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The Governance Institute

ICSA: The Governance Institute

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Dear Catherine

ICSA response to the Financial Reporting Council (FRC) consultation on Proposed Revisions to the UK Corporate Governance Code (the Code)

We welcome the opportunity to comment on the proposed revisions to the Code.

As you know, ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including the development of governance policies, the application of and compliance with the Code and supporting the board on all governance matters. Our members are therefore well placed to understand the consequences of the proposed revisions to the Code.

In preparing our response we have consulted, amongst others, with a number of groups of our members, including the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250, and a group of members working for some of the major investors. We have also benefitted from the views of members in our Australian division, where the 'if not, why not' model addresses some of the concerns sometimes expressed about 'comply' or 'apply' and 'explain'. However, the views expressed in this response are not necessarily those of any individual members of any of these groups, nor of the companies they represent.

We set out below some general comments, followed by our responses to the specific questions set out in the exposure draft and then some suggested textual amendments which will, we hope, make the new Code clearer to the average reader.

PART 1 – GENERAL OBSERVATIONS

In the vast majority of cases, we support the proposed revisions to the Code. Most of the changes appear sensible and useful and we particularly welcome the focus on board composition and refreshment and on culture. Our concerns about some specific revisions, highlighted below, should not be seen to detract from the excellent work that we believe the FRC have, overall, delivered in their review of the Code. Above all else, we would commend the FRC for retaining the focus on the 'comply or explain' model rather than seeking to impose rules. 'Comply or explain' is especially important in terms of the flexibility that it gives companies to make the arrangements that suit their particular circumstances rather than being forced to adopt a 'one size fits all' approach and then to explain to shareholders why those arrangements are appropriate. Shareholders and their advisers should then give proper consideration to alternative governance arrangements, appreciating the 'comply or explain' nature of the Code. We will revert to this point in our comments on the Stewardship Code below. The emphasis on the importance of culture is also important.

Directors' duties

Principle A states that "A successful company is led by an effective and entrepreneurial board, whose function is to promote the long-term sustainable success of the company, generate value for shareholders and contribute to wider society. The board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned." (our underlining).

We support further consideration of the balance of directors' duties between shareholders and other stakeholders, but do believe that the Code should be aligned with the statutory requirement. As drafted, this principle would appear to extend directors' duties beyond those set out in s172 Companies Act 2006 (the Act), to: "act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) ...."

We are concerned that a recasting of the role of the board in this way will create the potential for confusion and suggest that the Principle be reworded as follows:

A: A successful company is led by an effective and entrepreneurial board, whose function is to promote **the success of the company for the benefit of its members as a whole, having regard to the directors' legal duties under section 172 of the Companies Act 2006.** The board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned.

If, in the future, the wording of the Act is amended, the Code should then be amended to bring it into line.

Responsibility for the information provided to the board

The new Provision 10 states that "the chief executive is responsible for … ensuring timely and balanced information is presented in order for the board to make decisions effectively." In the current Code, the Supporting Principle under A3 and the Main Principle and Supporting Principles under B5 require that the board be supplied with appropriate information to discharge its duties and gives responsibility to the chairman to ensure this is provided. Supporting Principle B5 puts the obligation on management to provide such information.

We are concerned that this change may be interpreted as passing responsibility for deciding what 'balanced information' is presented to the board from the chair to the chief executive. We agree that the chief executive must provide all the information the board needs, but it is important that the chair decides what information should be provided to the board. We suggest that the wording of Provision 10 is amended to read 'The chief executive is responsible for … ensuring timely and balanced information**, including all information requested by the board or the chair,** is presented …'

Our concern is that the type of company who may misinterpret the Code in this way is exactly the sort of company by whom it should be applied. The board should have an absolute right to receive any information that it requests.

Independence and the role of the Chair

Provision B.1.2 of the existing Code provides that "Except for smaller companies, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors." The impact of removing this exemption could necessitate the appointment of additional non-executive directors (NEDs) to the boards of smaller companies, with associated cost, particularly if the board does not consider the chair to be independent. We note the proposal for the chair to be treated as an independent director for this purpose, on which we comment below, but are not convinced that an argument has been made for this change.

Provision A.3.1 of the current Code provides that "The chairman should on appointment meet the independence criteria set out in B.1.1 below…" The proposed revisions state that the chair should be regarded as independent if he or she fulfils the independence criteria set out in the revised Code. Previous Code requirements have always been that the chair be 'independent on appointment', which we believe is appropriate. The requirement to fulfil the criteria set out in the Code to establish independence ignores the unique role of the chair, and the importance of the role to both the company and the individual holding the position.

The impact of the changes proposed in the new Provision 11 is to require the chair to be one of the independent directors. This would reduce the requirement for independent NEDs as the chairman would now count as one, rather than being outside the calculation, which might help smaller companies if their exemption from the requirement to have a majority of independent directors is to be removed but, if this is the intention, we think it brings unhelpful consequences. For example, it is not unusual for the chair to act as interim CEO in the event of an unexpected vacancy whilst a successor is being sought, which would breach these independence criteria.

