TheCityUK response to the Financial Reporting Council (FRC) Corporate Governance Code Consultation

TheCityUK is the industry-led body representing UK-based financial and related professional services (FRPS). We champion and support the success of the ecosystem, and thereby our members, promoting policies in the UK, across Europe and internationally that drive competitiveness, support job creation and enable long-term economic growth. The industry contributes over 12% of the UK's total economic output and employs nearly 2.5 million people, with two-thirds of these jobs outside London, across the country's regions and nations. It is the UK's largest net exporting industry and generates a trade surplus exceeding that of all other net exporting industries combined. It is also the largest taxpayer and makes a real difference to people in their daily lives, helping them save for the future, buy a home, invest in a business and protect and manage risk.

We are grateful for the opportunity to provide feedback on the FRC's proposed amendments to the Code. The UK is widely recognised as a world leader in corporate governance. The importance of our corporate governance in ensuring market stability, predictability and investor trust is well established. TheCityUK recognises the role of good corporate governance in ensuring that the UK remains an internationally attractive and domestically competitive place for FRPS firms to do business.

This letter follows member feedback previously provided at TheCityUK roundtable with the FRC on 17 July. We thank the FRC for their attendance, which enabled our members to raise concerns directly with the FRC.

We broadly support the proposals outlined in the consultation and are grateful for the FRC's willingness to receive constructive feedback. We commend the FRC for the long consultation window, which has allowed for meaningful and considered feedback from members. This will help create a Code that drives the changes that the FRC and the government wish to see, in a proportionate and sustainable manner. However, we raise the following feedback for your consideration.

"Comply or Explain" Disconnect

1. We support the 'comply or explain' nature of the Code's provisions and note the FRC's efforts to reinforce this in the consultation. However, there is a disconnect between the FRC's vision of "comply or explain" and the real-world experiences of listed companies. Firms report that this has sometimes translated into a "comply or else" situation, where some investors approach compliance with the Code as a box-ticking exercise without scope for flexibility. As a result, companies feel compelled to follow guidelines rigidly to avoid negative consequences such as shareholder backlash or potential penalties. Exercising such strict compliance leads to a formulaic approach. Users benefit most from the innovation afforded when companies can demonstrate and articulate their reasons for departing from the Code, how they link to the business strategy, and how the risks arising from divergence have been minimised. This is key to securing the attractiveness of the UK as an international destination for equity listings. The current misalignment between this intended flexibility of "comply or explain" and the actual rigidity experienced by companies must be acknowledged and effectively addressed. **The FRC**

TheCityUK, Fitzwilliam House, 10 St Mary Axe, London, EC3A 8BF Registered in England number 7088009.
E: info@thecityuk.com | T: 020 3696 0100 | W: www.thecityuk.com

should continue its work to promote the flexible nature of the Code and be mindful, in expanding its provisions, of the risk that these may be interpreted prescriptively in practice.

2. To this end, both how voting proxies assess and subsequently report compliance with the Code to their clients, and how these clients (the asset owners and managers) utilise these reports need to be considered carefully. The assessment of corporate compliance with the Code and subsequent reporting by voting proxy firms play a pivotal role in shaping the perception of compliance within the market. These reports are accessed by asset owners and managers who make investment decisions based on them. If voting proxy firms overly emphasise strict adherence without considering the rationale for deviations, it could exacerbate the "comply or else" culture. Indeed, The FRC's recent report found concern from companies that proxy advisers were taking a 'box-ticking' approach to compliance which failed to consider individual companies' specific circumstances and offered little opportunity to explain[1]. Clients, in turn, may make investment decisions based on these reports, potentially undermining the spirit of the "comply or explain" principle. Having more extensive principles and provisions in the Code and more extensive outcomes-based disclosures is likely to worsen this issue. Many investors lack the bandwidth to focus in detail on all the companies in which they invest; having more extensive disclosures to review will exacerbate this issue (see paragraph 13). The FRC must reinforce the viability of the "explain" option with proxy advisers. This may find a more suitable resolution within an updated Stewardship Code, as opposed to the Corporate Governance Code itself.

3. The creation of a single listing category for commercial companies (with no distinction between premium and standard listing segments, as currently exists) as part of the FCA listing rule changes will potentially aggravate this issue. Companies currently categorised as standard-listed entities that transfer to the new ESCC category may face challenges in complying with guidelines that were originally designed for premium-listed entities. In particular, we must ensure that these companies are not unfairly penalised for their different governance structures, especially those that reflect the overseas regimes that they come from. These companies may be highly sensitive to negative reporting by voting proxy firms or public commentary, even if ignored by the actual shareholders. This underscores the importance of firms being able to *explain* non-compliance sensibly. The FRC and FCA must consider any cumulative impact here and refine their approach where needed.

