholder Services (Europe) Limited, and has offices in London, Brussels, Paris, Berlin, Stockholm and Zurich.

Our comments below reflect our views in our capacity as a proxy advisor and thought leader in the area of corporate governance, and not necessarily those of our clients.

UK Corporate Governance Code

ISS agrees that the Governance Code has successfully helped to raise standards of governance in the UK, resulting in strong confidence in the UK's equity capital markets and helping to attract significant overseas investment. We also agree that now is an appropriate time to make some changes to the Governance Code to ensure it remains fit for purpose and to continue to improve the governance of UK listed companies. We have not responded to all of the questions in the consultation, but rather have focused on the specific areas where we consider our observations as a proxy advisor may be relevant and useful.

Firstly, there are three proposed changes to the Governance Code which are not specifically addressed in the questionnaire, but which we would nonetheless like to comment on given their importance**.**

- **Removal of provision E.2.4. 'The company should arrange for the Notice of the AGM and related papers to be sent to shareholders at least 20 working days before the meeting. For other general meetings this should be at least 14 working days in advance.**

We understand that the change is being proposed because the notice of meeting requirements are already addressed by Section 307 of the Companies Act. We, however, consider it to be in the best interests of shareholders, other stakeholders (including proxy advisory firms) and companies themselves for this guidance to remain within the Governance Code. This is because the Companies Act does not refer to 'working days', so the interpretation of this rule is that companies only have to give 21 (clear) days' notice (or 14 days for general meetings), which in practical terms results in a material difference. For example, if a

UK company scheduled its AGM for 29 March 2018, in accordance with the current Governance Code it would have to provide the Notice and related papers by 28 February 2018. If this Governance Code requirement were removed, a company would be able to announce the meeting as late as 7 March 2018 and would still be in compliance with the Companies Act.

This change will potentially impact shareholders significantly with there being much less time to review the proxy materials and make informed voting decisions. The shorter notice period would also create extra challenges for ISS and other proxy advisory firms with regards to their ability to provide their research to investors in a timely manner, further reducing the already compressed time that investors have to internalize data, information and research and make informed decisions. It would also disadvantage companies by reducing the already limited time available for both shareholders and other stakeholder to engage with companies in the run-up to the AGM (in contradiction to other proposed changes to the Governance Code which encourage just this type of interaction). The impact will be even greater for extraordinary general meetings, which are frequently called on short notice.

- **Under the section 'Reporting on the Code,' the proposed revision to the Governance Code states that 'shareholders and their advisors should also give companies sufficient time to respond to enquiries about corporate governance reporting'.**

Whilst ISS agrees that companies, investors and proxy advisory firms should work together to ensure the revised Governance Code is appropriate and impactful, we believe it is important to recognize that it is still primarily incumbent on companies to make high quality and fulsome disclosures to **all** their shareholders in respect of their corporate governance arrangements, and particularly any departures from recommended good practice. A company's shareholders (or their advisors) should not have to formally "engage" in order to get important explanations and all key information needs to be made available to all shareholders. We note that the investor clients of proxy advisors rely on their advisors to provide both accurate and timely information. The current timescales are already very limited in terms of being able to give companies more time to respond to shareholders or their advisors. In conjunction with our point above regarding the proposed changes to the meeting notice timelines, we would have concerns with any changes that may inject further timing delays that might impact the ability of investors to receive and properly process proxy materials and/or research from proxy advisory firms.

- **Provisions 24 and 32 (Audit and Remuneration committee composition).**

We welcome that under the revised Governance Code, it is now clearly stated that the Audit and Remuneration committees should be comprised of independent, non-executive directors only, particularly as several companies have challenged the interpretation of the Governance Code on this point.

CONSULTATION QUESTIONS

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

No.

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

Yes, although the success of such will also depend on the quality of company disclosures.

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?

Being aware of many publicly shared investor views in this area, we believe that the Governance Code should acknowledge the increasing consideration by both investors and companies of social and

environmental issues. We believe that amongst the characteristics of a well governed company is that it takes affirmative steps to ensure that its business is sustainable. As such, it should adequately assess and disclose the environmental and social impact of its business. We consider that specific reference to the SDGs would be useful in the Guidance.

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. Although some may encourage further research on this issue, we believe it is generally accepted in the UK institutional investor community that after 9 or 10 years of service at a company, a director has served enough time for their independent nature to be potentially compromised relative to that company, particularly if they have served concurrently with the management for all, or most, of this period. We would also note that, whilst we consider it is important to have clear guidance around the consideration of long-tenured directors as non-independent, we believe this should not necessarily result in long-standing directors stepping down from the Board in a mechanistic fashion, but rather only from the key committees. It is important to recognise that in certain cases (which need to be evaluated and explained by each company), a non-independent director serving on a well-constituted Board with sufficient independent directors can be valuable to the Board, especially a director who has numerous years of experience in the industry. For this reason we do not consider that providing a maximum period of tenure is necessary or appropriate.