The chair's role is unlike that of other NEDs and is more akin to a part-time executive. The chair spends a great deal more time in the company, receives substantially higher fees than any other NED and has a unique relationship with the chief executive and finance director which is likely to lead to the chair being intellectually and emotionally invested in their success. There is an argument that the time that the chair and CEO have worked together is more important than the length of time that either of them have spent on the board. Whilst we would always expect the chair to behave independently, these factors all compromise the chair's objectivity from a practical perspective. Whilst he or she should continue to fulfil the independence criteria set out in the revised Code on a 'comply or explain' basis, we do not believe this is sufficient for him or her to be clearly perceived as independent in the same way as other independent directors.

Should the chair be regarded as independent as proposed, we believe that this will also cause confusion with the role of the senior independent director (SID). Part of the SID's role is to act as an 'independent sounding board' for the chair and, if the chair is regarded as independent, there would seem little need for this.

We would suggest that this provision be amended to read; "**Except for smaller companies,** independent non-executive directors, **excluding** the chair, should constitute the majority of the board. With reference to Provision 15, the board should identify in the annual report each director considered to be independent. The chair should hold meetings with the non-executive directors without the executives present."

Independence of directors

We are firm believers in the need for regular board refreshment and for both increasing and diversifying the pipeline of board-ready candidates as well as widening the pool from which potential directors are drawn. However, we do believe that the removal of the board's judgement over the independence of NEDs is unhelpful, as we believe the board is best placed to assess the independence of individual NEDs and the circumstances of their appointment, and to explain this appropriately.

It is important that the board review not only the independence but also the contribution of all directors. This should be done as part of the annual evaluation process with, perhaps, a more rigorous assessment at the end of each of the traditional three year cycles. It has been suggested to us that there is a risk that NEDs will begin to see nine years as the normal length of appointment but we do not believe this should be the case. As businesses change over time, we would expect the required competencies and skills of the directors to change too. It is striking that nine years is rather longer than most viability statements.

In the report that we produced with EY in 2016, Coming out of the shadows[1], we talked about the nomination committee looking at the skills that current board members have, and the need to compare those with the skills that the company's strategy will require the board to have in three or five years' time. The committee will then need to look at how any identified gaps will be filled, whether by training the existing directors or by appointing new directors with those specific skills. That process will mean that, in turn, some of the existing skills may no longer be necessary in five years' time and that is, in our view, a nettle that the nomination committee should grasp. Conversely, we see no reason why a particularly effective NED who has served nine years should not continue to serve while their skills are needed, but this would be exceptional and should be fully explained in the annual report, especially were the company to regard that individual as still independent. Equally, we would like to see companies taking the opportunity to bring in a new 'junior' independent NED, perhaps from an unusual background who could then retire after a short term if no longer needed.

Whilst we accept that it is appropriate for each director's independence to be subject to additional scrutiny after nine years' tenure, we do not believe it is appropriate that the chair's time as a NED prior to appointment as chair be included when tenure is assessed. The role of chair is very different from that of a NED and this could result in a chair being regarded as having 'served his time' at a point where he or she is likely to be at their most effective.

We appreciate that this provision is subject to the 'comply or explain' rule, but some investors and, particularly, their advisers tend to be rather more black and white than that – and a provision of this sort then becomes a 'box-tickers charter'.

[1] https://www.icsa.org.uk/assets/files/policy/research/ey-nomination-committee-digital.pdf

We would, therefore, suggest the insertion of the word 'normally' in provision 15 – "Individual non-executive directors, **excluding** the chair, should not **normally** be considered independent for the purposes of board and committee composition if any one of them …"

We have one other point on this provision. It is not at all unusual for directors to have *'cross-directorships or significant links with other directors through involvement in other companies or bodies'*. Directors of companies have specific skills, gained over a career spanning many years at a senior level in companies. It is therefore likely they will have connections through other companies and/or bodies. Currently, such connections are managed, where necessary, though other governance mechanisms put in place by the board and, where necessary, agreed with major shareholders. As drafted, Provision 15 would remove the board's discretion in such circumstances and it would become more difficult for companies to appoint new NEDs. 'Significant' is of course a very subjective term, and 'other companies or bodies' is a very wide one. We believe that this should be clarified in the Guidance as, otherwise, there will always be the risk of companies being second-guessed, probably with the benefit of hindsight, around what may have seemed a perfectly reasonable position to take at the time.

If, as we understand to be the case, the point on cross-directorships is intended to address situations where both executive and NED roles are concerned, this should be clarified either in a footnote to that effect or in the Guidance. We believe that this bullet point should be reworded to:

- **has significant links with other directors through** cross-directorships[FN] or involvement in other companies or bodies;

[FN] For these purposes, 'cross-directorships' mean situations where both parties serve as an executive director on one board and a NED on another. It does not include a situation where only NED roles are concerned.

