

13<sup>th</sup> September, 2023

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**Submitted by e-mail to:** [codereview@frc.org.uk](mailto:codereview@frc.org.uk)

Dear David,

### **CFA UK's Response to the FRC's consultation on the UK Corporate Governance Code**

The CFA Society of the UK ('CFA UK')<sup>1</sup> welcomes the opportunity to comment on the FRC's latest draft of the UK Corporate Governance Code (the 'UKCG Code'). CFA UK remains highly supportive of the UKCG Code and its 'comply-or-explain' format. CFA UK believes that the UKCG Code serves to provide a dynamic and effective framework to set and describe current expectations of best-in-class corporate governance and disclosures to corporates, investors and other stakeholders.

The proposed amendments to the UKCG Code, which introduce the new requirements for (i) a resilience statement, (ii) an audit & assurance policy, (iii) tighter governance of internal corporate controls, (iv) objective sustainability reporting, (v) improved transparency around malus and clawback remuneration provisions, are all measures which CFA UK supported in its response to the BEIS consultation: 'Restoring Trust in Audit and Corporate Governance' in 2021<sup>2</sup>. CFA UK's position on these issues has not changed in the interim and we broadly support the substance of the proposed changes with the following caveats.

We are very concerned about the deletion of the words: "The workforce should be able to raise any matters of concern" from the old Principle D in Section 1. We believe best corporate practice is to have an effective whistleblowing policy in place and a corporate culture that supports it, so this deletion from the Principle level of the Code, to rely just on provision 6, seems a highly retrograde step.

Also, in our response to the BEIS consultation:

- A. CFA UK supported the option to introduce new regulations requiring third-party assurance of internal controls, similar to those provided for in the Sarbanes-Oxley Act in the United States. We observed that the estimated £2.3 billion annual cost

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<sup>1</sup> CFA UK is a professional body representing over 11,000 investment professionals in the UK. Appendix I contains a summary of the mission, purpose and activities both of CFA UK and that of our umbrella organisation, CFA Institute.

<sup>2</sup> CFA UK response to BEIS consultation on 'Restoring trust in audit and corporate governance' (July 2021): <https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/cfa-uk-response-to-beis---restoring-trust---final.pdf>

represented less than 0.005% per annum of the then £5.1 trillion market value of the debt and equity of all the companies in the FTSE All-share and concluded that this was an acceptable price to pay for a third-party auditor validation that a company's internal controls were robust. We are still of this view. The compromise adopted by the government and now embodied in paragraph 30 of this new draft of Section 4 of the UKCG Code – that the company's directors be required to make their own statement as to the effectiveness of their internal controls – is, we believe, less likely to be effective in situations driven by management impropriety. However, we acknowledge that paragraph 30 does represent a significant improvement on the pre-existing governance landscape of internal controls.

- B. CFU UK stated: “The replacement of the FRC with the ARGA is fundamental to the goal of restoring trust in business and audit, and in the regulator itself. The change in title, from a council to an authority, signals that this new statutory body should have the necessary powers not only to set standards but to enforce them and to hold those involved in corporate governance and audit to account.” We reiterate our support for ARGA's formation and are disappointed with the speed of progress, notwithstanding the disruption of covid19. Since the Kingman report (2018), the FRC has had its resources increased and has implemented many of the recommendations using its supervisory powers over audit firms and the comply-or-explain approach of the Code. The government also plans pieces of legislation<sup>3</sup> that would achieve some of the other goals<sup>4</sup>. We welcome these measures and urge their passing. Notwithstanding the progress above, we still believe that ARGA should replace the FRC.
- C. CFA UK argued that the definition of PIEs could be improved by having the threshold set as a company with 750 employees OR a turnover of £750 million, rather than BOTH 750 employees AND £750 million turnover:
- This would be in closer alignment with the definitions of ‘Small’, ‘Medium’ and ‘Large’ companies as codified in the Companies Act, where the definitions require two-out-of-three thresholds relating to employee numbers, turnover and balance sheet footings to be exceeded.
  - It would better cater for modern-day, ‘scale-up’ businesses with high turnover but relatively few staff.
  - It would also be less easy for companies to circumnavigate through subcontracting employees, for example.

We have provided responses to the individual questions raised in the consultation in Appendix II.