We believe that assessing the board chair in the same way is a positive step. Under current Provision A.3.1, the independence of the chair is effectively only assessed on appointment ('thereafter the test of independence is not appropriate'). Our view is that the proposed change will promote greater independence among board chairs throughout the full length of their tenures, and also encourage more proactive and effective succession planning for this important role.

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

Yes, see answer to question 7.

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.

Yes, we agree it makes sense to apply this to companies beyond the FTSE 350. Diversity should be a consideration for all boards and if more companies are encouraged to improve gender diversity, it will ultimately help to address the concerns over insufficient gender-diverse candidate pools and pipelines. We consider that improved diversity can clearly be seen as strengthening boards and that extending the recommendation through the Code will encourage gender diversity and diversity as a whole to be integrated into board succession considerations in a way that will be positive for companies and their shareholders.

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.

In principle, improved reporting would be welcomed as it enables all stakeholders to form better views on the diversity in the company and to what extent this is improving. Certainly, the recommendation to address the inconsistencies in reporting is an important one. Encouraging companies to report on levels of ethnicity is a natural extension, but as alluded to in our answer to question 10, it is important to acknowledge that this is just one of numerous considerations that boards (and shareholders) may be evaluating when assessing board and senior management composition.

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?

Yes, we agree that remuneration committees have wider stakeholders to consider in their remit. We believe that these committees and their boards should decide how best to manage this (for example regular meetings with the HR team, among any other methods they have chosen to gather the views of the workforce), but how they do it should be evident to shareholders and wider stakeholders through the published remuneration report. This should include how pay is aligned with the culture and strategy of the business.

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

We believe that providing a meaningful proportion of remuneration in form of "locked" shares is one tool that would be beneficial to driving long-term sustainable performance. This is a fairly simple way to ensure Executives' interests are aligned with shareholders and naturally takes into account the satisfaction of other stakeholders. For example, if employee morale is low or customers are unhappy, the impact of poor productivity and financial performance will likely negatively affect the share price. The same applies to other considerations such as environmental and social issues to which companies are exposed, particularly in high risk sectors. Shareholding requirements that apply for some time post cessation of employment may also have merit as they will incentivize management to consider the impact of their strategy, decisions and succession plans after they have left the business. We are aware that some investors' public voting policies already express at least some of the aforementioned features and there is growing investor sentiment supporting the importance of boards promoting long-term value taking into account the social and environmental impact of their operations.

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

The requirement for the remuneration committee chair to have served on the committee before taking on this role is likely to provide shareholders with more confidence that the individual has sufficient experience in making pay decisions, including when considering the need to exercise discretion. Having a greater role to play in the remuneration of the wider workforce should also help remuneration committees to keep executive pay appropriately aligned within the company. However, we also consider that the current guidance already provides Remuneration committees with the flexibility to override formulaic outcomes and enable companies to recover sums or share awards. We consider that the annual advisory vote on pay will continue to give shareholders the opportunity to assess if and how Boards and Remuneration committee have exercised discretion, and to express their views on this, and that this is an appropriate mechanism.

Response to Initial Consultation on the future direction of the UK Stewardship Code

We also appreciate the opportunity to be able to respond to the FRC's high-level questions on the future direction of the Stewardship Code at this early stage. Although we understand that a specific and more in-depth consultation on the Stewardship Code will be organized later this year, we value the ability to provide some initial responses on the direction of the Stewardship Code and certain themes presented in the consultation document. We have not responded to all of the questions in the consultation, but rather have focused on the specific areas where we consider our observations as proxy advisors may be relevant and useful.

By way of background, since the introduction of the Stewardship Code, ISS has welcomed the clear set of practice guidelines it sets forth, seeking to enhance long-term shareholder value by promoting the engagement between investors and companies. ISS has been a signatory to the Stewardship Code since

2010. As the leading provider of corporate governance research, voting recommendations and proxy voting services to the UK and international investor communities, ISS places primary importance on conducting its business in a transparent, responsible and constructive manner, as we assist our clients in meeting their stewardship responsibilities.

CONSULTATION RESPONSES

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?

By way of background, it is important to clarify ISS' roles as a service provider to investors. The main aim of the Stewardship Code is to encourage effective stewardship by investors for the benefit of companies, investors and the economy as a whole. As such, the Stewardship Code focuses on the relationship between companies and their direct and/or indirect investors, where investors play an important role in holding the board to account for the fulfilment of its responsibilities.

As noted by the Financial Reporting Council, institutional investors may choose to outsource to external service providers some of the activities associated with stewardship. They cannot, however, delegate their responsibility for stewardship. ISS' research and voting services are designed to assist institutional investors in making informed voting decisions and actioning those effectively through the entire shareholder meeting and voting process. We note that the ultimate voting decision always remains the responsibility of, and is under the control of our clients, the investors.