Induction and training of directors

Section B4 of the existing Code makes much of the need for all directors to "receive induction on joining the board and should regularly update and refresh their skills and knowledge." Supporting principles and provisions place responsibility on the chairman for ensuring that this happens. Whilst we are sure that the majority of companies will continue to comply with this requirement, we are not convinced that there should no longer be any reference to induction or ongoing development in the revised Code.

We would suggest that Principle I be enhanced as follows: "The board and its committees should have a balance of skills, experience, independence and knowledge. Board membership should be regularly refreshed. **Board members should receive tailored induction from the company secretary on joining the board and should regularly update their skills and knowledge."**

This could be supported in provision 22 with an addition to the effect that: "The chair should act on the results of the evaluation by recognising the strengths and addressing any weaknesses of the board. Each director should engage with the process and take appropriate action when development needs have been identified. **The company secretary should work with the chair and the individual director to develop an appropriate development programme.**"

We do appreciate that these references are largely incorporated in the Guidance, but in the current governance climate, with the increasing focus on the responsibilities of a director and the complexity of many modern companies, it seems to us that it is important to emphasise the value of comprehensive and structured professional development for board members. As a professional body, we would not be doing our job were we to neglect the professional development of our members; companies would be wrong to neglect the training and development of their people. Directors do not come to the board fully formed, and are just as much in need of induction and professional development as those who serve them.

The workforce

As drafted the revised Code focuses on the ‘workforce’, which we assume is in response to the Government’s request that it consult on the three options for engagement. ‘Workforce’ is a much wider term that the ‘employees’ to whose interests the directors must have regard under s172. Some companies, particularly global ones, have very strict policies driven by employment and tax law which require them to treat consultants, agency and interim staff differently from employees and we are concerned about the potential complications to which, for example, consultations with the workforce may give rise. Although on the face of it, this is a minor wording change, the implications are significant. We would ask the FRC to discuss this change of emphasis in the Code with BEIS and HMRC to ensure that there are no unforeseen consequences, such as a change to the employment status of the contractors concerned before implementing this change.

The Stewardship Code

We appreciate that, following the initial introduction of a Stewardship Code, it was always intended that it would be developed over time. However the general view of companies is that the Stewardship Code does not seem to be working.

There are examples of investors where communication between the corporate governance teams and the fund management teams is lacking and companies receive contradictory views. We believe it would be worth having a wider review of the role of stewardship and the approach to a Stewardship Code.

Whilst our research shows that there has been some increase in both the quality and quantity of stewardship activity, commitment to the Stewardship Code varies between investors. Those who ‘did stewardship well’ before the introduction of the Stewardship Code now do it better; those who didn’t, still don’t. The tiering process, carried out by the Financial Reporting Council in 2016 served to emphasise this divide.

The Stewardship Code, as drafted, focusses on processes. It does not include principle based ideas, which play a major role in the Corporate Governance Code. One of the strengths of the Corporate Governance Code is that, when originally introduced, it was largely based on investor expectations of how companies should behave. However, the Stewardship Code is not based on companies’ expectations of investor behaviour; it focuses on investor expectations of how investors should behave. A greater focus on company expectations of investors would make the Stewardship Code more effective.

PART 2 – RESPONSES TO SPECIFIC QUESTIONS ABOUT THE REVISED UK CORPORATE GOVERNANCE CODE

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

No. Provided the final version of the new Code is published by early summer 2018, we think it is appropriate for the new Code to apply to accounting periods beginning on or after 1 January 2019. If the FRC proceeds with its proposal to remove the exemptions previously granted to companies outside the FTSE 350, an additional year should be allowed as a transition period for these companies.

Q2 Do you have any comments on the revised Guidance?

Yes. Overall we thought it well-written, comprehensive and helpful, especially the ‘questions for boards’ and ‘examples’ set out in boxes in the Guidance. It might be possible to develop more of these, and we will be happy to work with the FRC to do so.

Our main concern is that the status of the Guidance is not sufficiently clear. There are a number of areas where the Guidance provides much more flexibility than the Code but our members’ experience is that corporate governance bodies, proxy advisers and the media are unlikely to take account of the Guidance and/or give it sufficient weight, adopting a ‘tick box’ approach against the Code. It is therefore important that the increased flexibility is reflected in the wording of the Code and that the Code emphasises it is the responsibility of all investors and advisers to consider the Guidance and the Code together. We would suggest that this be done in the Introduction, perhaps in the final paragraph under ‘Reporting on the Code’. We have in mind something like:

“The Code is also supported by Guidance on Board Effectiveness, which assists boards when applying the Principles. It does not set out the ‘right way’ to apply the Code. It is intended to stimulate thinking on how boards can carry out their role most effectively. When reporting on the application of the Code’s Principles the board should consider how the guidance supports their actions and the decisions they have taken in response to the questions posed by it. The board should also take into account additional guidance, such as the Guidance on Audit Committees and the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. **The Code should be read in association with this Guidance and investors should bear the guidance in mind when assessing whether the company has applied the Code and, in particular, when assessing the quality of explanations of non-compliance with specific provisions. Compliance with the guidance should be treated as one, but not the only, means of evidencing application of the Code**.”

