TUC

Changing the world of work for good

Corporate Governance Code consultation – TUC response

September 2023

Introduction

The Trades Union Congress (TUC) is the voice of Britain at work. We represent more than five and a half million working people in 48 unions across the economy. We campaign for more and better jobs and a better working life for everyone, and we support trade unions to grow and thrive.

The TUC has long recognised the influence of the UK's corporate governance framework on the way in which business is conducted and on the discussions and priorities of the boardroom. The corporate governance framework therefore has a significant impact on the lives of our members and on all those working within the private sector. Our aim is to promote a corporate governance system that promotes long-term, sustainable company success based on good workforce and stakeholder relationships. We welcome this opportunity to respond to the Financial Reporting Council's (henceforth FRC) consultation on its proposed revisions to the Corporate Governance Code (henceforth, the Code).

We continue to believe that workforce voice in corporate governance is vital to promoting long-term, sustainable company success and that this is best achieved through worker directors on company boards. It is disappointing that the consultation does not seek to improve practice in workforce engagement, despite the significant variations in quality and clear room for improvement found by research commissioned and published by the FRC.[1]

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

The proposed amendment to Principle D should help to encourage more outcomes-based reporting. We believe that this aim is desirable in relation to reporting on engagement, as well as governance activity; this may be the intention of the current proposed wording, but we do not believe that this will be clear to readers. We would therefore suggest a further amendment so that Principle D would read:

When reporting on its governance and engagement activity the board should focus on outcomes in order to demonstrate the impact of governance and engagement practices and how the Code has been applied.

[1]Chris Rees and Patrick Brione (May 2021) *Workforce Engagement and the UK Corporate Governance Code: A Review of Company Reporting and Practice* available at: https://www.frc.org.uk/getattachment/56bdd5ed-3b2d-4a6f-a62b-979910a90a10/FRC-Workforce-Engagement-Report_May-2021.pdf

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?

We believe that the board should report on the company's climate ambitions and transition planning in the context of overall strategy, rather than only on the governance arrangements established to support this. As recommended by the Transition Plan Taskforce[2], such plans should cover Just Transition dimensions, including the expected changes to companies' workforces and the workforce engagement and skills planning measures taken to address these changes. The Code should reference this or make a link to the Transition Plan Taskforce's recommendations.

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

Workforce engagement

Research commissioned and published by the FRC has set out how companies have responded to Provision 5 on workforce engagement introduced in the 2018 Corporate Governance Code. The research assesses the progress made to date in implementation and sets out recommendations for future practice. It found that designating a non-executive director NED for workforce engagement is the most common approach taken by the FTSE 350, but also that most of the weakest and least substantive practices were those relying solely on NEDs, or on underdeveloped 'alternative arrangements'". While few companies had taken the route of appointing worker directors to the board, where they had done so the research found that it was working well. It is disappointing that this review of the Code has not taken the opportunity to reflect any of the report's recommendations for improvements in practice in this area or to ask for views on lessons learned from the early years of implementation.

As the report argues, "[t]he "principled and practical arguments for a greater workforce voice in corporate governance are now stronger than ever." If Provision 5 is to work to promote effective workforce engagement, it is essential that the way it is implemented reflects this. The TUC continues to believe that worker directors are the best and indeed the only way to ensure workforce voice on company boards, and are disappointed that this Code review does not at least encourage companies to learn from the experience of other companies that have successfully gone down this route. In addition, we believe it is essential that the Code should be amended to make clear that:

- The workforce should be consulted about which model of workforce engagement is adopted.

[2]See https://transitiontaskforce.net/

- Workforce representatives, or those responsible for workforce engagement on the board, including NEDs where the company has chosen this model, should be chosen by the workforce, rather than simply appointed by the board.

Provision 11

One factor that has discouraged the take up of worker directors by companies is that some investors, perhaps following the advice of proxy voting agencies, appear to have a policy of voting against their election on the grounds of lack of independence. This reflects a misunderstanding of the role of worker directors and their contribution in terms of bringing a unique perspective and diverse experience to the board. The concept of 'independence' was developed to ensure that there are boardroom voices who are independent of senior management who have responsibility for running the company on a day to day basis. Worker directors are not the same as senior management and should not be classed in the same category in terms of independence. Indeed, it is precisely the ability of worker directors to bring a workforce view to discussions, and one that reflects experience of the company but is distinct from senior management, which is particularly valued by other board members. Given the tendency of boards to appoint directors, both executive and non-executive, from a narrow pool, investors voting against worker directors for being 'non-independent' is misguided at best.

Solving this issue requires better education of and understanding from investors, but the Code has an important role to play in contributing to investors taking a more informed approach to the issue. We recommend that provision 11 should make clear that worker directors did not count towards the non-independent element of the board.

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?

It may be helpful to include the proposed wording "protected characteristics and non-protected characteristics" within Principle I, but we do not support this as a replacement for more specific reference to different elements of diversity. It is also not clear that all readers will understand the meaning of the phrase and it is important that the Code is as clear and accessible as possible.

