COMMENTS TO FRC ON UK CORPORATE GOVERNANCE CODE – CONSULTATION DOCUMENT (MAY 2023)

I offer the following comments on the questions posed in the consultation document in a personal capacity.

Q1: Do you agree that the changes to principle D in Section 1 of the Code will deliver more outcomes-based reporting?

Yes. Discussing the outcomes of a board's governance policies and practices will help users to assess the effectiveness with which they have been implemented. Where companies do not already measure the effectiveness of their governance approach, the proposal will encourage them to do so.

Q2: Do you think the board should report on the company's climate ambitions and transition planning, in the context of its strategy, as well as the surrounding governance?

The proposal involves adding to provision 1 a requirement for boards to report, in the annual report, on 'how environmental and social matters are taken into account in the delivery of its strategy, including its climate ambitions and transition planning'.

Making specific reference to these matters is, I suggest, unnecessary in the context of guidance on governance reporting. The existing requirements of the strategic report regarding risks and uncertainties already call for the discussion of environmental and social issues where they are relevant and material. Additionally, large companies are required by law to report on how the various criteria set out in s172 of the Companies Act have been addressed, so attention to social and environmental matters, as well as a specific requirement to report on climate change issues, are already mandated there. If environmental and social matters were to be additionally mandated in the Code, then all other matters referred to in s172 would perhaps also need to be expressly mentioned.

The other proposed addition concerns 'climate ambitions and transition planning'. This wording is very vague. Where it makes sense for a company to have 'climate ambitions', and where these are relevant to a user's understanding of the company's strategic thinking, one would expect them to be discussed in the strategic report, in line with existing requirements, along with all other relevant material considerations. A blanket and indiscriminate requirement on the lines proposed would likely only encourage boilerplate reporting.

Q3: Do you have any comments on the other changes proposed to Section 1?

I realise that this issue is not being consulted on but I suggest that it would be appropriate at this stage to make a small but significant change to the wording of principle B. This currently states that the board should establish 'the company's purpose, values and strategy…', to which it is now being proposed that policies on workplace practices be made consistent with the company's values.

The issue I see with the existing wording is that it does not categorically provide that the central role of the board is to achieve the mission for which the company exists and to which end its investors have provided funding. In grouping together purpose, values and strategy it creates the potential for each of these elements to be viewed interchangeably. This would in my view be inconsistent with the

core objective of good governance which is, surely, to achieve success for the company (as per the Companies Act 2006) in the light of its particular constitutional mission and/or corporate purpose.

A major issue in corporate governance currently is the extent to which directors and senior managers, particularly in the US but also, inevitably, in the UK, have adopted a politicised approach to the framing of corporate values. In some cases, when companies decide to adopt such values, their motivation seems to be less to do with facilitating the business interests of the company than with the idea that the company would attract niche attention by being associated with certain social or political causes. Worse, corporate values sometimes seem to be adopted in a way which is either heedless of their likely effect on business performance and investor returns or consciously disregarding of them. In recent years, we have seen a number of large corporations, from Gilette to Anheuser-Busch, engaging in aggressive and provocative marketing strategies which have resulted in massive consumer pushback and material damage to company reputation and market value. In the UK, we have just recently seen one of our major TV companies suffering major damage to its market value because its public commitment to certain 'values' were found, in practice, to be inconsistent with its actual workplace culture and practices and damaging to its commercial viability. While association with declared values may well help a company to market itself and its products, and hence achieve its business goals, there is a risk that too great an emphasis on 'values', especially if they are unconnected with the main purpose of the company, may supersede responsible and rational decision-making, and thereby work against the cause of good governance. It should be understood that 'values' must support a company's business strategy, not dictate it.

A secondary danger, in my opinion, is that an undue emphasis on 'values' in corporate governance guidance can lead to boards of directors being confronted with what are effectively competing benchmarks of governance expectations. Pressure from institutional investor groups is one source of this potential confusion, but stakeholder groups and awards schemes, e.g. the Corporate Equality Index, run by activist groups and commercial publications, are others. When, as has happened recently in the US with Target, the company's market value suffers a multi-billion dollar hit because of consumer pushback on its contentious 'values-driven' policies, but its board is acclaimed by third parties for its practices, a situation is created whereby observers – and directors too - can be forgiven for asking to whom are companies are really accountable – is it to investors and the market, to stakeholder activist groups, to employees, or to nobody in particular? Where such confusion is created, that can lead to company boards being distracted from their responsibility to adopt a clear vision of the company's path to business success.

