UK Corporate Governance Code consultation document – PIRC response

14/09/2023

The voice of responsible shareowners

Introduction

We welcome the opportunity to comment on the proposed revisions to the UK Corporate Governance Code. Below we have provided response to those questions where PIRC has a particular view. We have also provided additional comments in relation to two areas that we believe the FRC could explore further.

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?

Yes. For many companies responding to climate change is very clearly a strategic challenge and therefore the Code should reflect this. PIRC does consider that more guidance to boards on the need for specific skills, and independence, in relation to climate change is necessary. We have published our own report on this topic which we are happy to share with the FRC.[1] Our key recommendations were as follows:

- Boards should disclose a skills matrix, detailing the skills and experience Board members have which demonstrate why they have been chosen to be on the ESG committee or equivalent.
- In the case of the Chair of the committee, their understanding of implications from ESG/ Climate issues should be clearly laid out alongside their skills and experience.
- Companies should be required to have a fully independent ESG committee (based on the relevant Corporate Governance Code requirements) as well as at least one subject matter expert with experience that extends beyond the immediate industry.
- If directors do not have sufficient climate expertise, the company should outline the training needed for them to have a sufficient level of understanding.
- Boards should have employee or union representation on the ESG committee, preferably through employee directors or equivalents. Where companies have adopted the Designated NED or equivalent model, these directors should serve on the committee.
- Annual reports should provide information on how employee views have been considered in relation to transition risk.

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

Whilst most of the revised text is acceptable PIRC is concerned by the removal of the sentence 'The workforce should be able to raise any matters of concern.' Whilst similar text is included in the guidance in relation to workforce engagement models, its current prominence within the principles on leadership and company purpose does provide a clear steer to boards on the importance of this point. Therefore, PIRC urges that the FRC retains the original text.

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?

Yes. PIRC continues to find examples of boards where some directors have, in our view, too many external commitments, raising a question about their ability to provide effective oversight. Including consideration of this issue in the context of board performance reviews seems likely to encourage more reflection.

[1] *Board Governance and Oversight for a Just Transition*, PIRC Research Report, 2022

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?

Yes. It would be valuable for companies to report on any changes made as a result.

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?

Whilst we understand the drive behind this change, and hope that most board members and other users of the Code would be familiar with protected characteristics, it would be better to clarify the language. An alternative wording could keep the existing language, and therefore explicitly reference, gender, ethnicity, social background and cognitive diversity but also include a reference to protected characteristics.

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

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?

PIRC believes that it is important boards are held responsible for the nature and content of ESG reporting. In practice, we believe that this should be the responsibility of the board and, where reporting falls short of expectations, we seek to hold the chair and other board members accountable. Whilst we are not opposed to the audit committee having a remit to oversee such reporting this should not override board accountability.

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

The Code should emphasise that where a principal risk has been identified the expectation is that data will be disclosed in relation to this risk. The discussion of the issue in the risk section of the report could point to where related data can be found.

Currently this is not common practice in relation to some risks that companies disclose. PIRC's analysis of principal risk reporting in relation to workforce issues by PLCs revealed that companies often fail to provide meaningful data to support their reporting.[2] For example:

- 233 out of 388 (60%) FTSE All-Share companies listed Labour Retention and Recruitment as one of their principal risks. However, only 55 (24%) of these companies provided any kind of turnover data, whether that be voluntary, involuntary, or overall turnover rates.
- 121 out of 388 (32%) FTSE All-Share companies listed Health and Safety as one of their principal risks. 95 (79%) of these companies provided some level of H&S data, although as previous analysis by PIRC has shown, the lack of consistent measures used in H&S data makes comparative analysis very difficult.

Therefore, the Code could be revised to include guidance to encourage companies to both provide data in relation to disclosed risks, and to signpost data where it has been provided.

[2] *Not By The Numbers: Workforce related risks companies report and the data they (don't) disclose*, PIRC research report 2023.