4. In addition, ensuring that 'explain' is a viable option will become even more important given some of the proposed statements on internal controls (see paragraphs 7-12). We do not recommend embedding current market practice in the Code as this risks detracting from its principles-based approach by leading to a one-size-fits-all approach. This could stifle innovation, hinder the evolution of reporting methodologies, and prevent companies from

[1] The influence of proxy advisers and ESG rating agencies on the actions and reporting of FTSE350 companies and investor voting, Financial Reporting Council (June 2023), available at [Analytical Report (frc.org.uk)](frc.org.uk)

choosing a governance structure that fits their unique circumstances. **The Code should be explicit that an explanation for non-compliance is not a failure of governance.**

5. These proposals have significant implications for small and medium sized enterprises (SMEs). As the consultation notes, the creation of a single standard listings group as part of the FCA listing rule changes means that more companies would potentially be required by the Listing Rules to follow the Code. The FRC must engage with SMEs as they become subject to these regulations for the first time. A true "comply or explain" approach is vital to allow SMEs to explain the approach they have adopted in complying with, or diverging from, the Code.

6. In addition, FRC must be clearer about not requiring director attestations in relation to Code compliance. While the proposed changes to the Code only propose that declaration is required on the effectiveness of risk management and internal control systems, there is a risk that some, including accountants, believe that this will be necessary.

Amendments to Provision 30

7. We do not agree with the proposed drafting of the new Provision 30. **The declaration by the board on risk management and internal controls 'effectiveness' is too absolute.** This approach risks the declaration being interpreted as a declaration by the board that, since the board believes that the risk management and internal controls systems have been effective, risks have been eliminated. This leaves the company exposed to an increased likelihood of being sued in a situation where subsequent events develop in a way that could not reasonably have been foreseen at the time the declaration was made. We do not believe that this is the right approach by the FRC - there must be acceptance of some risk by investors.

8. Language is key here - firms need sufficient cover to be open about risks to produce realistic, high-quality disclosures. **We suggest an amendment to the language here to require the board to describe how the systems are 'appropriate' or 'proportionate' in light of the material risks faced by the company and identified by the board.** This would result in a less absolute declaration and one that does not indicate that there is no risk at all attached to the company's risk management and internal controls systems.

9. Considering the ever-evolving landscape of risks - such as those related to the new Consumer Duty, cyber threats, and greenwashing - companies' risk profiles are subject to constant change. A degree of flexibility is necessary, recognising that risk appetite varies across organisations. **The FRC should explicitly acknowledge 'risk appetite' in this provision to allow boards to set the amount of risk they are willing to take to achieve objectives and define the systems in place to manage risk within those boundaries.** This amendment could be introduced in either of the following ways:
    a. *A declaration of whether the board can reasonably conclude that the company's risk management and internal control systems have been effective in keeping the*

organisation within its agreed risk appetite throughout the reporting period and up to the date of the annual report;

b. *An explanation of the basis for its declaration, including how it has monitored and reviewed the effectiveness of these systems in keeping the organisation within its agreed risk appetite.*

10. In addition, our members are divided on the materiality test being the responsibility of the board. Some welcome this, while others expressed concern that there was not enough emphasis on the role of the executive leadership.

11. Beyond risk management, companies are concerned that the new requirement will have significant cost and resource implications for premium-listed companies, due to the level of internal and external assurance that many directors will require. The requirement for the declaration to effectively require monitoring up to the date of the annual report will mean regular monitoring by the board. While the proposed wording in the Code does not reference "continuous monitoring", the FRA's use of this term in the consultation paper is reflective of the fact that this regular monitoring is overly complex and risks a disproportionate burden for UK-listed companies and boards, with potential implications for the competitiveness of UK listed companies. This is at odds with the government's desire to increase the attractiveness of the UK as a public equity listing market, which we very much support.

12. Finally on Provision 30, **we do not support the amendment of 'financial' to 'reporting' to capture controls on narrative as well as financial reporting.** As stated in the consultation response, this creates an onus to report on environmental and social matters, which is counterproductive and duplicates other reporting requirements (see paragraph 19).

A proportionate and consistent approach to reporting

13. Whilst good corporate governance standards play a part in ensuring investor confidence in a particular market, overly prescriptive standards and excessively onerous disclosure burdens can decrease the attractiveness of a market as a business and investment environment (see paragraph 11). Considered in this light, there are aspects of the Code which are disproportionate (for example the provisions regarding remuneration disclosure) and which play a part in the current negative narrative about listing in the UK. **Any changes proposed to the Code should, therefore, be considered in the light of what is proportionate, both in terms of the requirements set and the costs of complying with them**. In addition, the FRC should conduct a full impact analysis of any proposed changes to the Code, particularly those relating to the internal controls reporting (see paragraphs 7-12).