By way of an example, Provision 3 of the Code gives just three methods that the board ‘*would normally’* establish for gathering the views of the workforce; whereas the Guidance provides nine additional suggestions for workforce engagement.

There are some areas of the Guidance, the tone of which read like a Code. This may be where provisions have been moved from the Code to Guidance, but it would be helpful were the two documents reviewed to give each a distinctive ‘voice’. For example, the word ‘should’ appears a number of times in both documents (139 times in appendix A and 129 times in appendix B to the consultation!). It is right for it to appear in the Code, but we felt that on each occasion when it appears in the Guidance it may be helpful to consider whether it is appropriate.

Some detailed comments on the text of Guidance are attached as an appendix.

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

No, probably not if taken in isolation. As we suggested in our joint paper with the Investment Association, *The Stakeholder Voice in Board Decision Making*[2], it is likely that the optimum solution for any company will be a combination of some, all or none of these methods and probably something else. It is unlikely that any one method will, in isolation, be sufficient. Companies should choose whichever approach or approaches is/are, in the opinion of the board, most likely to lead to effective engagement and an enhanced understanding of the impact of their decisions on their key stakeholders. However this also depends on what is regarded as 'sufficient', what is meant by 'meaningful engagement' and what is meant by 'workforce' as these terms are subjective. Provision 3 of the proposed Code refers to '*gathering the views of the workforce'*, which is different from '*engagement*'.

The tone and emphasis of paragraphs 35 and 36 of the Guidance do not sit easily with the wording of Code Provision 3 and we therefore would suggest that Provision 3 makes it clear that the three methods described are not the only options and there are many other suitable methods of engaging with a workforce. We suggest that it be reworded to say "The board should establish a method for gathering the views of the workforce. This **might** be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director…" As we noted in ICSA's paper referenced above, whilst the workforce are an important stakeholder, they are not the only one.

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?

No. We do not consider it is appropriate to make reference to any NGO principles in the Code. Companies refer to such principles as appropriate and to the extent such principles are relevant to their organisation. Some reference in the Guidance would be more appropriate.

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?

Yes. Although this is an arbitrary figure, 20 per cent has become the accepted level at which a vote against is considered 'significant'. It might be better, however, were the Code to refer to 'a significant vote against' and put 20% in the Guidance as this would encourage companies to use a lower percentage where that is appropriate (for example where there is a significant shareholder). We agree that the publication of an update no later than six months after the vote is appropriate, but it should be understood that this is an update on the issue, not necessarily its resolution.

The Guidance should recognise that it is not always possible for companies to obtain an understanding of why a shareholder has voted against a resolution as this depends on engagement by the shareholder(s) with the company. In circumstances where information on the reason for a shareholder to vote against a resolution cannot be obtained, or where a number of shareholders report conflicting issues, it is impossible for the company to take meaningful action to address the issues or to give an update on its progress in doing so.

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[2] https://www.icsa.org.uk/assets/files/free-guidance-notes/the-stakeholder-voice-in-Board-Decision-Making-09-2017.pdf

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 have mixed views on this question. We believe that a periodic independent board evaluation or board effectiveness review is valuable for companies, indeed organisations, of all sizes. That view will come as no surprise as these are services that ICSA provides on a commercial basis. However, we also accept that this requirement could be quite onerous and costly for smaller companies and we are not yet convinced there is an adequate pool of organisations providing good quality board evaluation services to support this widening of the market. We also believe that the type and depth of evaluation required should be for the board to decide.

One way in which this requirement could be made less onerous might be to extend it to companies outside the FTSE 350 only if their size and structure is similar to a FTSE 350 company, as discussed in paragraph 49 of your consultation document; or perhaps by requiring such companies to carry out an independent evaluation every five years rather than three.

If, however, less expensive methods of independent evaluation are envisaged for smaller companies, such as the use of questionnaires from external providers, it would be helpful for the FRC's Guidance to clarify which evaluation services would be considered Code compliant.

On a related point, we are not convinced that a case has been made for the change in Provision 18 to all directors, rather than just those of FTSE 350 companies, to be subject to annual election. Smaller companies tend to have a more concentrated shareholder base and the directors can, therefore, be vulnerable to the narrow views of a single shareholder.

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

Generally, yes. The nine year limit is entirely arbitrary but it has become accepted practice. However, in our members' experience, independence is a state of mind; some directors retain an independent mind after twenty years; others lose it within six months and so we believe that it is appropriate for the board to decide whether or not a director is independent and to explain this where that director breaches any of these criteria, rather than for them to be applied arbitrarily. Our suggestion above that the word 'normally' be inserted in provision 15 addresses this issue. We would also reiterate our comment above that we do not believe that tenure or, particularly, a period as NED before appointment as chair should be taken into consideration when assessing the chair's tenure.