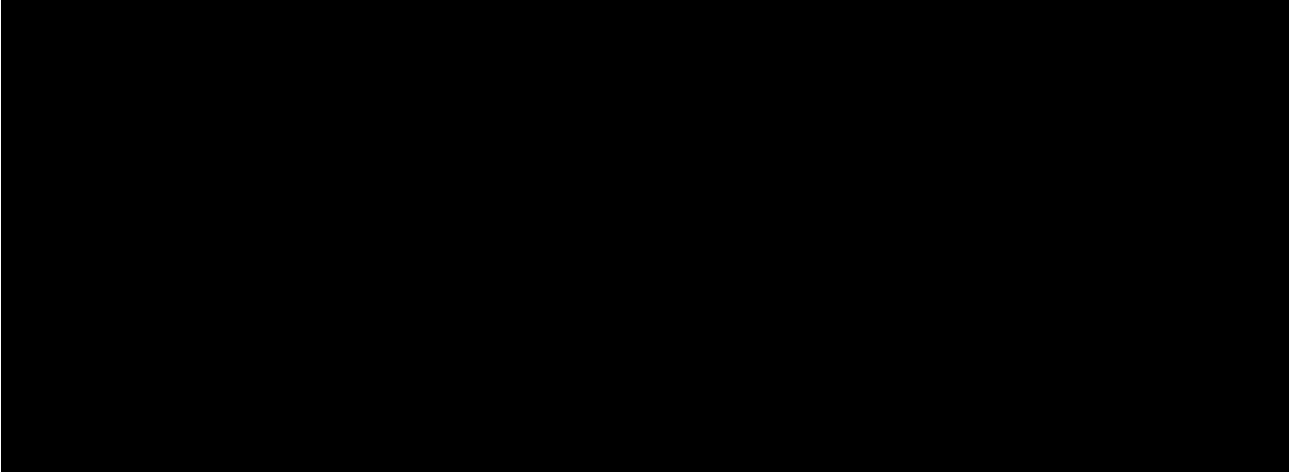
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<sup>3</sup> The Companies (Strategic Report and Directors' Report) (Amendment) Regulations 2023

<sup>4</sup> See Appendix C, p63, of this consultation, “Summary of draft secondary legislation on corporate reporting”. This legislation includes new reporting requirements for an audit & assurance policy, the resilience statement, distributable profits and steps to detect/prevent fraud

In line with our Society's purpose, we aim to highlight relevant issues to help the investment community to serve its stakeholders well and to build a more sustainable future.

Yours sincerely,



## APPENDIX I: About CFA UK and CFA Institute

**CFA UK** serves over eleven thousand leading members of the UK investment profession. Many of our members work either managing investment portfolios, analysing and advising on investments, or in some form of investment operations and oversight role.

The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.

Founded in 1955, CFA UK is one of the largest member societies of CFA Institute and provides continuing education, advocacy, information, networking and career support on behalf of its members.

CFA UK has pioneered the development of ESG-related examinations for investment professional in recent years, specifically the Certificate of ESG Investing (now run by CFA Institute), the Certificate of Climate Investing and the Certificate of Impact Investing (currently under development).

Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

For more information, visit [www.cfauk.org](http://www.cfauk.org) or follow us on Twitter @cfauk and on LinkedIn.com/company/cfa-uk/.

**CFA Institute** is the global association for investment professionals that sets the standard for professional excellence and credentials.

The organisation is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

It awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations worldwide, publishes research, conducts professional development programs, and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

There are nearly 200,000 CFA® charterholders worldwide in more than 160 markets. CFA Institute has ten offices worldwide, and there are 160 local societies.

For more information, visit [www.cfainstitute.org](http://www.cfainstitute.org) or follow us on [LinkedIn](#) and Twitter at [@CFAINstitute](#).

**APPENDIX II: CFA UK RESPONSES TO QUESTIONS****Section 1: Board Leadership & company purpose**

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

Yes.

**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. We believe this is also in alignment with the guidance of the government's Transition Planning Taskforce Disclosure Framework<sup>5</sup>.

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

We were surprised to see the deletion, without any explanation, of the requirement in the old Principle E (new Principle D): *"The workforce should be able to raise any matters of concern."*

We regard this change as an unwisely swift reversal of the spirit of the reforms introduced under Theresa May only in 2016 which were designed to improve employee participation in corporate decision-making through board representation, employee surveys or works councils. Recent events within the NHS underline that the value of this principle applies equally to any PIE – whether a state-run organisations or a private or publicly listed company.