In line with the essence of company law, the personal convictions of directors and senior managers should never take preference, in governance practice, over the interests of the company, as personified principally by its investors. Even where all or a majority of directors are agreed on the adoption of a particular values-driven initiative, the dangers of group think – so disastrous in the crisis of 2007/8 – need to be heeded. The board collectively must acknowledge as a core principle the paramount importance of the corporate interest, which should be reiterated in all recruitment processes. While UK companies are required by law to take a range of factors into account in their decision-making, the business interests of the company should always be the primary factor driving their work. Companies should remain free to espouse corporate values, for the purpose of market differentiation and employee engagement, but, to reiterate, any such values should support the business direction of the company, not dictate it. For this reason, I suggest an alternative wording for principle B, viz

The board is responsible for identifying the company's purpose, which should reflect its constitutional mission, if any, and must ensure that the company acts always to further that

purpose. It should also set the company's strategy, which should be in line with its corporate purpose, and identify the values and culture that it wishes the company to adopt. The purpose, strategy, values and culture should all be aligned. *All directors must act with integrity, lead by example and promote the desired culture. The board should ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success.*

Q4: Do you agree with the proposed change to Code principle K (in Section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?

It would be surprising if boards did not already take into consideration, in the performance review process, the ongoing ability of a board member to contribute effectively, especially given his or her other business commitments. But I would agree that this is important enough to make express provision in the Code.

Q5: Do you agree with the proposed change to Code provision 15, which is designed to encourage greater transparency on directors' commitments to other organisations?

If the FRC considers, on the strength of feedback, that users need more assurance about whether directors are able to devote sufficient time to their board duties, then it may be helpful to add something to provision 15. But this should not, in my view, go as far as to require detailed information about the commitments of each individual director. A cross-reference to the board's actions under new principle K, with a note of any remedial action taken subsequently, should suffice.

Q6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication?

For the reasons set out below I suggest that the Code should not duplicate the regulatory measures being introduced by the FCA.

Q7: Do you support the changes to principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

It is proposed to add to the (new) principle I that appointments and succession plans 'should promote equal opportunity, and diversity and inclusion of protected characteristics and non-protected characteristics including cognitive and personal strengths'.

It goes without saying that any board should seek to appoint individuals who can collectively bring to a board the qualities it needs in order to successfully lead the company. The Code already states 'the board and its committees should have a combination of skills, experience and knowledge'.

The proposed additional wording would introduce into the Code the criteria used in the Equality Act, and because of this would effectively fail to achieve the objective set out in the question. The criteria in the Act were intended to be applied in the specific circumstances of the employment relationship, to ensure that individuals were not discriminated against for reasons related to their group identity, and to provide a basis for redress. The revised Code, in the governance context, would go further and call on boards to actually promote 'diversity and inclusion of protected characteristics' as well as other criteria, and promote diversity of gender, social and ethnic backgrounds.

Without evidence that boards of directors are currently discriminating against individuals who embody 'protected characteristics', or that company governance would necessarily improve if boards applied the proposed new requirements, the new provisions are unreasonable. The FRC offers no reason to believe that governance would improve by the simple expedient of appointing to boards

and senior management people with particular 'characteristics', nor would it be possible to do so. The proposed wording would require boards to actively factor in identity categories when considering appointments and succession plans, as opposed to considering individuals on the basis of their skills and experience and what they can offer the company. The risk is that boards would feel pressurised, by regulators, activist groups and others, into, possibly, making decisions that were not motivated primarily by a consideration of the best interests of the company, and thereby frustrate their ability to govern the company effectively. This outcome should be pre-empted.

The FRC should also bear in mind that the Law Commission has in the recent past proposed extending the range of protected characteristic categories in the Equality Act: a number of new categories were floated for addition, including members of youth cults such as 'Goths'. While those specific proposals are not, for the moment, being taken forward, it is likely that there remains a political appetite for moving in the direction of an expanded range of protected characteristics. The likelihood that they will be added to should be taken into account by the FRC before it suggests that boards of directors be obliged in due course to routinely cross-reference the provisions of the Equality Act in their board planning.

Any good board of directors, and any good chairman, will always be open to the prospect of recruiting new members who can enhance the quality of the board either by adding new perspectives and qualities or by strengthening those that already exist. It is entirely right that boards be expected to embrace equality of opportunity and to consider recruiting individuals with different skill sets and from a range of backgrounds, but effectively mandating them to adopt a 'representational' approach to board composition risks resulting in dysfunction.