Within discussions on diversity, especially in relation to boards, there is much greater recognition of the importance of gender diversity than either ethnic diversity or social diversity. Social diversity in particular is often left out of discussion on board diversity. Given the role that employment models play in shaping social issues and outcomes, the lack of recognition of the importance of social diversity is very problematic. We recommend that the references to gender, ethnic and social diversity are maintained in the Code. This could be done while keeping the proposed addition – for example, the text could read:

They should promote equal opportunity, and diversity and inclusion of protected characteristics and non-protected characteristics, including gender, social and ethnic backgrounds, and cognitive and personal strengths.

We would also question the clarity of the phrase 'personal strengths' means and would suggest that it is either replaced or deleted from the text.

It would be helpful to highlight that the aim is to promote a culture of challenge and open-minded debate to boardroom discussions, which is best ensured by the inclusion of different perspectives.

We also believe that this section of the Code should highlight the contribution of worker directors in terms of social and cognitive diversity and diversity of experience and skills.

Provision 21 Open advertising and/or an external search consultancy should generally be used for the appointment of the chair and non-executive directors.

Open advertising for roles is a necessary, though not sufficient, requirement for ensuring equal opportunities in recruitment. This applies to equally to board recruitment as to other areas - if board positions are not advertised, then by definition a very wide range of people, especially those with experience and/or backgrounds that vary from the majority of board members, will not have the opportunity to apply. There is no justification for treating board appointments differently from other roles in this regard. Recruitment consultants are not necessarily well placed to contribute to opening up board appointments to a wider range of backgrounds and experience. We propose the text is amended to make clear that open advertising should always be used, for example as set out below:

Open advertising should be used for the appointment of the chair and non-executive directors, whether or not an external search consultancy is used.

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

We would welcome a greater emphasis on the importance of promoting diversity and inclusion throughout the whole organisation to ensure that the company has an effective process of recruitment, training and career progression that enables potential leaders to progress from the bottom to the top of a company, regardless of background and personal characteristics.

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?

There is an ongoing problem with the quality of narrative reporting and a tendency to present an overly positive picture of company non-financial performance, through the selection and presentation of the material included. If audit committees "monitoring the integrity of narrative reporting, including sustainability matters, and reviewing any significant reporting judgements" brings greater balance in the selection of information and greater rigour to the reporting process, that would be welcome.

On the other hand, audit committees as currently constituted generally do not have expertise in stakeholder impacts and environmental impacts. This means they are unlikely to be best placed to judge the quality of the information provided. It is important that this is acknowledged and addressed in guidance, if this proposal goes ahead.

There are significant barriers for external organisations in assessing labour issues and employment practices effectively and external audits are not sufficient to ensure that unacceptable labour practices are identified and addressed. The presence of independent trade unions, able to speak to workers in confidence, anonymise their concerns and raise them in their role as representatives, is the most effective means of monitoring and improving labour practices and the only reliable means of assessing whether ILO labour standards are adhered to. There are numerous examples of social audits failing to identify labour exploitation in supply chains. Following media reports that workers at factories in India supplying companies including Tesco, Sainsburys and Ralph Lauren had been subjected to forced overtime, verbal abuse and poor working conditions, a factory owner commented:

"The factory is aware when the auditors are coming, so they keep everything in perfect condition before," he said. "The moment the audit is over, everything goes back to normal, which means exploitation and non compliance."[3]

If audit committees are to play a useful role in narrative reporting, they will need to change their membership to gain expertise in the issues covered by narrative reporting and the processes involved. They will also need to understand the limitations of social auditing in relation to labour practices. While improving the veracity and quality of narrative reporting is an important and worthwhile aim, it is important that Code revisions in this area acknowledge the challenges involved in its achievement.

We urge the FRC not to use vague terms like sustainability in the Code and instead to refer explicitly to impacts on stakeholders and on the environment. This can be expanded by adding 'and other social/sustainability matters' if needed.

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[3]BBC News (17 November 2020) *Indian factory workers supplying major brands allege routine exploitation*, available at https://www.bbc.co.uk/news/world-asia-54960346

The collapse of Carillion and other corporate scandals led to increased public and political concern about the significant damage that short-term decision-making and poor corporate practice can cause for workers and other stakeholders. This led to the welcome changes made in the 2018 Corporate Governance Code to clearly reference the importance of relationships with workers and other stakeholders within the Code.

We are concerned that these welcome improvements will be muddied by references to sustainability in the Code. There is no one accepted meaning of the term ‘sustainability’ and it is used very differently in different circumstances and by different speakers/authors. Like ESG, is often understood and used to mean environmental impacts and measures, with social and stakeholder impacts excluded. There is a significant risk that the use of such vague terms will facilitate a pick and choose approach from companies about what they report, rather than encouraging a clear and systematic approach to reporting on their key stakeholder and environmental impacts. We urge the FRC not to risk going backwards in this area and to refer clearly to ‘stakeholder and environmental impacts’, rather than sustainability or ESG, in the relevant bits of the Code.