While many of the Principles of the Stewardship Code do not have direct application to ISS as a service provider, through the products and services we offer, ISS can clearly assist our clients with their own efforts to comply with the Stewardship Code. ISS pays great attention to ensuring it conducts its business in a way that complies with the Stewardship Code where relevant, and, even more importantly, that we are in a position to offer our clients products and services that can help them with their own primary compliance with the Stewardship Code to the extent they are signatories. In that regard, our annual compliance statement, and this response for that matter, focuses on the ISS offerings that can be used to support the stewardship activities of our institutional investor clients in meeting the overarching goals of the Stewardship Code. We do not believe that a distinct code for service providers would enhance the objectives of, or compliance with, the Stewardship Code, as service providers to institutional investors provide many varied services which nonetheless could support stewardship objectives, depending on how investors chose to use them. In that regard, we consider that the current model of one Stewardship Code, focused primarily on institutional investors, and with service providers able to become signatories with respect to the support roles they can provide is an appropriate, helpful and proportionate model.

We believe the annual compliance statements from ISS and from other service providers under the Stewardship Code encourage service providers to develop and improve their service offerings to directly support investors in meeting their ever-changing set of stewardship responsibilities as responsible investors. With regard to changing responsibilities, this leads us into the following theme as part of the pre-consultation on the Stewardship Code: the Shareholder Rights Directive (the "Directive") raised in the FRC's discussion points relating to Q18 (see below).

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?

Notwithstanding the UK's decision to leave the European Union, we understand that the UK government is looking into transposing the Directive into UK company law. The Directive, which mainly aims to reinforce the notion of effective and long-term shareholder engagement and monitoring of company performance,

appears partly aligned with the overarching goals of the Stewardship Code. It is highly recommended that changes or additions to the Stewardship Code be assessed prudently to avoid duplication or complication in the regulatory landscape for both investors and their advisors who, by the nature of investors' often international investment portfolios, must often work across many different jurisdictions irrespective of where they are based. In the meantime, the Directive presents a large set of new regulatory requirements to institutional investors, which could even go beyond the suggested "comply-or-explain" framework. As such, we would support a prudent approach at this stage awaiting the transposition of the Directive into law to understand investors' responsibilities covered by law and best practice expectations not covered by law. The same approach seems sensible for Article 3j of the Directive where proxy advisors, such as ISS, will be required to publicly disclose reference to a code of conduct. As pointed out by Paul George, Executive Director, Corporate Governance and Reporting at the Financial Reporting Council, in its response to the Best Practice Principles for Shareholder Voting Research Consultation Steering Group, 'the principles are suitable as an appropriate code of conduct for adoption by the United Kingdom in fulfilling its obligation to implement the SRD, and the FRC awaits the decision of the UK Government as to how they wish to proceed on this matter'. Considering this new requirement for proxy advisors, we believe it would be prudent and in investors' interest to await implementation of the Directive and the establishment of a code of conduct for proxy advisors at a European level. Responsible investment, engagement and stewardship, and the notion of proxy advisors informing their clients about the accuracy and reliability of their services should be consistent across Europe and the United Kingdom. It is also within the framework of the subsidiarity principle that the European Union has decided to address encouragement of long-term shareholder engagement and enhancement of transparency between companies and investors at a European level. This would create a uniform set of rules for investors investing in Europe as well as a uniform transparency framework for proxy advisors. Hence, at this stage it might be premature to undertake at the national level initiatives for separate codes applicable to service providers, and more specifically proxy advisors.

Also, as mentioned above, the Best Practice Principles for Shareholder Voting Research are currently under review. The purpose of the review is not only to assess the implementation and content of the Best Practice Principles, to ensure that they are achieving the original objectives, and to identify where there is scope to improve practice and transparency, but the review is also considering what actions are needed to ensure the Principles are fully compatible with the mandatory requirements for proxy advisors operating in the European Union that are contained in the revised Directive, which takes effect in 2019. The review is being overseen by a steering group comprising representatives from the current signatories to the Principles, an advisory panel with wide stakeholder representation, and an independent chair, Chris Hodge.

Considering the review is ongoing and that the process will also be informed by Article 3j of the Directive, this review, in addition to the SRD implementation, further strengthens our belief that it is appropriate to await implementation and developments at a European level that could meet all expectations in a consistent way.

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?

We recognize in our growing range of services that many investors are increasingly taking into account a broad array of elements within the scope of responsible and/or sustainable investment. However, we also recognize that ISS has a broad and diverse client base on many levels (e.g. geography, size, investment/governance philosophy etc.), including differing views and approaches to responsible and/or sustainable investment. In our capacity as a service provider we do not advocate a specific position in terms of how investors should take their investment decisions and which elements should be taken into account in arriving at either their investment/stewardship decisions. Instead, our services are aimed at providing high-quality data, information and insight, along- side practical tools, that can be used by investors in

whatever way they consider appropriate and helpful for their own (often multiple) investment philosophies and approaches. Our services are aligned with supporting many different investor needs and standards worldwide, as well as ongoing initiatives at the EU level (e.g. the HLEG on sustainable finance), which aim at encouraging consideration of sustainability in the investment process.

ISS' comments to this consultation represent our views in our capacity as a proxy advisor and thought leader in the area of corporate governance, and not necessarily those of our clients.

We hope that you will find our comments useful, and we are available if you would like to discuss anything in further detail.

Yours sincerely,

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