The final sentence of Principle I, that "Board membership should be regularly refreshed", is particularly important. We are pleased to see it given such a high profile in the principles and our commitment to this refreshment informs the rest of our response in this section. However, it is also right to recognise the importance of experience and the value that this can bring to boardroom discussions. The role of the board, and the expectations placed on board members, particularly in the regulated sectors, means that achieving this balance is particularly important and, as you will see from our more detailed comments below, we are not sure that the proposed revisions always do this.

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

Yes. We think this should be a decision for the board, to be assessed according to the individual circumstances, with the board's decision being subject to shareholder approval by way of annual re-election (where applicable).

Q9 Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

Yes, but with some reservations. We agree it is important to build diversity in the boardroom but not at the expense of board performance and having the right skills on the board. It is preferable for boards to be diverse but appointments need to be meritocratic. We have concerns that if the directors fail to appoint the most suitable candidate they may be in breach of their duties under s172 Companies Act 2006. We believe that the focus should be on the 'pipeline' of future directors with the emphasis on the development of people below board level and succession planning, rather than the setting of targets for board diversity. The latter is not a matter for the Code.

Q10 Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If no, please provide information relating to the potential costs and other burdens involved.

Yes, but not with the same time goal as set for the FTSE 350. Diverse boards make better use of the talent pool, and the targets currently set for the FTSE 350 are likely to be met by many FTSE 100 companies. However, FTSE 250 companies are finding the targets difficult to achieve within the timeframe and companies below the FTSE 350 will almost certainly fail to achieve the targets in a relatively short timescale, especially given their typically smaller boards. That is unhelpful to the driving forward of the Hampton-Alexander initiative.

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.

On the surface, this is a good idea as it may help to develop an ethnicly diverse pipeline of future senior executives. However, it is not as simple as it sounds. Most companies within the FTSE 100 and many in the FTSE 250 are global companies. In a number of jurisdictions, they have no right to ask employees for details of their ethnicity, and employees are not obliged to disclose their ethnicity to their employer. There is also a variety of definitions of ethnicity so any information available would be of limited use and reporting would be meaningless.

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?

No. We do not think there should be any duplication with the Listing Rules, DTRs or Companies Act. This leads to confusion and requirements become out of alignment when changes are made to one or the other.

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.

Yes. We think it is now common practice for the roles and responsibilities of the audit committee to be published on companies' websites so we have no concerns about this requirement being removed from the Code and included in the Guidance.

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, but with some reservations. We believe it is important for the remuneration committee to have oversight and understanding of remuneration structures across the company as a whole to provide the broader context when considering executive pay and that this should include senior management as well as executive directors. This already happens with the majority of remuneration committees. We therefore agree that the board, through the remuneration committee, should have 'oversight of workforce policies and practices', but only in so far as they relate to pay. It is important that the terms of reference set clear boundaries between the oversight role of the board, delegated to the remuneration committee, and legitimate day to day management activities. Workforce policies include many areas outside pay, such as disciplinary policies and policies on annual leave, which are management responsibilities albeit that they may be subject to the oversight of the board. This is particularly the case for large global companies.

One suggestion would be that the wording of Provision 33 be amended to make it clear that there is flexibility for the oversight of 'workforce policies and practices' to be delegated to other committees, as explained in paragraph 85 of the consultation document, and that the committees to which this may be delegated should include the executive committee. For example: "The remuneration committee should have delegated responsibility for determining the policy for director remuneration and setting remuneration for the board and senior management. It should oversee remuneration and workforce policies and practices **with regard to remuneration,** taking these into account when setting the policy for director remuneration."

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

No. We believe the appropriate place for remuneration proposals to drive long-term sustainable performance is the Stewardship Code. It is the experience of our members that, when they have tried to propose alternative approaches to executive remuneration, their Remuneration Policy has been rejected by shareholders and their advisers.

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

No. Again, the experience of our members is that when boards try to exercise discretion in ways that are not regarded as 'standard' or 'conforming', its proposals are rejected by shareholders and their advisers.

PART 3 – SUGGESTED ENHANCEMENTS TO THE TEXT OF THE REVISED UK CORPORATE GOVERNANCE CODE

In **Provision 5**, we suggest one minor addition "…Committee chairs should engage **as appropriate** with shareholders on significant matters related to their areas of responsibility." This is because what may be a significant matter for the chair of that committee may not be significant to shareholders. A number of members have told us that shareholders are not usually interested in seeing the chairs of the audit or nomination committee.

