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Sent via email: codereview@frc.org.uk

Dear David,

Railpen response | UK Corporate Governance Code consultation

About Railpen

Railpen is the trading name of Railway Pension Investments Limited, which is authorised and regulated by the Financial Conduct Authority (FCA). Railpen acts as the investment manager for the railways pension schemes and is responsible for c. £34 billion of assets on behalf of over 350,000 members.

Sustainable Ownership is Railpen's approach to integrating sustainability considerations across the investments it manages on behalf of members. Railpen's work is enabled by the Trustee's related investment belief: "Incorporating and acting upon climate risk and other environmental, social and governance factors is a significant driver of investment outcomes and part of our fiduciary duty."

Unlike many UK Defined Benefit (DB) schemes, the railways pension schemes include several open DB sections, which means that the Trustee expects to be paying the pension of an eighteen-year-old who is in their first job today out to 2100 and beyond. Our investment time horizon is, accordingly, very long and Railpen was an early pioneer in UK corporate governance, being one of the first UK investors to publish its global voting policy and corporate governance framework in 1992 and has continued to do so since.

We therefore welcome the Financial Reporting Council's work to create and uphold the UK Corporate Governance Code ("the Code"). We believe the Code has played a fundamental part in ensuring the UK is recognised worldwide for its high corporate governance standards, and helping protect the end saver from poor corporate behaviour. Both the FRC and the team responsible for producing and maintaining the Code are to be congratulated on this achievement.

Our response below draws upon our experience as a user of financial reports and from our engagements with companies on corporate governance, audit and other issues, as well as from our responses to consultations, including the BEIS paper *Restoring trust in audit and corporate governance* as well as the FRC's recent papers on *Audit Quality Indicators* and the *Audit Committee Standard.* We have focused our response on those issues where our expertise can add the most value.

RAILPEN

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Our response

We are supportive of many of the ways in which the FRC has sought to strengthen the UK Corporate Governance Code. However, we believe the proposals could be further strengthened to better ensure a framework that supports the creation of well-run and high-quality firms. Our recommendations are focused on achieving that strengthening.

The proposed improvements are particularly needed at a time when initiatives elsewhere, including some of the Financial Conduct Authority (FCA)'s proposals in CP23/10: *Primary Markets Effectiveness Review – Feedback to DP22/2 and proposed equity listing rule reforms*, risk diluting corporate governance standards and investor protections. Although we should note that we do not believe that any 'soft law' approach – no matter how thoughtful – could ever, by itself, provide the same (and necessary) level of protection for everyday savers and investors as 'hard law' like the listings rules and other regulatory requirements.

We recognise that the review of the Code takes place at a time when cost of living challenges mean that the search is on for all conceivable ways to support companies and individuals through difficult circumstances. We believe the FRC has taken a proportionate approach to its proposed changes, striking the right balance between ensuring that companies are able to 'flex' the Code as best suits their circumstances, while also providing investors with the information they need to be able to make effective investment decisions. Given the role high corporate governance standards play in supporting long-term, sustainable financial growth, we would strongly urge the FRC to continue to promote an approach that balances flexibility with decision-useful information for investors.

Aspects that we strongly support as drafted

We welcome the majority of the FRC's proposals, and are particularly supportive of the following aspects:

Supporting outcomes- and activities-based reporting. Investors – and thereby end savers and beneficiaries – benefit from having information that helps them understand what has happened in the year under review and how impactful and effective a company's governance arrangements are. We therefore support the proposed additional Principle D, which we think will underscore the importance of this kind of reporting. We note that not every governance arrangement or consideration will have a concrete impact in a given year, but we think the drafting gives sufficient flexibility for this not to pose an insurmountable issue for firms.

Proposed approach to the Audit and Assurance Policy (AAP). Although our preference would have been for an AAP process which includes an annual vote on the policy and implementation report[1], we have been strong supporters of the AAP, which we think should i) help investors assess how robust and considered a company's approach is, ii) encourage greater investor engagement with the audit process and iii) help remind auditors that their true clients are a company's shareholders, as opposed to the company itself.

To this end, we are particularly supportive of wording around the need to engage with shareholders. We do not think that it should be softened to "seek to engage" with shareholders, as this allows too much scope for companies to avoid fulfilling this aspect. In

[1] We recognise that this is beyond the scope of this consultation but please see our response to the BEIS paper *Restoring trust in audit and corporate governance* for further details.

light of the important role of the AAP, we agree that reporting against this – in a comply or explain fashion – should apply to all firms reporting against the Code and not just Public Interest Entities (PIEs). This is particularly important should proposals elsewhere to roll back corporate governance safeguards be implemented.

Giving more prominence to the importance of sufficient director time and commitment. We agree that it is difficult to place a fixed, applicable-in-all-cases and specific number on how many appointments constitute an over-committed director. However, we believe more clarity should be given, perhaps a series of ranges and considerations. This would align with the reality that most investors and proxy advisers use their own guidelines and figures to help assess a director's time commitments. It would also provide useful, practical guidance for company directors when considering whether to take on any additional responsibility.