The interests of good governance are served by boards possessing the range of personal qualities that they and their companies need. They would not be served by pressurising boards to meet benchmarks of representation that have no obvious relevance to the quality of governance. The Code should encourage boards to ensure they have available to them all the expertise and experience their business needs, and to consider individuals from all sorts of backgrounds, but should not restrict boards unreasonably by requiring them to base their recruitment practices on a representational model. A board of directors needs to bring together individuals who are best equipped to further the interests of the company: it must not be seen as a platform for the representation of any particular category of person.

Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?

The proposed additional text in new provisions 18 and 24 dwells further on 'diversity and inclusion', with a specific reference to the 'diversity pipeline'. The document does not explain the intended meaning of these terms or suggest how their adoption would actually improve the quality of corporate governance, which surely should be the whole point of governance guidance. Presumably, though, given the earlier cross-reference to the Equality Act, these concepts are meant to link to the identity-based criteria found there. The problem with mandating these concepts, as suggested above, is that boards will feel pressurised to base their decision-making in the area of recruitment on broadly political grounds rather than on the basis of equal opportunity, competence and the best interests of the company. Rather than requiring companies to adopt standard procedures on the lines proposed, it would I suggest be more constructive if companies were strongly encouraged via the Code to adopt an open-minded approach to the recruitment process and then users could come to their own conclusions, via the subsequent reporting, as to how well they have done this. I would therefore suggest that the 'new' provision 18 might read something like:

*The Nominations Committee should lead the process for making board appointments and should develop a plan for orderly succession to both board and senior management positions**. In carrying out these tasks the Committee should promote the principle of equality of opportunity and should in particular consider the potential benefits to the company of strengthening and deepening the expertise and experience of the board and senior management by recruiting individuals from a variety of backgrounds, including those not currently represented on the board.***

If a wording such as this were adopted, new provision 24 would call on companies to discuss how they have gone about these tasks, specifying any targets set and performance against those targets.

Q9: Do you support the proposed adoption of the CGI recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?

In contrast to the suggestion made in the document, the proposed amended text in new provision 22 appears to include both terms, 'board evaluation' and 'board performance review', with the latter referring to the externally-undertaken reviews that should happen at 3 year intervals. But if adoption of the new term would help to give a more future-orientated character to the external review that may well help. As regards content, key provisions in guidance should include board culture, the embedding of corporate strategy and values in the company, and the optimal flow of information from the executive to the board.

Q10: Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a 'comply or explain' basis?

Since large companies are to be required to produce an audit and assurance policy, there seems no reason why best practice guidance should not be extended to so as to expect all reporting companies to produce one.

Q11: Do you agree that amending Provisions 25 and 26 and referring Code companies to the Minimum Standard for Audit Committees is an effective way of removing duplication?

Yes.

Q12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

Yes, although it may be appropriate for the audit committee report to refer to other expertise that has contributed to the committee's reporting on non-financial reporting.

Q13: Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal controls systems in a proportionate way?

I believe the proposed changes address the perceived need to strengthen the Code in respect of internal controls and risk management.

Q14: Should the board's declaration be based on continuous monitoring throughout the reporting period up to the date of the annual report, or should it be based on the date of the balance sheet?

The board's specific declaration can only be based on the date of the balance sheet but might also refer to the board's on-going responsibility to maintain effective controls.

Q15: Where controls are referenced in the Code, should 'financial' be changed to 'reporting' to capture controls on narrative as well as financial reporting, or should reporting be limited to controls over financial reporting?

I would not agree that it would be appropriate to delete the word 'financial' from the new Code provision 30. The inclusion of the wider term 'reporting' is appropriate given the greater emphasis being given to non-financial reporting, but the term 'financial' should remain so as to provide a direct reference to what will remain the core element of the reporting process, viz financial information.

Q16: To what extent should the guidance set out examples of methodologies or frameworks for the review of the effectiveness of risk management and internal controls systems?

The board/audit committee should be free to decide the most appropriate methodologies/frameworks for their purposes.

Q17: Do you have any proposals regarding the definitional issues, e.g. what constitutes an effective risk management and internal controls system or a material weakness?

The concepts mentioned are essentially subjective and judgemental in nature and should be left to the discretion of individual boards, subject always to referral to professional standards and guidance.

