Schroders

13 September 2023

Financial Reporting Council
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By e mail: codereview@frc.org.uk

Dear Sir/Madam,

UK Corporate Governance Code Consultation

Schroders welcomes the chance to respond to your consultation on the UK's Corporate Governance Code (the "Code"). We are a global asset manager, managing over £720 billion on behalf of clients around the world. We are headquartered in London, listed on the London Stock Exchange and subject to the Code. We have reviewed your proposals first and foremost as a major investor in UK listed corporates.

We think your proposals will further reduce the competitiveness of the UK as a place to do business at the very point at which the Government and other stakeholders are coalescing around reforms to reinvigorate our market as a place to start, grow and list a business. They will divert business investment towards compliance and regulation (spending on consultants and external auditors will inevitably rise) and away from innovation and growth. And we think the changes provide a further disincentive (particularly for medium sized companies) to list on the UK's public markets and will exacerbate the current trend of public UK companies being taken into private ownership.

We understand the genesis of the work was in the wake of a small number of high profile corporate failures, and an ask of the FRC by Government. But the context has changed dramatically since then and the scope and prescription of the proposals now appear completely out of step with the prevailing aims of UK public policy. The Government's Edinburgh and Mansion House reforms, supported by the FCA's listing proposals, all work together to support the international competitiveness of the UK's capital markets. We think the Code proposals will have the opposite effect.

We want to stress that our concerns are not motivated by the additional burdens on us as a listed issuer. As a large company operating in a heavily regulated sector, we think the costs of complying with the revisions to the Code would generally be manageable. Rather, we are concerned as a major investor in UK corporates that the changes will not add value to us and other investors (and by extension, our own investors). The standards of good governance, and the descriptions of these in reporting, that the Code seeks to deliver are there first and foremost for the benefit of the investors and wider stakeholders in listed companies. If as a large investor and issuer we do not see value in the changes you are proposing, we think this calls into question whether they are advancing the core purpose of the Code.

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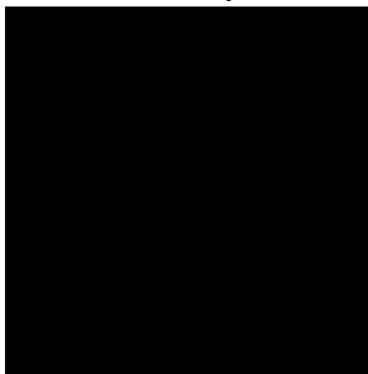
We recognise that in principle the Code operates on a 'comply or explain' basis, but we share the concerns of many corporates who feel in practice it operates as 'comply or else'. While this may be a problem with its roots in the market, not regulation, we think it nevertheless *is* the current market reality. So, in this context, your proposals will introduce significant burdens to a wide range of companies that they will in practice have no realistic option but to follow irrespective of the relevance or fit for their particular business. This is particularly important because, as your consultation notes, the FCA's listing proposals are likely to lead to more companies becoming subject to the Code.

These points are we think exacerbated by the logistics of the proposed changes. Much is left to FRC guidance which we have not seen yet, and which has been only partially consulted on. In places your proposals duplicate other incoming regulation such as the forthcoming International Sustainability Standards Board standards. And implementation from financial years commencing 2025 implies in areas such as 'continuous' monitoring that changes must be in place by financial years in 2024. This is clearly insufficient time to implement effectively such a material package of change.

Standing back, we think there is an opportunity for the FRC to work with the market and other stakeholders to ask a more fundamental set of questions about the purpose and effect of the Code. We accept that the genesis of your proposals lies in corporate failure, but such failures remain rare, and we do not think a vibrant market is a risk-free market. High standards do not have to equate to detailed regulation. We think focusing on the broadening and deepening of the corporate control environment, the external assurance of this and ever more detailed disclosures in reports and accounts all serve to strengthen the combative environment that has taken hold in UK stewardship. We strongly argue for the FRC to consider the alternative. That a return to a truly principles based Code could help enable a 'reset' in UK capital markets that seeks to bring issuers and investors together for the benefit of savers, rather than setting them at odds with one another in an environment of mistrust. It is underlying savers who will ultimately bear the cost of this dysfunction.

I recognise this response is very direct, but as a group we felt it was important to express our concerns directly and clearly. We would welcome the chance to work with the FRC and others to consider how reform of the Code could be recast to focus on the competitiveness of UK capital markets, and through that deliver the returns to savers, and support for the UK economy, that is sorely needed at this juncture.