Changes to board diversity, equity and inclusion (DEI) principles. Evidence shows that cognitive diversity is fundamental for well-functioning boards (and governance committees of any kind). In order to avoid 'the revolving door of diversity'[2], it is also important that the culture of a board is as inclusive and equitable as possible. We agree that the proposed approach should encourage companies to consider diversity beyond gender and ethnicity (and beyond protected characteristics more generally – as long as it is done in a way which does not underplay the importance of diversity across protected characteristics). However, we think that clarity as to what characteristics are considered protected should be provided. This could, for instance, be a footnote.

Ensuring greater transparency from companies regarding their malus and clawback provisions. These provisions are important to ensure the appropriate long-term incentives for company management. It is therefore vital that investors have full visibility into where and how they are used at a company. The requirement of disclosures regarding the circumstances in which these measures may be implemented will be particularly useful.

Aspects that we think could be [further] strengthened

Workforce and fair pay issues. Evidence shows that human capital continues to be a material issue for nearly every company in every sector and it is particularly vital that company executives hear the voice of the wider workforce. We were therefore particularly supportive of the changes in the 2018 update to the Code, which emphasised the importance of effective workforce engagement mechanisms. Our suggested changes here fall into three categories:

- Strengthening Provision 5 (workforce engagement mechanisms). We note the findings from the 2021 FRC, the Involvement and Participation Association (IPA) and Royal Holloway report on *Workforce engagement and the UK Corporate Governance Code: A Review of Company Reporting and Practice* that workforce directors in particular are relatively rarely utilised as a workforce engagement mechanism across the FTSE 350. Although our own guidance[3], launched in 2023 with the support of other UK asset owners and managers, notes that workforce directors will not be suitable for every company, we think that more could be done within the Code to get companies to genuinely consider whether a workforce director might be the right approach for them. Our experience of engagements with companies, investors and others indicates that the barriers to serious consideration

[2] For further explanation of this concept, please see Diversity without inclusion creates a revolving door of talent (neuroleadershipinstitute.org).
[3] *Workforce inclusion and voice: investor guidance on workforce directors* (April 2023).

include a misperception about the possible value that a workforce director might bring to a board-level discussion, as well as concerns that they would be unable to handle conflicts of interest – a concern that we think is easily overcome with the proper training.

In light of the potential benefits of a workforce director – which we outline in our guidance – including boosting cognitive diversity, we think it would be worth including the following wording in Provision 5 (our addition in italics):

Regardless of the arrangement chosen, the board should provide a high-level summary as to what assessment they had made of the effectiveness of each of the three engagement methods explicitly mentioned in the Code, and why it reached the conclusion that the others would not be as effective. If the board has not chosen one or more of these methods, it should explain what alternative arrangements are in place and why it considers that they are effective."

- Underlining the importance of fair pay. Fair pay is a fundamental ingredient in ensuring the kind of engaged and motivated workforce that helps contribute to long-term financial performance. We are therefore supportive of the proposals to move wording on a company's "approach to investing in and rewarding its workforce" to Provision 35 (new) and we are also very supportive of the explicit mention in (new) Provision 43 around engaging with the workforce on remuneration issues. However, we do not support the proposal to remove the reference to pay ratios and pay gaps from this Provision. Although we understand the need to avoid duplication, the Annual Report & Accounts is the single most important investor communication. Therefore,ensuring that companies report on how they have approached these fundamental fair pay considerations in their AR&A is not only easier for investors to access, but also underlines the importance of fair pay approaches – particularly relevant during the current cost of living challenges[4].

- Reinstating the wording on whistleblowing (old Principle D, Section 1). We think that the phrase "the workforce should be able to raise any matters of concern" would be important to maintain in the new Code as it cements the importance of having a culture and robust policy in place which supports whistleblowing. It does not appear to have been placed elsewhere in the new text.

Shareholder engagement. We have been concerned by research and media reports that would seem to demonstrate that some company directors do not fully appreciate the importance of meaningful engagement on material ESG issues with their shareholder base[5]. As the owners of capital, with fiduciary duties to their clients or beneficiaries, investors are an important constituency.We believe that the new Code should further emphasise the need for appropriate director-level engagement with the breadth of the shareholder base. Our suggested changes fall into two categories:

- Dual-class share structures. We remain hopeful that the FCA will reconsider its proposal to roll back important shareholder rights around significant transactions, related party transactions and – most pertinently for this consultation – the 'one

[4] We also highlight here the important work of asset owners – led by the Church of England Pension Board – in compiling the *Fair Reward Framework* (FRF).
[5] For instance, the 2022 *State of Stewardship* from Tulchan Communications noted that "Directors have to worry about whether their gender pay gap has gone up or down and what that might mean" – but the gender pay gap is a material issue and worthy of company directors' consideration.

share, one vote' principle. However, should this go ahead, and in light of the importance of equal voting rights to the shareholder voice and companies fully complying with Principle C to "ensure effective engagement with, and encourage participation from, [shareholders and stakeholders]", we would suggest that Provision 3 be amended to explicitly include wording on how – where a dual-class share structure has been used – the board ensures and evidences that it listens to and acts upon views expressed by shareholders.