The wording of **Provision 7** as drafted goes beyond the requirement of the Companies Act 2006 that companies *manage* conflicts of interest. We do not believe it is practical – or even possible – for the board to *eliminate* conflicts of interest – they will more often than not exist and the critical point is that they be recognised and managed. We suggest that the wording be amended to require the board to '…identify and **manage** conflicts of interest.'

In **Provision 9**, it has always felt slightly odd that "The responsibilities of … management should be clear, set out in writing, agreed by the board and made publicly available." We would suggest that this be clarified to read …"**executive directors …**".

A similar point applies in **Provision 13**, where we would suggest that "Non-executive directors should scrutinise and hold to account the performance of **the** management **team** and individual directors against agreed performance objectives" might be more helpful.

Provision 14 states that "…All directors should ensure that they have sufficient time to meet their board responsibilities. External appointments should not be undertaken without prior approval of the board, with the reasons explained in the annual report. Full-time executive directors should not take on more than one non-executive directorship in a FTSE 100 company or equivalent."

We would certainly expect an executive director to seek permission before accepting a non-executive position, but it is usual for a NED to have a portfolio career and so we do not believe that explanation in the annual report or board approval is necessary or appropriate. If shareholders believe that an individual is over-boarded, they can vote them off the board. We therefore recommend deletion of the second sentence.

Footnote 3 in Principle J defines "'senior management' … [as] …the executive committee or the first layer of management below board level, including the company secretary." Whilst the company secretary is a member of the senior management team, he or she may not be a member of the executive committee. We suggest that this footnote be amended to read:
"The definition of 'senior management' for this purpose should be the executive committee **(or equivalent)** or the first layer of management below board level**. It should also include** the company secretary."

Provision 23 requires that: "The annual report should describe the work of the nomination committee and should **also** include … a description of how the board evaluation has been conducted, detailing the outcomes, actions taken and how it has influenced board composition…."

Reporting of the board evaluation will usually form part of the corporate governance report, rather than of the nomination committee report. Please note our comments on the Guidance that the greater the detail that companies are required to provide in their annual report, the less likely it is that those subject to the evaluation will be candid in their comments.

Provision 37, requiring that "Remuneration schemes and policies should provide boards with discretion to override formulaic outcomes" should be highlighted to institutional investors and, especially, their advisers who sometimes object to the exercise of discretion by the board.

The requirement in the first paragraph of **Provision 40** that 'the remuneration committee should address the following' suggests that these are matters requiring correction. We would suggest an amendment to: "When determining executive director remuneration policy and practices, the remuneration committee should **consider** the following: … "

In the last sentence of the fourth bullet point, the words 'poor performance' and 'excessive' are subjective notions, the latter more so than the former, and need a context within which they can be considered. We suggest that this sentence be deleted but, if this cannot be done, it should be reworded to read "…Outcomes should not reward poor performance and total rewards available should not **exceed normal market levels**."

PART 4 – ANSWERS TO QUESTIONS IN THE INITIAL CONSULTATION ON FUTURE DIRECTION OF UK STEWARDSHIP CODE

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?

We believe that the Stewardship Code should be more explicit about what is expected of signatories, but in our view the critical gap is the lack of effective enforcement mechanisms. We regularly receive reports from companies that even some of the largest investors do not engage before submitting against votes, or limit their engagement with companies to one meeting per annum etc. We do not believe that this is effective or responsible stewardship. The assumption, especially by the media, is usually that it is the company that has failed to engage with its investors, whereas many companies report that their attempts to engage have been ignored.

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 Stewardship Code needs to reflect companies' expectations and their need for engagement from investors, rather than just voting, as discussed in paragraph 25. A requirement to report on engagement would be helpful. It needs to be more aspirational and would be greatly enhanced by examples of good practice. In order to determine what good practice (rather than 'best practice') is, it is important that companies are asked to provide this input.

The Shareholder Rights Directive may provide a helpful incentive for asset managers and other institutional investors to report on their stewardship activities but to be effective this needs to be effectively policed. In our view the Financial Conduct Authority should take responsibility for this as part of their oversight of regulated businesses.

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?

Since 2015, we have been making an award for Best Investor Engagement as part of the ICSA Awards, which has been won for each of the last three years by Legal and General Investment Management. The judging criteria is simple. We contact the company secretaries of all FTSE 350 companies and asked them to nominate the investor or investment manager who has been responsible for the most constructive stewardship engagement with the company in the last year. Each company secretary will have one vote, these are collected and the shortlist and winner chosen on the basis of the highest number of votes. We accept that this is unscientific, but we believe it important to recognise excellence and have been delighted that Stephen Haddrill has been willing to present the award for us.

If the Financial Reporting Council would like to work with us to develop a more rigorous set of criteria against stewardship can be judged, we would be delighted to do so.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

A model blending principles and provisions might be a means of improving the Stewardship Code. The consequences of a breach of the UK Corporate Governance Code are negative votes from investors; there are currently no real consequences for a failure to comply with Stewardship Code obligations.

