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The Financial Reporting Council
8th Floor, 125 London Wall
London EC2Y 5AS
By email: codereview@frc.org.uk

Financial Reporting Council Consultation:
Proposed Revisions to the UK Corporate Governance Code
ICGN submission

The International Corporate Governance Network (ICGN) is a global investor-led body based in London, whose mission is to promote high standards of governance in companies and responsible investment practices by investors, with a long-term perspective on sustainable value creation. This mission extends systemically to promoting efficient financial markets and economies world-wide.

ICGN was established in 1995, and today our network of governance professionals spans over 45 countries and includes investors representing assets under management in excess of US$26 trillion. Our policy positions are guided by the ICGN Global Governance Principles and the ICGN Global Stewardship Principles, both of which have been developed in consultation with ICGN Members and as part of a wider peer review.

Proposed Revisions to the UK Corporate Governance Code

ICGN is pleased to respond to the Financial Reporting Council's (FRC) consultation regarding its proposed revisions to the UK Corporate Governance Code (Code). The UK is an important market for ICGN, as many of our Members are based in the UK, and an even larger group of Members are investing in UK listed companies. We recognise the leadership the UK has shown in the evolution of its own Code, with predecessors dating back to the Cadbury Code of 1992 to the Code of the present day. This series of Codes has helped to shape thinking about corporate governance globally. It has proven to be a positive influence for UK markets, and has also been regarded as a global standard by many outside the UK. To keep the Code fresh and effective in promoting good corporate governance, it is appropriate to periodically consider revisions to the Code, and we recognise in particular the linkage of this new Code consultation with the UK government's recent review of corporate governance standards in the UK. On the whole, we welcome the reduction of Principles and Provisions in the new Code, and believe the attention given to stakeholder relations as a matter of corporate governance is appropriate.

Saffron House 6-10 - Kirby Street - London - EC1N 8TS - UK
VAT No. 927 1665 09 | Registered in England No 6467372
t: +44 (0)207 612 7011
f: +44 (0)207 612 7085
e: secretariat@icgn.org
w: www.icgn.org
@ICGNCorpGov
ICGN

Comments on the draft Corporate Governance Code

Section 1: Leadership and Purpose

We support the emphasis of this section on the long-term sustainable success of the company, and the importance of linking a company's success to its purpose. In particular we support the language that states that "the board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned." We believe this new language should encourage companies and boards to pay attention to their social impact and impact on their stakeholders—both of which we believe are relevant to companies' sustainable value creation.

However, introducing the term "purpose" to this heading invites greater clarity as to how this term is defined. Moreover, the phrase "contribute to wider society" in Principle 1-A is very broad in scope and raises questions about what is meant by "contribute". In particular, it suggests a possibly different or extended formulation to director duties, as compared with those defined in Section 172 of the Companies Act. We believe that the Code and the Companies Act should be consistent in their approach to directors' duties, and would caution against leaving scope for differing interpretations of what is meant by the role of companies and directors in contributing to wider society. We would also note that in the medical profession the professional oath is to "do no harm", which dictates an ethos and conduct of behaviour without the burden of having to define what it means to do "good." A similar formulation might be helpful in this regard for purposes of the Code.

In light of the above, FRC may wish to clarify its views on the purpose of the firm and the relative positioning of shareholders versus stakeholders that may come from this Code review—in particular, is the shareholder primacy model or "the enlightened shareholder value model" still embraced, or is it being redefined? We support the emphasis on values integrity and culture that are outlined in this Section, but would also note that these qualities, while real, can be difficult to become realised in company governance if the tone at the top is not there in the first place.

In Provision 3, we believe it does make sense for boards to understand views from the workforce, and it is important that flexibility is granted about which approach would work best for individual companies. The workforce is a critical stakeholder for long-term company success, but companies and workers must remember that the workforce of one of a number of important stakeholders—and the workforce should not become the board's proxy for all stakeholders. It is also the case that the three options listed may not be the only ways to address stakeholder issues, and the Code may wish to encourage greater flexibility on this point.

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In Provision 5 we strongly support the idea of the chairman and committee engaging with major shareholders. While the role of the Senior Independent Director (SID) is discussed elsewhere in the Code, you may wish to make reference to the SID in this Provision, particularly given the active role that many SIDs play – or should play-- in shareholder engagement. Otherwise this runs the risk of diminishing the role of the SID.

We support Provision 6, as it gives more teeth to investors and the voting process. A 20% opposition is significant, and it is appropriate that companies are required to respond to this level of investor dissent.

In Provision 8 you may also wish to add reference to the SID here.