We would suggest the following changes to Provision 3 (our suggested addition in italics):

"The chair should ensure that the board has a clear understanding of the views of shareholders, and report in the annual report on the outcomes of the engagement which has taken place with them during the reporting period. *Where the company has decided to put in place dual-class share structures, it should report in the annual report what additional measures have been put in place to ensure the views of shareholders are listened to and acted upon, and its assessment of the effectiveness of such measures. This should include any relevant examples and outcomes."*

- Ensuring democratic annual general meetings (AGMs). Together with the annual report, a company's AGM is one of the most important opportunities for shareholders to engage with its board and senior management. We believe that Provision C should be further strengthened to clarify how boards should take responsibility for ensuring that AGMs are managed in such a way as to support genuine engagement with shareholders.

  We make this point in light of our concern at the increasing trend of companies to shift towards either fully virtual meetings, or where directors appear virtually. Although we recognise that there are benefits to allowing some virtual attendance at company meetings, particularly for international shareholders, we do not believe that purely or mostly virtual AGMs allow for full democratic participation. Our experience has been that it is easier for companies to 'cherry-pick' questions from shareholders and harder for shareholders to be heard more generally. We think that any wording in this regard could usefully leverage the wording and expectations included in Principle 10 of the ICGN Global Governance Principles[6].

Although strictly outside the scope of this consultation, we would also request that – in keeping with its objective to promote transparency and integrity – the FRC considers what more it could do to discourage companies from listing with a dual-class share structure, should the FCA proposals go ahead as they are. This could include:

- Further steps to ensure other regulators and departments – both in the UK and elsewhere – truly understand the value of effective stewardship and the role shareholder rights play in supporting this; and
- Including wording in the *Wates Corporate Governance Principles for Large Private Companies* aimed at companies which are thinking of a future listing to recognise at this stage the importance of engagement with shareholders and robust shareholder rights and think about how best they can support this through the appropriate share structure.

[6] Please see ICGN Global Governance Principles 2021.pdf for further details.

Language on, and oversight of, environmental, social and governance (ESG) issues

We are extremely supportive of the new reference in Provision 1, whereby the board describes in the annual report how environmental and social matters are considered in the delivery of its strategy, including its climate ambitions and transition planning. We have a few additional suggestions:

- Reinstate the mention of 'governance' in Provision 1. We would suggest a reinstatement of the reference to the need for the annual report to include how governance contributes to the delivery of company strategy. Good governance is fundamental to any work to address material environmental and social issues and, given some reports[7] that companies are addressing environmental and social issues to the exclusion of governance issues, we think this bears continued emphasis in the Code.

- Emphasise the need to report on and consider *material* ESG issues. There are some ESG issues, like climate change and human capital, that are universally material to almost every company in every sector. However, this is not always the case. As investors, we see ourselves from our engagement with companies that some feel pressured to dedicate resource (and reporting) to ESG issues that are arguably less material to their financial performance than others which have been relatively neglected. What matters to investors is how a company approaches the ESG issues that are most material to performance and we think that the FRC should therefore:

  i) Insert the phrase "material" into its mentions of environmental and social issues. This would include references in Provisions 1, 27 and 34 (all new), and Principle P (new).
  ii) Define "ESG" in this document as "financially material ESG investment factors" (or similar). This would help clear up confusion around what is meant by this term and would be an important first step to support broader clarity of language across the industry.

  As well as ensuring that investors have the right information on a company's approach to the ESG issues that matter most for them, companies would also be able to look to the Code to help them withstand pressure from internal and external stakeholders and campaign groups to focus on less pertinent ESG issues.

  Oversight of ESG reporting. We are supportive of mandatory sustainability reporting requirements, which we think will help provide the consistent and comparable information that investors need to be able to take the most effective investment decisions. In light of the materiality of some ESG issues to a company's financial performance, and the Audit Committee's established role in overseeing the company's approach to financial statements, we agree that the Audit Committee will often be the most appropriate oversight body for sustainability reporting.

  However, we do not think that this will *always* be the case. For instance, human capital issues are likely to be highly material to most companies. Yet the expertise required for oversight of good people reporting may well lie with another

[7] See, for instance, Governance neglected despite increased focus on ESG | Global (environment-analyst.com).

committee, such as the People Committee or a Nominations Committee. We would suggest guidance is provided which genuinely gives comfort that, where the company can provide an appropriate rationale for doing so, alternative oversight approaches are also acceptable.

Of secondary importance but also worth highlighting here: the requirements and role of the Audit Committee have already changed significantly in recent years. We also think that recent corporate scandals have shown that some Audit Committees need to refocus their efforts on how they effectively plan, engage with and scrutinise the work of the external auditor (amongst other things). As an investor, we would therefore be comfortable if a company's rationale for assigning oversight of sustainability reporting to another committee – assuming there was relevant expertise – was that it wanted the Audit Committee to focus its resource on other core issues and activities.

We hope that the information contained within this response has been helpful. We would welcome the opportunity to discuss these and other related issues further with the FRC.

Yours sincerely,