Q18: Are there any other areas in relation to risk management and internal controls which you would like to see covered in guidance?

Since the guidance is not intended to be prescriptive, only the core elements should be laid down in it.

Q19: Do you agree that current Provision 30, which requires companies to state whether they are adopting a going concern basis of accounting, should be retained to keep this reporting together with reporting on prospects in the next Provision, and to achieve consistency across the Code for all companies (not just PIEs)?

Yes.

Q20: Do you agree that all Code companies should continue to report on their future prospects?

Yes. Viability/resilience has become a key element of governance reporting and must be retained in some form or other in the Code.

Q21: Do you agree that the proposed revisions to the Code provide sufficient flexibility for non-PIE Code companies to report on their future prospects?

Yes. The proposals are appropriate for this purpose. I would only suggest that, given the significance of this matter, a separate principle on viability/resilience should be added.

Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

The proposed additions regarding the identification of remuneration-related risks, and ensuring that outcomes are proportionate and do not reward poor performance are welcome, although with regard to the latter, boards and directors alike need to have a clear understanding of what constitutes poor performance. I also agree with the proposal to require explanation of the company's approach to incentivising and rewarding the workforce.

The case for making specific reference to ESG objectives in this section is in my opinion less clear. Currently, boards are expected to adopt remuneration policies that support the company's strategy and promote long-term sustainable success. This is how it should be. The proposal to 'clearly align' policies in this area to companies' performance, purpose and values and the successful long-term strategy will add usefully to the onus on boards to ensure that their remuneration arrangements are linked to the achievement of the company's goals. Making specific reference, however, in new principle P and provision 43, to the company's ESG objectives, seems superfluous, since those considerations will be addressed in the company's strategic planning process as well as by separate reporting requirements. There seems no reason why ESG objectives should be singled out in the Code for special attention in this context. Were they to be included, the risk is that boards would feel obliged to give those factors greater prominence than factors that are perhaps more germane to remuneration decisions, such as turnover and earnings per share. If the rationale for the proposed wording is to give investor groups a specific benchmark by which to influence remuneration policy and strategic planning more generally, this would arguably amount to a regulatory intrusion into the board's freedom to plan in the particular circumstances in which it operates, and would risk distracting boards from their core function of deciding what should be the priorities as regards the direction of their company and the incentivisation of their people. Provisions relating to strategy reporting should focus on strategy in the holistic sense and not be unnecessarily broken down into subsets of information. If boards feel that disclosing information on the relationship between remuneration planning and ESG objectives would be materially useful to users of their reports, they are already free to do so, either in their end-year reporting or in 121 meetings. The issue of specific disclosures in this discrete area should therefore be for companies and their stakeholders to address, rather than a matter for the Code.

Q23: Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?

I support the proposals for the Code to require malus and clawback provisions to be included in directors' contracts etc, and for the remuneration committee report to include relevant information about them. I would make only the following suggestions. First, the proposed amended text in (new) provision 39 is unrelated to the first sentence of that passage and might more appropriately become the first sentence of new provision 40. Second, the draft new text suggests only that the report speak of the 'minimum circumstances' in which the provisions might be used: it might be more helpful to users if the word 'minimum' were omitted and companies were encouraged to provide the level of information that they think users need to have. Third, I would query whether the report needs to cover the company's use of malus and clawback provisions over five years.

Q24: Do you agree with the proposed changes to Provisions 40 and 41?

Yes.

Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

The proposed revised provision 35 requires boards to include in the annual report an explanation of the company's approach to incentivising and rewarding its workforce. This is very appropriate in the light of the directors' obligation, under s172 of the Companies Act, to have regard to the interests of the company's employees; ensuring a properly incentivised and managed workforce can fairly be said to be vital to the achievement of the company's business goals and therefore a matter of strategic governance importance. As regards the proposed deletion of the Code's specific reference to pay gaps and pay ratios, the strategic report section of the annual report and supporting guidance

already contain disclosure requirements relating to employee matters (insofar as they are relevant to an understanding of the company's strategic development). Information regarding these particular matters are likely to remain of interest to many users, and monitoring and disclosure of gaps and ratios should continue to be encouraged, but should not be strictly speaking be dealt with as a governance matter. If considered appropriate, separate guidance on disclosures in this area should be developed. In the interests of avoiding duplication and ensuring that governance reporting remains properly focused, I support the deletion of the current reference.

J P Davies FCIS, company secretary/company director

7/6/23