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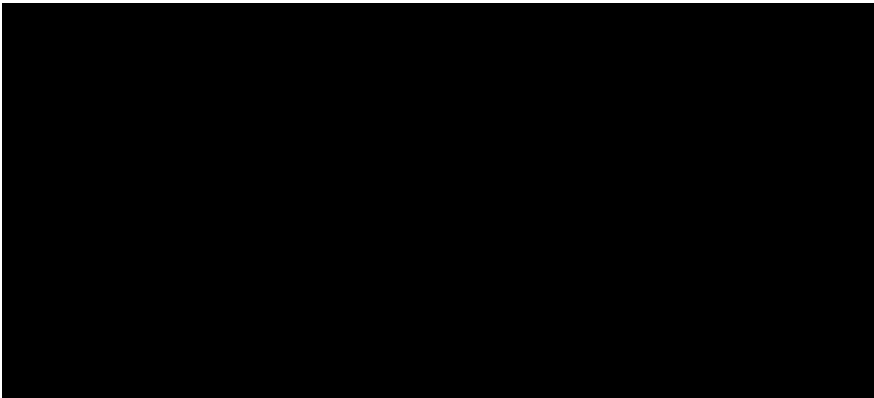
## **UK Corporate Governance Code consultation**

Dear all,

We at Columbia Threadneedle Investments welcome the opportunity to respond to the consultation of the UK Corporate Governance Code review.

Please find our considerations below.

With best regards,



## **Part 1: Executive Summary**

The UK Corporate Governance framework is one of the leading governance frameworks globally. As a large active investor that focuses on research intensity, we support the comply or explain model of the UK Corporate Governance Code (“the Code”) as it provides a best practice reporting framework and common understanding between investors and a company’s board on corporate governance. In addition, the Code highlights the importance of long-term corporate success and sustainability, addresses issues of public trust in business and continues to be an innovative framework incorporating market best practice which aligns with UK corporate culture.

We have provided a response to certain questions in the consultation in Part 2. However, there are four key issues which we feel are important to discuss which are not covered in the code. These are outlined below:

### (A) The changing nature of the Code and how it is becoming overly prescriptive

Through the years, the Code has gone through various iterations keeping up with market trends and evolving in line with business culture in the UK. These include the early Cadbury Code (1992)<sup>1</sup> on the importance of companies being free to drive their business forward within a framework of effective accountability, the addition of the Higgs<sup>2</sup> and Greenbury Reports<sup>3</sup> emphasising the role of the Board and the latest version of the Code highlighting the importance of the role of ‘purpose’ and growing attention to other stakeholder matters to help build trust in business<sup>4</sup>.

Given where we are today, we question whether the current state of the Code focuses on purely ‘Corporate Governance’ matters as it appears to pursue other objectives. The Code itself includes a wide range of topics and is now incorporating other important financially material long-term factors including environmental and social issues.

In the next comprehensive review of the Code, the Financial Reporting Council (FRC) should ensure that users understand how the Code complements other disclosing requirements which are not corporate governance matters and be clear it is not duplicative of other frameworks (e.g. TCFD).

### (B) Shift away from focus on transparency and accountability principles

*‘Comply or explain’ to ‘comply or else’*

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<sup>1</sup> [https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-\(the-Cadbury-Code\).pdf](https://www.frc.org.uk/getattachment/9c19ea6f-bcc7-434c-b481-f2e29c1c271a/The-Financial-Aspects-of-Corporate-Governance-(the-Cadbury-Code).pdf)

<sup>2</sup> <https://webarchive.nationalarchives.gov.uk/ukgwa/20121212135622/http://www.bis.gov.uk/files/file23012.pdf>

<sup>3</sup> <https://www.ecgi.global/download/file/fid/9446>

<sup>4</sup> <https://www.frc.org.uk/news/january-2020/improved-governance-and-reporting-required-to-prom>

In the UK, the comply or explain model has been an important ingredient to the successful application of the Code's framework including both principles and provisions. It provides an incentive for companies to develop governance processes which best suits their business model, providing the necessary flexibility for the company to succeed.

In our meetings with companies, some directors have expressed that the Code is becoming more onerous with an overemphasis on complying rather than explaining. The purpose of an 'explanation' is to provide meaningful transparency and show that, despite non-compliance, the company can still meet the spirit of good governance.

Therefore, we question whether the expansion of the Code over the past twenty plus years has meant growing expectations of compliance with its provisions have overshadowed the need to apply a balanced and understandable assessment of a company's position (through transparency and accountability), irrespective of whether it chooses to comply or explain with respect to a particular requirement of the code.

At the next comprehensive review of the Code, the FRC should not only examine the principles and provisions by topic, but also how it is applied by corporates to achieve optimal governance frameworks which are flexible.

(C) One size fits all approach to corporate governance

*Corporate Governance expectations for smaller companies*

Whilst there are clear expectations from investors of what constitutes good corporate governance standards, there isn't a one size fits all approach when applied in practice.