Yours faithfully



Responses to the questions raised

Section 1 - Board Leadership and company purpose

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

We think this is a good example where we see the positive intent of the proposed change, but we are concerned that in practice it will not work. A greater focus on outcomes-based reporting would be positive, but given the inherent challenges involved in attributing causation to the actions of a corporate, we do not think the changes will raise the bar. In practice we think disclosures will prove to be 'boilerplate' and not useful for investors.

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?

As an investor we find transparency on these points has improved as a result of other reporting requirements such as TCFD and the forthcoming ISSB standards. We think the proposed change to the Code is duplicative, and not required.

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

Yes, we question why the proposed Provision 3 replaces "seek engagement" with "engage"? We presume this is part of a move to more outcomes-based reporting, with the focus moving from the act of seeking to actively engaging. But ultimately it is not in a corporate's gift to guarantee engagement with their shareholders, they can try, but if there is not interest they cannot force engagement to happen.

This is a another example where we understand the spirit of the change, but do not think it will prove to be practical to implement. The current wording provides more flexibility and better reflects the reality of corporate engagement. We think the current wording should be retained.

Section 2 – Division of responsibilities

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?

We agree that a Director's commitments are an important part of the individual evaluation process as per the existing code, but we question why this needs to be referred to explicitly in Principle K given that their ability to devote sufficient time is an inherent part of "…*their ability to continue to contribute effectively*." which is part of the existing text.

Principle K should remain a high-level principle, with any detail the FRC wishes to emphasise either not being necessary, or more appropriate as part of associated guidance.

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?

Following on from the prior question, we particularly question the value of the addition to Provision 15. Any list of appointments in the annual report will represent a point in time and risks being immediately out of date. The more important points about considering other commitments when making appointments, and then on an ongoing basis considering Directors' continuing ability to contribute effectively are covered already in the code. We therefore think this will not add meaningful value.

Section 3 Composition, succession and evaluation

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

The proposals support the changes proposed by the FCA in this area and we agree with them.

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?

We believe that cognitive diversity is an important part of avoiding 'group think' on the Boards of corporates. The principle underpinning the proposed change is one we support.

However, we think this is very likely to simply lead to boilerplate reporting where corporates confirm that they attach value to cognitive and other aspects of diversity and that they incorporate this into their relevant HR processes. This will therefore lead to more reporting, but not more meaningful insight for investors. We therefore do not support the proposed wording and suggest Principle I ends after the words "They should promote equal opportunity and diversity".

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

Again, the principle that corporates should have robust succession planning in place is unarguable.

But given the obvious personnel sensitivities of the underlying detail of succession we again expect that any reporting will be high level and vague, and so we do not think this will add value for investors.

Q9: Do you support the proposed adoption of the CGI recommendations [in relation to board performance reviews] as set out above, and are there particular areas you would like to see covered in the guidance in addition to those set out by the CGI.

We support the proposed adoption of the CGI recommendations as set out in the Code and have no further additions.

Section 4 Audit, risk and internal control

Q.10 Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a 'comply or explain' basis?

We do not think the AAP should apply to all companies. This will be a resource intensive exercise and the Government intends to apply this to Public Interest Entities ("PIEs") only. We do not believe this should be extended to all companies, even with a comply or explain approach (see our cover letter on the market reality of explaining non-compliance).

We do not think this is proportionate, and we do not think the case has been made for such an extension. The harm that can be caused by the failure in a corporate's control environment will be more consequential the larger and more systemic the company is. This is why the Government has proposed an expansion in the definition of these companies (PIEs) and intends to legislate to apply the AAP to these companies only. We think this is a proportionate approach, and that the FRC should not expand the scope at this stage.

Q.11 Do you agree amending Provisions 25 and 26 and referring Code companies to the Minimum Standard for Audit Committees is an effective way of removing duplication?

Yes we agree with the proposed amendments, duplication should be reduced wherever possible.

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?

At Schroders we would place these requirements within our audit committee’s remit, but this may not be appropriate for all companies. We therefore think the Code should not mandate where these responsibilities should lie.

We welcome the proposal not to require a specific sustainability committee as it is for boards to decide how best to oversee sustainability risks and opportunities arising from their business models and strategy.

Q.13. Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal control systems in a proportionate way?

Overall we think your proposals are disproportionate and require a rethink.

We think in general keeping the Code high level and principles based, with additional detail left sparingly to guidance is the correct approach, but it is difficult to comment on this definitively without sight of the final guidance. The FRC consulting fully on any guidance before confirming it would help the market to better assess this balance.

Elsewhere in our response we disagree with applying the AAP to all Code companies.

We also note that having a single declaration may be a significant undertaking for some firms meaning that even if no changes of substance are made we think that more time than currently proposed should be given before introducing this requirement or phase in all the new requirements over a number of reporting cycles.