It is, perhaps, a more radical solution, but we see much merit in a revised UK Corporate Governance Code which combines both the existing Code and the Stewardship Code. Having separate codes for companies and shareholders is unhelpful and causes confusion. A combined code which provided a ‘joined up’ approach to governance for all parties in the governance relationship might be more effective.

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

No additional comments.

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?

Possibly, but this might be overly prescriptive unless on a ‘comply or explain’ basis. There are a wide variety of investors, with a wide variety of investment criteria, for not all of whom ESG issues are important.

Q23. How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

There could be a requirement for some explanation as to how the person compiling the investor's report has focused on 'best practice' for their role, on how engagement has had an impact and on how conflicts of interest have been addressed. However, ultimately this can only be done through some independent external enforcement mechanism. The Financial Conduct Authority already have the necessary powers. Alternatively, these could be given to the FRC.

Q24. How could the Stewardship Code take account of some investors' wider view of responsible investment?

We do not believe that it should, unless on a 'comply or explain' basis. The operative word in this question is 'some'. As noted in our response to question 22 above, there are a wide variety of investors, with a wide variety of investment criteria, for not all of whom ESG issues are important. Ethical funds and 'responsible investment' vehicles should be, and are, widely available for all those who wish to invest in this way, but not everyone does.

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

Not of which we are aware. These relate to different markets and legal structures and are not, generally, relevant to the UK.

Q26. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

Independent assurance can be helpful, but as you note in the consultation document, its effectiveness can be variable and, of course, is subject to a perceived conflict of interest. We believe that the key issue is independent enforcement.

Q27: Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

Yes. In our view directed voting in pooled funds is only appropriate where the asset owner has the resource and inclination to make a proper assessment of the explanation given by the company for divergence from the Code. We regard the Association of Member Nominated Trustees 'Red Lines' campaign as risking a failure in fiduciary responsibility as we do not believe that such 'red lines; can always be assumed to be in the best interests of beneficiaries.

Q28: Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

No. This should be up to individual investors and their clients to decide.

Q29: Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

No. This should be up to individual investors and their clients to decide.

Q30: 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?

No comment.

Q31: Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

This might be helpful, but the reporting requirement should be kept proportionate.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours sincerely

Peter Swabey
Policy & Research Director

APPENDIX 1

SUGGESTED AMENDMENTS TO THE REVISED UK CORPORATE GOVERNANCE CODE

Our suggestions in respect of the text of the revised Code are, therefore, as follows:

Introduction

"The Code is also supported by Guidance on Board Effectiveness, which assists boards when applying the Principles. It does not set out the 'right way' to apply the Code. It is intended to stimulate thinking on how boards can carry out their role most effectively. When reporting on the application of the Code's Principles the board should consider how the guidance supports their actions and the decisions they have taken in response to the questions posed by it. The board should also take into account additional guidance, such as the Guidance on Audit Committees and the Guidance on Risk Management, Internal Control and Related Financial and Business Reporting. **The Code should be read in association with this Guidance and investors should bear the guidance in mind when assessing whether the company has applied the Code and, in particular, when assessing the quality of explanations of non-compliance with specific provisions. Compliance with the guidance should be treated as one, but not the only, means of evidencing application of the Code**."

Section 1 – Leadership and purpose

Principles

"A: A successful company is led by an effective and entrepreneurial board, whose function is to promote **the success of the company for the benefit of its members as a whole, having regard to the directors' legal duties under section 172 of the Companies Act 2006.** The board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned."

Provisions

"3. The board should establish a method for gathering the views of the workforce. This **might** be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously. The board should review this and ensure that arrangements are in place for the proportionate and independent investigation of such matters and for follow-up action.

"5. In addition to formal general meetings, the chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against the strategy. Committee chairs should engage **as appropriate** with shareholders on significant matters related to their areas of responsibility. The chair should ensure that the board has a clear understanding of the views of shareholders."

"6. When **a significant percentage** of votes have been cast against a resolution, the company should explain..."

"7. The board should take action to identify and **manage** conflicts of interest, including those resulting from significant shareholdings, and ensure that the influence of third parties does not compromise or override independent judgement."

Section 2 – Division of responsibilities

Provisions

"9: The roles of chair and chief executive should not be exercised by the same individual.
The responsibilities of the chair, chief executive, senior independent director, board, committees and **executive directors** should be clear, set out in writing, agreed by the board and made publicly available. The annual report should set out the number of meetings of the board and its committees, and the individual attendance by directors."

"10. The chief executive is responsible for proposing strategy to the board, delivering it as agreed, and ensuring timely and balanced information**, including all information requested by the board or the chair,** is presented in order for the board to make decisions effectively."

"11. **Except for smaller companies,** independent non-executive directors, **excluding** the chair, should constitute the majority of the board. With reference to Provision 15, the board should identify in the annual report each director considered to be independent. The chair should hold meetings with the non-executive directors without the executives present."