In particular, the difference in the size and scale of small companies ("small caps") in comparison to larger peers means that the corporate governance structures of small caps are on a development path. Small caps have less resources and are challenged around providing granular disclosure (e.g. limitations in resources and data collection) and investor engagement.

The FRC's consultation also makes reference to the Financial Conduct Authority's (FCA) consultation on changes to the Listing Rules. The issue of improving the competitiveness of the UK equity market is a concern for us and we believe there is merit to look at whether there are higher barriers to entry in governance expectations for potential listings which are deterring companies away from listing in the UK, in particular small caps which will not fit the governance mould straight away. A balanced approach should be taken with smaller companies allowing their corporate governance structure to develop in line with their objectives.

*Remuneration*

An example of where a one size fits all may not work is in relation to remuneration matters. Pay continues to be a high-tension point between investors and boards. Unhelpfully, the conversation has led to more complex remuneration structures being developed as well as distracting engagement away from other important issues such as succession planning, accounting, and risk.

Clear principles on remuneration based on transparency and accountability will simplify remuneration structures in the UK. We recommend that the FRC conducts a study into the state of the landscape of remuneration in the UK, with a focus on small cap/high growth companies and role of proxy voting advisors.

(D) Improvement in other stewardship market mechanisms

*Investment Association (IA) Public Register*

To improve transparency of dissenting votes in the IA Public Register (UK Corporate Governance Code, Provision 4<sup>5</sup>) we recommend that a separate section in the disclosure is included which states whether proxy voting advisors have also recommended an adverse vote on a resolution. This will complement the Code in a stewardship context in terms of how understanding how voting powers are exercised by investors and to whom companies are accountable to in improving their governance practices because of a high dissent vote.

*Efficiency in Committee Chairs engaging with Investors*

Given the demand for investors in requesting information from companies on a range of different issues, efficiencies in the way meetings are handled would benefit the market. In particular, meeting Committee Chairs from the same sector where there has been a sector wide issue (e.g. the Audit Committee or Sustainability Committee Chairs gathering together) could be held in a group investor meeting and hosted by organisations such as the Investor Forum<sup>6</sup> who have strict guidelines in place to ensure compliance with applicable law/regulation including around competition and disclosure of sensitive commercial information.

This will enable investors to engage with different companies all on the same issue simultaneously without replacing the valuable one-on-one engagement that investors already have with companies.

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<sup>5</sup> <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf>, page 5

<sup>6</sup> <https://www.investorforum.org.uk/what-we-do/>

## Part 2: Answers to your questions

### 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?**

**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?**

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

The length of annual reports has grown significantly over the years and we question if there is enough clarity and conciseness to assist investors in making informed investment decisions. In the next detailed update of the Code, the FRC should consider where efficiencies can be made, and duplication removed to improve the quality and length of reporting by companies.

Overall, we support the proposed amendments by the FRC, however it remains to be seen whether these amendments will deliver more outcomes-based reporting. The FRC Lab<sup>7</sup> may want to examine whether this change in the Code has made the expected impact in a few years.

In addition to the proposals, we would recommend one slight addition in Provision 1 with regard to the explicit mentioning of environmental and social matters to be taken into account. We agree that this focus will bring more attention to these issues which have become more important for our clients given they can help or hinder the generation of long-term financial returns. As active investors, financially material ESG issues have always been a focus and we see such issues being more pronounced in the future although these terms may imply that the subject is niche.

The Code should ensure that it is able to stay relevant and encapsulates a wide range of ESG factors where they are financially material. We would support keeping in the terms 'environmental and social' but also to include an umbrella term to describe these factors more holistically leaving it up to companies to define specific topics and areas they want to prioritise in line with their business strategy. For example, the FRC could use the term "*financially material factors*" which is more broad, more understood by investors and highlights explicit environmental and social matters as being important matters to be considered. Proposed wording below:

*"The Board should assess the basis on which the company generates and preserves value over the long-term. It should describe in the annual report how opportunities and risks to the future success of the business have been considered and addressed, the sustainability of the company's business model and **how** the handling of **financially material factors** including environmental and social matters, are taken into account in the delivery of the strategy. Such matters include climate ambitions and transitioning planning."*

### Section 2 - Division of responsibilities

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<sup>7</sup> <https://www.frc.org.uk/investors/frc-lab>

**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?**

**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?**

We agree with the changes proposed by the FRC. In particular, we agree that it is not in the best interest of companies that the Code specifies a maximum number of appointments a director could have as each case will be different depending on the size of the company, its strategy, individual director ability and overall board quality. For example, smaller growth focused companies may face distinct problems with regards to scaling, the level of experience and expertise a director requires and have a different risk appetite on time commitment in comparison to larger peers. The use of the annual performance review of the board is the appropriate medium in which to convey to investors that the board is of sufficient quality and a director's time commitment is part of the assessment in examining a well-functioning board.