Q.14. 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 balance sheet?

We think ‘continuous’ monitoring suggests an unrealistic standard of perpetual or real time monitoring. We think that ‘Regular monitoring’ throughout the reporting period is a more proportionate (and practical) approach.

Q.15: 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?

In keeping with our overall argument for proportionality, we think the focus should remain first and foremost on financial controls, with a strong case being made – which we do not think to date has been made – before the scope of reporting on controls is expanding.

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?

If the FRC proceeds with its proposals we think examples will be necessary to help firms adjust to the new expectations.

Given we operate in a heavily regulated sector, we are comfortable that we will be able to comply with this requirement as we have a well developed risk management and internal controls system as required by PRA and FCA rules. But for companies in less regulated sectors these requirements will be newer and so

examples of good and bad practice will help support these companies. For example, the COSO framework might provide a useful starting point for companies.

We want to stress the importance of any examples being proportionate. We do not want to introduce an unnecessarily onerous standard where this is not necessary.

Q.17: Do you have any proposals regarding definitional issues, e.g. what constitutes an effective risk management and internal control system or a material weakness?

If this change is made we think it is very important that the final Code and any associated Guidance make clear that the material weaknesses in question are related to the *systems* a company has to monitor its risks and controls, not the underlying substance of any business weaknesses. We think this is your intention, but we think it is important this is understood beyond doubt.

To illustrate this, were a corporate to find a weakness in its process for assessing the risks it faces, then disclosure about this and what had been done to remediate would be reasonable, and may be of interest to investors (for example if periodic monitoring was found to not to cover a material part of the business and this has now been corrected).

However, if a review found an underlying weakness in e.g. a company's cyber security, and this had been remediated, we think disclosure of this through the Code would expose corporates to significant risk. We think this would naturally mean an extremely high bar would be placed on what constituted a 'material weakness' such that very little would ever be disclosed.

FCA listing rules already require timely market disclosures if an issue at a corporate is material enough to investors. We would not want requirements in the Code to also require ex-post disclosures of underlying weaknesses (particularly where this might lead to questions about whether this was to a different standard?). This would be duplicative and we fear very risky for corporates which would be counterproductive for both the corporate and their investors.

Q.18: Are there any other areas in relation to risk management and internal controls which you would like to see covered in the guidance?

We do not see the need for additional guidance.

Q.19: 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, we think this should be retained for all companies.

Q.20 Do you agree that all Code companies should continue to report on their future prospects?

Yes, we agree with the proposed amendments

Q.21 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 proposed wording allows sufficient flexibility.

Section 5 Remuneration

Q.22: Do the proposed revisions strengthen the link between remuneration policy and corporate performance.

We think the proposed wording of principle P should stop at “purposes and values” and not go on to explicitly mention ESG. For large companies and/or those that have made serious ESG commitments, this will be relevant to the “purpose and values” and they will report on this as a result.

But this will not necessarily be the case for all companies and the expanded wording would require them either to do work solely as a result of the code (when this may not be the best use of resources or management focus) or have to explain non-compliance on a sensitive topic.

We note the allocation of responsibility of Principle Q to the remuneration committee and question whether it is necessary to prescribe this, rather allow companies flexibility to allocate the responsibility where necessary.

Q.23 Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?

We support the proposals to discuss the overall policy and approach of a company to malus and clawback, where this is relevant. However, we do not support the Code requiring disclosure of where malus or clawback have been used in practice. While companies may choose to disclose this of their own volition, this can be subject to settlement agreements with staff that prevent the disclosure of the circumstances of departures, including on pay.

Q.24. Do you agree with the proposed changes to Provisions 40 and 41?

The removal of the current Provision 40 is a welcome change. We agree with the consultation paper’s findings that the current drafting of Provision 40 has resulted in disclosures that often detail how companies have met each criterion of the Provision with similarly homogenous language used across many companies, where more flexibility for each company to address the new Provision 35 would provide more meaningful information for investors.

Q.25 Should references to pay gaps and pay ratios be removed or strengthened?

We support the proposed removal of the reference to pay gaps / ratios in the amended Provision 43 in acknowledgement that reporting of such information is widely available to the investment community and to limit duplication in annual disclosures required by the Code.

Other matters for consideration

Q.26 Are there any areas of the Code which you consider require amendment of additional guidance, in support of the Government’s White Paper on artificial intelligence?

We do not think the Code needs amendment to support the Government’s White Paper on AI. The Code should remain high level and allow company boards to oversee the use of AI in their business and manage any specific risks and report if this is considered material under existing provisions.