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)?

Yes, we agree that this makes sense – the existing provision 30 is not replaced by the draft requirement for PIEs, so to remove provision 30 would lead to an overall diminution of reporting on this issue.

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

Yes, we agree that this is an important area for all Code companies, not just PIEs.

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

There is significant evidence that other than with simple, repetitive tasks, incentive-related pay does not work in terms of improving performance. For complex roles, there are simply too many things to balance in order to do the job well to make a small number of targets an effective incentive. And increasing the number of targets simply make schemes too complex to be effective. PWC research found that less than half company executives think that their LTIP is an effective incentive and that lengthening vesting periods and adding additional targets make the schemes less effective in terms of their impact on motivation, as both ambiguity and deferral lead executives to value pay less.[4]

In terms of incentive pay rewarding performance, there have been repeated studies showing that the link between executive pay levels and company performance is completely broken and has been for many years. The main determinator of executive pay levels is company size, not company performance.

Most working people, including those in very senior and challenging roles, carry out their job to the best of their ability for a fixed salary, and work hard each day to fulfil their role without needing financial targets to encourage them to do a good job. It is extremely worrying that investors and the FRC appear to think that those running the UK's companies are not able to do the same. The risk of relying heavily on financial incentives is that you may end up attracting people whose primary goal is personal enrichment, rather than company performance. We have seen the dangers of this in the financial sector, particularly in the run-up to the financial crisis of 2008. We surely want those running UK companies to be motivated by the desire to do their best for their company, and to be paid fairly for doing so, rather than the size of their bonus.

It is the incentive elements of pay that have fuelled the escalation of executive pay over the last two decades and contributed most to the huge gap between executive and workforce pay. Incentive pay schemes for directors fail to recognise the contribution of the workers who actually make the company's products or deliver their services, and are excluded from such schemes. Their use of incentive pay for executives fuels an 'us and them' approach to pay. While executive pay has grown significantly over the last 15 years, average pay in the UK is 2.7% lower in real terms than it was in 2008.[5]

Moving away from a reliance on incentive pay would promote greater convergence between company directors and their workforce in terms of remuneration approach and strategy, and would greatly simplify executive pay packages, freeing up the time of both company directors and investors.

The TUC believes that the Code should be amended to make the case for simplifying executive pay. The Code should also acknowledge that the management of directors' performance and remuneration policy are two separate issues that do not have to be entwined.

At the very least, Principle P should not simply assume that all companies will use incentive pay. This could be done by adding 'if incentive pay is used' at the beginning so it would read:

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[4] PWC (2012) *Making executive pay work - the psychology of incentives*
[5] TUC (10 July 2023) *UK workers will miss out on £3,600 in pay this year as a result of wages not keeping pace with the OECD*, available at https://www.tuc.org.uk/news/uk-workers-will-miss-out-ps3600-pay-year-result-wages-not-keeping-pace-oecd

'*If incentive pay is used*, remuneration outcomes should be clearly aligned to company performance, purpose and values, and the successful delivery of the company's long-term strategy including environmental, social and governance objectives.'

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

The reasons for proposing the deletion of provision 40 and subsequent amendment of Provision 41 are very unclear. We do not believe that the factors set out in Provision 40 are summarised, as suggested in the consultation document, by Provision 33. Clarity, simplicity, risk, predictability, proportionality and alignment with culture are all extremely important factors in a desirable remuneration strategy. The fact that companies have not achieved this, either in their remuneration practices or their reporting, reflects the contradiction between these factors and the continued reliance on incentive pay, which creates complexity, can fuel risk (as was the case in the financial crisis), is affected by unpredictable external factors and contributes to pay gaps. If companies are failing to adhere to Provision 40, the approach should be to address this, rather than simply delete it. We are strongly opposed to the deletion of Provision 40.

In Provision 41, we are opposed to the deletion of the 2nd bullet on pay gaps and ratios (discussed further below) and the 3rd bullet, which relates to Provision 40 discussed above.

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

The TUC strongly believes that the reference to pay gaps and pay ratios should be strengthened and not removed. We are surprised and disappointed at the suggestion that their removal is under consideration.

There has been a requirement for remuneration committees to take account of workforce pay and conditions in setting executive pay ever since the Greenbury Report of 1999. The lack of progress made in implementing this has led to regulatory changes[6] to require large listed companies to calculate and report on pay ratios between top and upper quartile, median and lower quartile employee pay, starting in 2020. Gender pay gap reporting requirements were introduced in 2017.

As company reporting on pay ratios and pay gaps shows, there is a long way to go in achieving a fairer distribution of pay within organisations and between men and women. We would support strengthening the reference to pay gaps and ratios in the Corporate Governance Code.

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[6] Department for Business, Energy & Industrial Strategy (1 January 2019) *New executive pay transparency measures come into force*, available at https://www.gov.uk/government/news/new-executive-pay-transparency-measures-come-into-force

We propose that this should be done by requiring companies to explain the extent of their pay gaps and pay ratios and to set out an action plan for reducing them.