We would also recommend that Provision 14 captures the trend in attendance levels as it is important to understand whether absences are a specific one-off event or more regular. Therefore, we propose the wording to be adapted to include: "*The annual report should set out the number of meetings of the board and its committee, and the individual attendance by directors **per annum over the last three years.***"

Whilst we agree with conventional wisdom that directors acquire valuable knowledge and practice by serving in governance capacities at other companies and that they are likely to be pursued for their expertise, we are concerned that the time commitment for directors serving on boards is ever increasing, in particular at large complex organisations. Our worry as investors is that decisions in the boardroom are taken sub-optimally in terms of how the company is managed and that good quality directors may be deterred from sitting on UK plc boards. Whilst this is not a specific issue for the FRC to solve, it should be cognisant of how the Code impacts board directors in terms of demands placed on them. The regulatory reporting burden on board directors is ever increasing and there is a risk that it distracts them from discussing other important issues such as strategy, capital allocation and management execution.<sup>8</sup>

### 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?**

**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?**

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

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<sup>8</sup> <https://www.cgi.org.uk/knowledge/research/bellwether-2023>

**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?**

We support the revisions in the Code by the FRC to align with the FCA's policy on diversity and to avoid duplicative targets or regulations. In addition, we support the amendments to clarify the term board performance review and it should be commissioned.

However, we would recommend in Provision 24 that explicit reference to nomination committee work also includes “*the consideration of skills, experience and talent*” which are also important factors to take into account during recruitment.

Section 4 - Audit, risk and internal control

*[We have answered this section in line with what we think are applicable for investors. Questions 10, 13 to 19 have not been answered as we don't have a strong view and are more appropriate for companies to respond]*

**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?**

Whilst we understand the rationale for the proposal, we question whether there could be unintended consequences of delegating such matters only for the audit committee to consider. Given it could be an important driver to the creation of long-term sustainable value and could impact operational risk, the whole board should be involved in understanding how these matters are reported and measured.

In addition, we view the role of the audit committee as already having a number of issues to contend with (risk management, audit, financial reporting) which are time consuming. Corporate failures in recent years attest to the importance of a focused audit committee.

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

**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?**

As active investors, we are very interested in the proposals to strengthen viability statements. We strongly support the FRCs recommendation to apply this to all companies under the Code so as long as the 'comply or explain' model is operating appropriately. This information is useful for investors as it provides greater insight into how boards examine principal risks during the relevant review period, how they apply a scientific approach to scenario planning, stress testing, sensitive analysis, modelling and the assumptions which underpin their decision making.

## Section 5 - Remuneration

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

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

**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?**

We do not have any significant concerns with the proposals made by the FRC in the remuneration section. Many of the amendments are aligned with market practice and align with our expectation of companies being transparent and open with investors in how it applies its remuneration policy.

However, we would like to highlight that remuneration as a topic itself has grown in complexity and at times has become the dominant corporate governance conversation during engagement with companies. The scrutiny on remuneration has also created unhelpful tension between investors and companies in voting at annual general meetings and is at risk in distracting the conversation on promoting good corporate governance away from other important factors which drive long-term value in companies.

Each company is unique and faces its own set of different challenges and opportunities. We expect companies to determine which specific pay structures work best for their own company and to explain this clearly to investors. When we engage with companies, we don't seek to micro-manage pay, but rather request a better understanding of how we can link pay more closely with the interest of investors to position themselves best for future success.

The level of remuneration – or quantum – is often the sole focus of debate, contention, and sets attention-grabbing headline for media outlets. Companies often describe their key person risk and justify a desire to increase the level of remuneration through benchmarking international peers. Remuneration itself does not have to be complex subject and can be based on some very basic guiding principles, many of which the FRC has helped to define through different iterations of the Corporate Governance Code. For example, the previous Combined Code<sup>9</sup> set as its first principle in B.1 "*Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose*". Therefore, the Code should encourage a focus on what increasing quantum is intended to facilitate, by way of creating value for stakeholders and not ratchet up pay levels where there is no expected corresponding improvement.

This issue is more profound for us in small caps where often they are expected to apply standards of remuneration guidelines which do not correspond with the size and scale of the company and its objectives.

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<sup>9</sup> [https://www.frc.org.uk/getattachment/8238c251-5cfe-43b7-abc0-4318ccbd0fd/Combined-Code-2006-\(Oct-version\).pdf](https://www.frc.org.uk/getattachment/8238c251-5cfe-43b7-abc0-4318ccbd0fd/Combined-Code-2006-(Oct-version).pdf)



In terms of making further progress, we recommend that the FRC (perhaps in conjunction with investor bodies such as the Investor Forum and the Investment Association) conduct further research on the landscape of remuneration in the UK. This study could touch on a wide range of areas including a better understanding of the evolution around pay structure over the years and the role of different stakeholders (e.g. recruitment consultants, proxy voting advisors), how this compares internationally (to address the question of competition of talent abroad) and how best to provide support for Remuneration Committee Chairs who deal with significant scrutiny around pay.