CFA UK believes it is best corporate practice to have an effective whistleblowing policy in place and a corporate culture that supports it. We cannot see similar replacement wording inserted elsewhere in the Principles of the revised Code and we believe it is ill-advised and inappropriate to just rely on Provision 6 in this regard.

We also believe Provision 6 should be further strengthened to read as follows (NEW WORDING IN BOLD):

"There should be a means for the workforce to raise concerns in confidence and, if they wish, anonymously. The board should routinely review the effectiveness of these arrangements and the reports arising from its operation. ~~It should ensure~~ **THE BOARD SHOULD ASSURE ITSELF** that these arrangements **ALLOW COMPLAINANTS TO RAISE CONCERNS WITHOUT FEAR OF ANY RESULTING UNFAIR RECRIMINATION OR DISADVANTAGE AND PROVIDE** ~~are in place~~ **are in place** for the appropriate and independent investigation of such matters and for follow-up action."

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<sup>5</sup> <https://transitiontaskforce.net/wp-content/uploads/2022/11/TPT-Disclosure-Framework.pdf>

## 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?***

Yes, though we would add back the words “against objectives” after “performance” to make clear that directors should still be held to account against their set targets.

***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 partly agree. We believe the requirement for directors to list their other commitments should be mandatory, but the requirement to explain how they fulfil the responsibilities of their role should be voluntary. In many cases, the latter will not be required or meaningful.

## 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?***

Yes.

***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?***

Yes. We support the broad direction of travel but think it is an omission to focus on diversity without ensuring that provision is made for improving inclusion. See also our response to Q8 below.

Another concern is that a rigorous and transparent process needs to be used sensitively to ascertain the characteristics, protected and otherwise, of board members and candidates for board membership. As investors we support the requirement for such data to be collected and published in the annual report; for many of our members this is important data for their analysis. However, we also believe it is important that it should be optional for board members and board candidates to respond to such questions.

***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. We agree that appointments should be subject to a ‘formal, rigorous and transparent procedure’ but as importantly it should be transparent and ideally shared on the company website. One common barrier to engagement from individuals from either a minority background or with a minority view is that the criteria for selection are not obvious and opacity allows bias to affect decisions. Similarly annual evaluation should have a clear

process which is shared on appointment. Therefore, we welcome the requirements set out in provision 24. In addition, we recommend that evaluation should cover inclusive leadership for the chair and inclusive behaviour for all board members.

***Q9: Do you support the proposed adoption of the CGI recommendations<sup>6</sup> 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?***

Yes. We agree with the statement in paragraph 33 on page 13 that it is not appropriate to be too prescriptive in this area.

This feels like semantics, but we tend to disagree with the FRC's conclusion in paragraph 34 on page 13 that 'evaluation' is 'backwards-looking' whereas 'performance review' is not; if anything, we would suggest that the term 'performance review' is more backwards-looking than 'evaluation'. Surely an annual board review also explores matters such as the board's current composition, skills mix and gaps in the context of its performance? A 'performance review' would seem to fall short of this fairly critical component of any board assessment. Perhaps the recommendation should be for a 'Board performance review and evaluation' or simply, 'Board Assessment'?

## Section 4: Audit, risk and internal control

### AUDIT & ASSURANCE POLICY ('AAP')

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

Yes, whilst noting that government legislation is expected to make this mandatory for Public Interest Entities (PIEs).

In our response to the BEIS 2021 consultation 'Restoring Trust in Audit and Corporate Governance', CFA UK argued that the definition of PIEs could be improved by having the threshold set as a company with 750 employees OR a turnover of £750 million, rather than BOTH 750 employees AND £750 million turnover:

- This would be in closer alignment with the definitions of Small, Medium and Large companies as laid down in the Companies Act, where the definitions require two-out-of-three thresholds relating to employee numbers, turnover and balance sheet footings to be exceeded.
- It would better cater for modern-day, 'scale-up' businesses with high turnover but relatively few staff.
- It would also be less easy for companies to circumnavigate through subcontracting employees, for example.