14. The granularity of certain of the proposed additional disclosures, such as those related to succession planning and over-boarding (see paragraph 20), run the risk of becoming standardised and lack meaningful substance. This risks adding to the reporting burden of companies without achieving the outcome required.

15. We support the FRC's efforts to remove duplication and ensure consistency in different governance requirements. Simplifying the regulatory landscape, reducing compliance burdens, and promoting clarity for market participants are vital to ensuring the continued competitiveness and attractiveness of the UK capital market. The consultation paper expressly acknowledges that the proposed changes will result in some degree of overlap with other legal and/or regulatory requirements. **The FRC should consider which of these are necessary to avoid duplication of compliance and disclosure requirements.** The Code should not duplicate existing governance requirements, for example, the Listing Rules and the Companies Act 2006.

16. **Further action is required here to maintain alignment with recent reviews and proposals, including Lord Hill's Listing Review, the Secondary Capital Raising Review led by Mark Austin, the FCA's Primary Markets Effectiveness Review and the most recent consultation CP23/10, and changes to the Prospectus Regime. These have not been referenced in the consultation document. Failure to review the Code through this lens sits at odds with the approach and expectations of other regulators and participants in the UK capital markets.**

17. Some of the changes proposed are being undertaken at the request of government to deliver on the Audit and Corporate Governance reform package. However, some of these elements have not yet been introduced through legislation, nor has the government given any commitment on when they will be. This includes replacing the FRC with a new regulator, the 'Audit, Reporting and Governance Authority' (ARGA). There is a risk that moving forward with some of the proposals will not be seen in the round with other elements of the reform package - particularly those that need to be given effect via legislation - as well as evolving expectations on the competitiveness of the UK listings regime.

18. Indeed, the Code changes and the new reporting rules will come into effect for financial years commencing 1 January 2025. However, the FRC is due to be replaced by the ARGA. The government has proposed that the ARGA will have extensive powers, but so far there is very little information available on what these powers will be. One area of concern is the government's proposal to grant powers to the ARGA to enforce directors' duties. This is already enforced by the courts (and the FCA in the context of directors of listed companies), so risks duplication and resulting inconsistencies in enforcement. **Clear and consistent governance will be essential in maintaining the attractiveness of the UK as a preferred listing destination.**

19. **We do not support the proposed amendment of Provision 1 to extend the annual report to cover environmental matters**, including climate ambitions and transition planning. Environmental, social, and corporate governance (ESG) has already been brought under the FCA's Listing Rules. FRC should avoid duplication, as too many overlapping ESG and sustainability requirements will deter or complicate compliance. In addition, such an extension of the Code before wider ESG reporting frameworks and data are sufficiently

mature would create a major new burden for firms reporting voluntarily on ESG. There is a real concern that an extension at this stage would provide an excuse for firms not to report on ESG in the first place, and would likely reduce the number of firms reporting just at the point that we need to see an increase. The FRC should delay until the International Sustainability Standards Board (ISSB) standards frameworks are in place, or by ensuring that FRC guidance is very clear on the different levels of assurance required for non-financial reporting. In the interim, the government and regulators should suggest businesses align their reporting with the Taskforce on Nature-related Financial Disclosures (TNFD) Framework.

The role of non-executive directors (NEDs)

20. The proposed changes exacerbate the already significant responsibility that the Code places on NEDs, expanding boards' involvement to areas such as internal controls and succession planning and not just in the oversight of management of these areas. Whilst we agree that there should be board involvement in these areas, responsibility for them lies primarily with the executive management team. The proposed changes to the Code would continue to not give enough focus to the role and responsibilities of the executive team, placing disproportionate expectations on NEDs, who serve their companies on a part-time basis.

21. While we do not take issue with NEDs being subject to internal assessment on their outside appointments, the proposal that such commitments and their impacts must be listed in the annual report is burdensome and risks deterring persons from becoming NEDs, or not putting themselves forward for re-election.

Further points for consideration

22. Beyond the FRC's proposed changes, the existing reporting requirement listed in Provision 4 for companies where there has been a 20% vote against a resolution fails to account for many of these votes being majority (or occasionally 75%) decisions. Therefore, provided that the resolutions are passed, this should be sufficient.

We look forward to continued collaboration and the opportunity to engage in meaningful discussions to ensure that the UK's corporate governance framework remains robust, proportionate, and adaptable in the face of evolving challenges. This will ensure that the UK remains an internationally attractive and domestically competitive place for FRPS firms to do business.