Section 2: Division of Responsibilities

We agree on the articulation of director responsibilities, and agree with the focus on importance of culture and openness as an important feature of effective boards. We support Provision 11 calling for an independent majority of directors on the board, particularly for widely held companies. But we also recognise that controlled companies may resist surrendering majority control, particularly if their ownership stake is greater than 50%. The FRC may wish to clarify if this new majority provision is to apply to companies with controlling owners, as well as for smaller quoted companies complying with the Code.

In Provision 15, the FRC is proposing to change the way that the Code defines “independence”. Specifically, in Provision 15, the proposed new approach is that a director “should not be considered independent” if any of the seven listed criteria apply. This is a change from the current approach, under which (i) those seven criteria are matters that boards should take into account in their assessment of independence, and (ii) the board needs to explain its position if independence is determined despite the existence of one of the criteria. The change may appear subtle, but in practice it is likely to be significant, particularly with regard to the time based criteria, where a nine year limit is a crude, if not arbitrary, test for independence.

Currently, a board can make a balanced, good faith, determination that a director is independent despite the existence of one of the criteria. For example, the director may have been on the board for 10 years (one year longer than the nine-year criterion). Currently, that director could still serve on the audit committee or the remuneration committee, and the company would “comply” with the Code provisions calling for 100% independence on those two committees. Under the proposed new approach, if a 10-year tenured director were to serve on the audit committee or the remuneration committee, the company would have to disclose that it did not comply with the 100% independence provision for those committees. That in turn could trigger votes against that director under investor voting guidelines.

In light of the above, while we support the general emphasis on independence and board/committee refreshment, we do recognise the value (and often independence of mind) that longstanding directors can bring. Hence, we are concerned that this more rigid definition of independence might be overly prescriptive and could in cases result in unintended consequences, particularly if applied equally to the company's chairman as to other non-executive directors.

Section 3: Composition, succession and evaluation

We are generally supportive of this section, including the provision for majority independence in the nomination committee and annual director elections and board evaluations.

Section 4: Audit, risk and internal control

We support the emphasis on audit quality, control and risk management, but given the Code's new emphasis on stakeholders the language in this section may be too narrow. There is scope for this section to more substantively include stakeholder, or ESG-related , risks in the context of overall enterprise risk management. For example, while non-financial risks are briefly mentioned in Provision 29 they do not feature prominently in the purview of the board or its audit committee.

We support Provision 24 calling for 100% audit committee independence, but we believe the Code could be tougher, or at least clearer, on membership qualifications. It may not simply be enough to have one member with recent and relevant financial experience. We believe that every audit committee member should be financially literate, and that audit committees should not allow any member to be lacking in financial understanding. The final sentence of Provision 24 is awkwardly written, and it there may be better clarification on what is meant by "the committee as a whole".

In Provision 28 the board's assessment of its risk management and internal controls could be expanded to include self-assessment of board expertise in the field of risk, and whether or not a dedicated expert or stand-alone risk committee might be appropriate, though we would not suggest being prescriptive on this point.

With regard to Provision 29 the Code is silent on systemic risks that companies and economies face that may also impact on sustainable value creation. This might include financial sector stability, climate risk, or social risks prompted by income inequality, human rights abuses and forced migration. These are also the types of issues addressed in the UN's Sustainable Development Goals (SDGs), and there is increasing focus on how it can be to the self-interest of the private sector to address these systemic risks. This is a new area of focus at ICGN and we believe that boards and audit committees of companies will increasingly focus on those SDGs that are relevant to the company's long-term performance and its business model.

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Section 5: Remuneration

With regard to Principle O we appreciate the importance of the board ensuring proper alignment with regard to workforce pay, as part of its broader understanding of the workforce as a key stakeholder. However the Code may wish to clarify that this broader workforce perspective does not also bring with it operational decision making regarding workforce pay, as this should remain with the company's executive management.

We support Provision 32 calling for a fully independent remuneration committee and that the chair should have served on a remuneration committee for at least 12 months—preferably at the company itself.

Capital Allocation: a missing item?

There is a clear corporate governance dimension to capital allocation; however the Code is silent on this topic. We also note that the Department of Business, Energy and Industrial Strategy has announced a review of share buybacks as a possible mechanism for executives to inflate their own pay. The FRC may wish to consider incorporating the issue of capital allocation more explicitly into the new Code it is developing—if nothing else to call for companies to disclose their buyback and capital allocation policies as part of their annual reporting practices. From a stewardship dimension, it is also relevant for shareholders and creditors to feature buybacks-- and capital allocation more broadly-- as topics for engagement with both company executives and non-executive directors. In particular, shareholders with voting rights should be prepared to use these rights to vote against buyback transactions that may have the effect of asymmetrical rewards to company managers at the expense of other investors and the company's own long-term financial health. This topic could also feature in the FRC's forthcoming review of the UK Stewardship Code.

Consultation Paper Questions:

We respond below to some selected questions in the consultation paper which complement our comments above on the proposed new Code.