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<sup>6</sup> Chartered Governance Institute of UK & Ireland's Review of the effectiveness of independent board evaluation in the UK listed sector (Jan. 2021):  
[https://www.cgi.org.uk/assets/files/pdfs/Publications/2021/cgiuki-board-evaluation\\_full-report.pdf](https://www.cgi.org.uk/assets/files/pdfs/Publications/2021/cgiuki-board-evaluation_full-report.pdf)

**AUDIT COMMITTEES & THE EXTERNAL AUDIT: MINIMUM STANDARD**

***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.

**SUSTAINABILITY REPORTING**

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

Yes. This is an area of great importance for institutional investors who are increasingly required to run portfolios in accordance with such metrics and accurately report against them to end-investors.

We note the planned implementation of the ISSB's S1 and S2 standards will make elements of this mandatory for many companies anyway.

**RISK MANAGEMENT & INTERNAL CONTROLS**

***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?***

In our response to the BEIS 2021 consultation, CFA UK supported the option to introduce new regulations requiring third-party assurance of internal controls, similar to those provided for in the Sarbanes-Oxley Act in the United States. We observed that the estimated £2.3 billion annual cost represented less than 0.005% per annum of the then £5.1 trillion market value of the debt and equity of all the companies in the FTSE All-share and concluded that this was an acceptable price to pay for a third-party auditor validation that a company's internal controls were robust.

We still remain of this view. The compromise adopted by the government and now embodied in Principle 30 of this new draft of Section 4 of the UKCG Code – that the company's directors be required to make their own statement as to the effectiveness of their internal controls – is, we believe, less likely to be effective in situations of management impropriety.

However, we acknowledge that paragraph 30 does represent a significant improvement on the pre-existing governance landscape of internal controls and that the costs of implementing it are significantly less than those of introducing a full-blown Sarbanes-Oxley regulation requiring auditor sign-off.



***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?***

We firmly believe that it should be based on continuous monitoring. We believe that this is the approach which management and boards themselves should have, and know that this form of declaration would be most meaningful and useful for investors. We recognise that issues identified, and fully addressed, during the year should be disclosed on the continuous monitoring approach but not at all under a year-end approach. We believe that this would be of particular value to investors, and build their confidence in the substance of the oversight by boards and of the disclosures made.

***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?***

No. We believe both 'financial' and 'non-financial' reporting should be explicitly referred to. They are both important and complimentary to one another.

***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?***

We suggest that the guidance should provide examples of what the FRC considers good and also what the FRC considers inadequate.

As discussed in our response to the BEIS 2021 consultation, we would expect to see references to and discussions of the outputs of reverse stress tests.

***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?***

To make reporting effective some definition of what is considered 'material' would be helpful. This should ensure that only material risks are discussed and that the reporting narrative stays focused on these. Ultimately, and in line with the reporting standards, material risks are those that might influence investors' decisions. To use the IASB's definition of materiality seems a sensible solution. The effectiveness of internal controls is crucial to forming a view on the reliability of the information.

We note that there will be significant variances in definitions used by different companies and sectors.

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

No comment.

**GOING CONCERN**

***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)?***

Ideally yes. We would hope that all Code Companies that are not PIEs will still want to comply with this element of the Code. If they elect not to, which is their right as it will not be legally mandatory for them, then they should be required to explain why they have chosen not to comply.

**RESILIENCE STATEMENT**

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

Yes.

***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.

**Section 5: Remuneration****CHANGES TO STRENGTHEN LINKS TO OVERALL CORPORATE PERFORMANCE**

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

Yes.

**MALUS & CLAWBACK**

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

Yes.

**CHANGES TO IMPROVE THE QUALITY OF REPORTING**

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

We find it regrettable that the old clauses 40 & 41, which seemed to us to have been well written, have in fact produced such poor reporting by companies of their remuneration policies. We tend to agree that better guidance might improve disclosures in this area.

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

Whilst we understand the current debate around unduly onerous UK governance reporting we do not believe that references to pay gaps and pay ratios should be removed and that, if anything, it should be strengthened. The current court case at a leading UK supermarket and the recent bankruptcy of a major metropolitan local authority provide two good examples of how a pay gap can lead to real financial risk and exposure. Such data can be material to investment decisions.

In addition, guiding a company to set out their pay philosophy, any market research and workforce consultation as examples of potential practice would also be helpful. Investors and employees alike can then establish whether their human resources strategy is consistent with the company's communications to its employees and potential employees around their employee value proposition and employer brand in the market.

***Q26: Are there any areas of the Code which you consider require amendment or additional guidance, in support of the Government's White Paper on artificial intelligence?***

No comment.