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

Whilst it is valuable to revise the text to emphasise the need to ensure remuneration policy aligns with performance, PIRC considers that it is equally important that policy aligns with organisational values. In many cases where companies experience difficulties in relation to remuneration the outcomes that are controversial might be internally justified by reference to existing remuneration policy targets but fail a common-sense test. Awards are made even when it is obvious that these will cause reputational damage to the company both internally and externally. In extreme cases the failure of remuneration committee members to take account of this can result in a loss of confidence in the leadership of the company.
In the current high inflation environment, where companies are faced with difficult decisions regarding pay across the organisation, remuneration committees should be looking wider than performance linkage alone.

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

PIRC supports the proposed changes. The extent to which this results in improved transparency is dependent on the responses of companies.

Q24: Do you agree with the proposed changes to Provisions 40 and 41?
Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

PIRC utilises pay ratio and pay gap data disclosed by companies both in the production of proxy research reports for our clients and our analysis of workforce issues. We consider this data, particularly the average pay at quartiles, to provide a valuable snapshot. The Code emphasises that remuneration committees should consider workforce pay and conditions when both setting policy and determining outcomes. Therefore, removing the guidance to consider pay ratios and pay gaps is in conflict with this objective, and no rationale has been provided for its removal. This is a particularly important issue at a point where the workforce of companies is facing very significant cost of living pressures.

Therefore, PIRC does not support this revision and rather believes that the reference to pay ratios and pay gaps should be strengthened.

Additional comments

There are two additional areas where PIRC would encourage the FRC to consider undertaking further work: workforce engagement models and mergers and acquisitions.

Workforce engagement

In relation to the first area, given that five years have passed since the introduction of guidance on engagement with the workforce, PIRC believes that now is the time for a review of how this section of the Code has worked in practice. We have identified a number of concerns with existing practice through our own research and analysis that warrant further exploration.

These include:

1. Many designated NEDs not being formally expected to commit extra time to the role.
2. Some NEDs appointed to the designated NED role being wholly inappropriate candidates.

3. The lack of involvement of designated NEDs in engagement meetings relating to workforce issues.
4. Resistance from some investors to workforce directors.

In relation to point 3 above, PIRC has undertaken numerous engagements with companies over workforce issues and it is notable that companies exceptionally rarely include designated NEDs. This is in stark contrast to remuneration-related engagements where remuneration committee members, usually the committee chair, are almost always in attendance.

In relation to point 4, PIRC has discovered that some investor voting policies state that they will vote against employees on the boards of companies who are members of audit or remuneration committees where they are not required to be so by law. This appears to have driven a vote against one of the handful of employee directors on UK PLC boards in the 2022 season. This was large enough - in line with Code guidance in relation to votes against management recommendations of over 20% - to require a formal response from the company. This inevitably acts as a disincentive for other boards to adopt the employee director model.

Overall, we have found the employee director model to be most aligned with our expectations of how effective workforce engagement might be operationalised. In contrast, we have often been disappointed in respect of the designated model. Therefore, PIRC would support further guidance to the Code that encourages proper consideration of the employee director model, in addition to a review of the impact of this aspect of the Code more generally.

Mergers and acquisitions

In relation to mergers and acquisitions, we note that the Code contains no references to the subject currently. M&A activity entails significant structural change, potential value creation or destruction, workforce growth or reduction and so on. Such activity, even when deals fail to progress, can require a significant amount of executive management time and company resource.

In practice we have observed that M&A activity can become a significant distraction. There are undoubtedly occasions where the interests of directors who are undertaking or are subject to such activity do not necessarily align with the interests of shareholders or other stakeholders. In addition, PIRC's analysis of voting activity during takeovers reveals that there might be unique governance risks during the process.[3]

Therefore, it is intuitive that when companies are involved in such activity this is a period in which independent oversight at board level is particularly valuable. Currently there is no guidance within the Code as to which directors, or committees, would provide such oversight or what form this might take. Similarly, the Stewardship Code contains no language on this topic. Therefore, PIRC encourages the FRC to review how issues relating to M&A might be captured in future iterations of both the UK Corporate Governance Code and Stewardship Code.

[3] *Democratic Deficit: Takeovers, Derivatives and Stewardship*, PIRC Research Report, 2022