- Q 4: Sustainable Development Goals. We note in earlier our comments on the new Code: "With regard to Provision 29 the Code is silent on systemic risks that companies and economies face that may also impact on sustainable value creation. This might include financial sector stability, climate risk, or social risks prompted by income inequality, human rights abuses and forced migration. These are also the types of issues addressed in the UN's Sustainable Development Goals (SDGs), and there is increasing focus on how it can be to the self-interest of the private sector to address these systemic risks. This is a new area of focus at ICGN and we believe that boards and audit committees of companies will increasingly focus on those

SDGs that are relevant to the company and its business model." From a fiduciary duty perspective, it is important that SDGs are considered with regard to how they may help individual companies' own sustainable value creation, thereby providing benefit to investors and their end beneficiaries.

- Q5: 20% vote. We agree that this is significant and it warrants the form of company update that is proposed. This gives some teeth to minority shareholders in the voting process.
- Q6: Annual board evaluations for smaller companies. We appreciate how that some small companies might find this prescriptive, but we believe that board evaluations are positive and that an independent evaluation every three years is a healthy exercise, and need not impose a great cost.
- Q7: Nine-year rule. As discussed above in our comments on the Code, the nine-year rule has good intentions, and is a not unreasonable line in the sand. But it is ultimately arbitrary, as some directors may lose their independence of mind well in advance of nine years and others may retain independence of mind well beyond nine years. It is important to recognise this is a rigid system and can produce unintended consequences. A 9-year independence test is particularly problematic if this test is applied to the chair (especially as the 9-year clock begins on appointment to the board, not on appointment as chair). It is increasingly common for a chair to have served on the board as a non-executive director, before being appointed as chair. But if this individual would have been on the board as a NED for four or five years, this new approach would mean he or she could only serve for four or five years as chair. And that fact may rule out good candidates or bring successful chairmanships to a premature conclusion.
- Q14: Remuneration committee remit. We believe it is sensible for remuneration committees to expand their purview to have a better grasp on workforce pay and how it may link to executive pay. But this should not be a slippery slope for involving non-executive directors in decisions that should be made by company management. With regard to pay ratios (your point 88) if these are to be introduced it may make more sense to make the common denominator the average per capita income in the UK, as opposed to the individual company's own workforce. That would reduce the potential for manipulating the ratio, and also make for a more meaningful basis of comparison with companies in other sectors.

Initial Consultation on the Future Direction of the Stewardship Code

- Q17: Separate Codes for different participants. We would encourage there to be one Code, taking a holistic approach. But this holistic code could include bespoke sections on individual entities in the investment chain. We would note, as an example, that ICGN's Global Stewardship Principles contain a section on the "ecosystem" of stewardship, including commentary on the individual roles of asset owners, asset managers, companies, regulators and service providers (proxy advisors and investor consultants) in the stewardship process.

- Q20: Mirroring the Stewardship Code with the Corporate Governance Code. As the various aspects of stakeholder relations and company application of Section 172 in the Corporate Governance Code are confirmed, there should be an appropriate dimension to the Stewardship Code on these points.
- Q22: Wider stakeholders and societal impact. Reflecting the UK government's emphasis on stakeholders in its recent review of UK corporate governance, Statement 4 of the Introduction states that the revised Code "encourages corporate governance policies and practices that generate value for shareholders and aim to benefit society." Introducing the dimension of social benefit is an important new development, and may call for greater clarification from both companies and investors as to what this means in practical terms. The increasing investor integration of ESG factors into the stewardship process in many ways addresses the question of investors monitoring stakeholder and company social impact. So apart from possibly recognising ESG as a core principle to the UK Stewardship Code, we do not think the Stewardship Code needs to be more explicit about the company's "wider stakeholders".
- Q 25: International stewardship codes. We are pleased to see the consultation make reference to ICGN's Global Stewardship Principles (GSP), which provide a global framework for investor stewardship, endorsed by ICGN members. As the consultation document suggests, ICGN's GSP prioritise investor governance as a driving principle of stewardship, and we believe that investor governance could be more robustly reflected in the revised UK Stewardship Code. As suggested above we would also encourage the UK Stewardship Code to more explicitly articulate the importance of ESG integration as a component of good stewardship; this is at the core of one of ICGN's seven stewardship Principles.

In conclusion, ICGN applauds the efforts of the FRC, and we hope that our feedback and comments are helpful in your deliberations. Should you wish to discuss our comments further, please contact me or George Dallas, ICGN's Policy Director, by email at george.dallas@icgn.org.

Yours faithfully,

Kerrie Waring,

Executive Director, ICGN

Copy:

Catherine Jackson, Co- Chair, ICGN Board Governance Committee: catherine.jackson@jacksonpg.ca

Carola van Lamoen, Co- Chair, ICGN Board Governance Committee: c.van.lamoen@robeco.nl