"13. Non-executive directors are responsible for appointing and, where necessary, removing executive directors. Non-executive directors should scrutinise and hold to account the performance of **the** management **team** and individual directors against agreed performance objectives."

"14. All directors should ensure that they have sufficient time to meet their board responsibilities. ~~External appointments should not be undertaken without prior approval of the board, with the reasons explained in the annual report.~~ Full-time executive directors should not take on more than one non-executive directorship in a FTSE 100 company or equivalent."

"15. Individual non-executive directors, **excluding** the chair, should not **normally** be considered independent for the purposes of board and committee composition if any one of them:
• is or has been an employee of the company or group within the last five years;
• has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
• has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
• has close family ties with any of the company's advisers, directors or senior employees;
• **has significant links with other directors through** cross-directorships **(FN)** or involvement in other companies or bodies;
• represents a significant shareholder; or
• has served on the board for more than nine years from the date of their first election".

(FN) "**For these purposes 'cross directorships' means situations where both parties serve as an executive director on one board and a NED on the other. It does not included a situation where only NED roles are concerned**."

Section 3 – Composition, succession and evaluation

Principles
"I. The board and its committees should have a balance of skills, experience, independence and knowledge. Board membership should be regularly refreshed. **Board members should receive tailored induction from the company secretary on joining the board and should regularly update their skills and knowledge."**

"J. Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be in place for board and senior management.[3] Both appointments and succession plans should be based on merit and objective criteria,[4] and promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.

Footnote 3 – ""The definition of 'senior management' for this purpose should be the executive committee **(or equivalent)** or the first layer of management below board level**. It should also include** the company secretary."

Provisions
"22. The chair should act on the results of the evaluation by recognising the strengths and addressing any weaknesses of the board. Each director should engage with the process and take appropriate action when development needs have been identified. **The company secretary should work with the chair and the individual director to develop an appropriate development programme.**"

"23. The annual report should describe the work of the nomination committee and should **also** include …."

Section 5 – Remuneration

Provisions
"33. The remuneration committee should have delegated responsibility for determining the policy for director remuneration and setting remuneration for the board and senior management. It should oversee remuneration and workforce policies and practices **with regard to remuneration,** taking these into account when setting the policy for director remuneration."

"40. Executive remuneration should support long-term company performance and value generation. When determining executive director remuneration policy and practices, the remuneration committee should **consider** the following:
• clarity – remuneration arrangements should be transparent and facilitate effective engagement;
• simplicity – remuneration structures should avoid complexity; their rationale and operation should be easy to understand;
• predictability – the range of possible values of rewards to individual directors should be identified and explained at the time of approving the policy;
• proportionality and reward for individual performance – there should be a demonstrable link between individual awards and the long-term performance of the company. ~~Outcomes should not reward poor performance and total rewards available should not be excessive~~; and
• alignment to culture – incentives should drive behaviours consistent with company purpose, strategy and values."

APPENDIX 2

SUGGESTED AMENDMENTS TO THE GUIDANCE ON BOARD EFFECTIVENESS

As mentioned in our response to question 2 above, our overall impression was that the Guidance is well-written, comprehensive and helpful, especially the 'questions for boards' and 'examples' set out in boxes in the Guidance. It might be possible to develop more of these, and we will be happy to work with the FRC to do so. The Guidance builds on an excellent original document, with which we were pleased to be associated, and we would be delighted to continue to be so in the future.

Our main concern with the guidance is around its status vis-a-vis the Code, and we have commented on that issue in our response to question 2 above. We do, however, have a few suggestions on the text of the guidance and apologise if these seem somewhat detailed. We do, however, believe that they add to the Guidance.

Paragraph 13 combines challenge in the boardroom with diversity, but the two topics are not necessarily related. Perhaps this might be better split into two separate paragraphs in the Guidance or to delete the diversity point here given that it is well-covered in part 3 of the Guidance, relating to the nomination committee.

Paragraph 20 suggests extra steps that a board may wish to take in the context of significant decisions, including, "… ensuring that board minutes document the details of the discussion that led to the decision including evidence of challenge." As you are aware, we published our own guidance on minute taking last year[3], following an extensive consultation, and one of the concerns expressed to us was that detailed notes of a meeting can obscure the decisions taken and the reasons for them. Attributing specific views to individuals tends to militate against the unitary responsibility of board members. We therefore suggest deleting the words 'details of' in this paragraph – "…ensuring that board minutes document the ~~details of~~ the discussion that led to the decision including evidence of challenge."

In **section 5**, on remuneration, the Guidance refers throughout to 'workforce'. We believe that, in this section, the word 'employees' is more appropriate as the term 'workforce' includes contractors and others for whom the responsibilities of the board are different.

Paragraph 113 suggests that "The remuneration committee should engage with the workforce …" We believe that this should say 'oversee engagement' rather than 'engage' as the actual engagement will be a management responsibility.

[3] https://www.icsa.org.uk/knowledge/resources/minutetaking