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Financial Reporting Council
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26th February 2018

By email to codereview@frc.org.uk

Dear Catherine

PROPOSED REVISIONS TO THE UK CORPORATE GOVERNANCE CODE

Please find enclosed Nestor Advisors' response to your consultation on the proposed revisions to the UK Corporate Governance Code.

We strongly support the FRC's aim to rebalance both the scope and structure of the Code, and believe that, for the most part, the revised draft Code achieves that aim.

We welcome the prominent references to corporate culture in the revised Code. We are also particularly pleased to see the proposed extension to the remit of the remuneration committee. This is something that we argued for when giving evidence to the Government's Green Paper and the BEIS Select Committee Inquiry, and which we believe could have a greater impact on how boards set senior pay in relation to their workforce than some of the other, regulatory, proposals.

Inevitably, though, we have some comments. These are attached and are divided into general comments on the structure of the Code, including where we think you may not have achieved the aim of refocusing the Code on the application of its principles, and those that respond to some of the specific questions in your consultation document or raise other points of detail.

Please let me know if you would like to discuss any of our comments in more detail, or if I can be of any further assistance.

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GENERAL COMMENTS

Principles and provisions

We support your aim to try to focus companies and investors' attention more on the principles of the Code than on the 'comply or explain' provisions in order to discourage them from thinking of governance and the Code purely as an exercise in compliance. We would not underestimate the challenge, as the 'box-ticking' approach is deeply engrained in many companies as well as in some shareholders and their advisers; but we support the objective and believe it is important to attempt to change the mindset.

For that reason, we support your proposal to group principles and provisions together and remove the direct 'one to one' relationship between each provision and a single principle. This will hopefully make it clearer to companies that compliance with the provision on its own is not necessarily a sufficient means of applying the principles.

We also support your effort to reduce the overall number of provisions, and only retain them where there continues to be a need for good practice to become embedded or standards to be raised, or for greater transparency about companies' practices. We are not sure, however, that the draft Code is always consistent in the level of detail contained in the provisions.

In particular, we consider that Section 5 (Remuneration) is much more detailed than the other sections, and we are not convinced that this is justified or desirable. We would observe that one of the effects of greater transparency and prescription on remuneration packages has been a greater standardisation of those packages, with similar structures and metrics being used. While this may have helped to eliminate or reduce certain undesirable practices, it has arguably led to some companies adopting policies that may not be the most suitable for their circumstances or in the long-term interests of their shareholders and stakeholders.

The use of guidance

Based on our experience when working with regulators and stock exchanges in other countries to introduce or update corporate governance codes and reporting frameworks, we suspect that the structural changes to the Code will not be sufficient on their own to achieve your aim, and that companies will need further prompting to look at the principles as well as the provisions.

We understand from the consultation document that the revised 'Guidance of Board Effectiveness' is intended to assist boards in thinking about how to apply the principles of the Code. In principle it serves that purpose, but we think care needs to be taken in the drafting and positioning of the guidance.

In the current draft, there seems to us to be two distinct styles. Some sections, including those that have been moved from the Code to the guidance, could be read as being relatively prescriptive; others are much more open, for example, those sections that include 'questions for boards'. Our view is that the second style is preferable, as it reduces the risk of the guidance replacing the Code provisions as the 'go to' place for box-tickers. While we do not have any specific drafting suggestions, it may be

worth revisiting some sections of the guidance to see whether they could be rewritten in a more open style.

DETAILED COMMENTS AND RESPONSES TO SPECIFIC QUESTIONS

Culture (Principle A; Provision 2)

We strongly welcome the prominent focus being given to corporate culture in the revised draft Code. They are in many ways the missing piece from the current Code, and could help to bind together the other aspects of governance that the Code rightly emphasizes – having the right people and good processes.

We do, however, think that the wording of Provision 2 should be looked at again. As noted above, the purpose of provisions should be to embed good practice, raise standards or increase transparency in a meaningful way. Our concern is that this provision, as drafted, is worded too generally to achieve any of these outcomes. There are many specific practices that can help to strengthen culture – including some of those identified in the FRC’s ‘Corporate Culture and the Role of Boards’ – that could be included here to give the provision a bit more force.

Chairman independence (Provision 11)

We understand the reasons why the chairman is currently considered neither independent nor ‘not independent’ in terms of applying the Code. However, we consider that the result of that classification has been that the chairman’s status is ambiguous and not well understood. For that reason, on balance, we support the proposed reclassification of the chairman as independent for the purposes of the Code.

That said, it is not entirely clear from the drafting of the Code precisely what status the FRC intends the chairman to have – are they an “independent chairman” or an “independent non-executive director”? For example, Provisions 11 and 15 appear to classify the chairman as one of the NEDs, while Provision 12 appears to see them as having a role distinct from the NEDs. We think this ambiguity needs to be clarified in the final Code.

Board evaluation (Question 6, Provision 21)

We support the proposal to remove the exemption for companies below the FTSE 300 from the provision on independent board evaluation. We believe that the additional costs for companies are far outweighed by the benefits to the functioning and effectiveness of the board and, in any event, smaller companies would continue to be able to explain rather than comply with the new Provision 21.

Diversity (Questions 9-11, Principle J and Provision 23)

The revised Code puts an increased focus on fostering gender, social, and ethnic diversity at the board and executive levels, and the consultation document asks whether further detailed provisions on ethnic diversity should be added.

In our view it is necessary to distinguish between the business and public policy cases for diversity. Both are important, but that does not necessarily mean that the Code is the right mechanism for promoting both of them. The test for inclusion in the Code should be whether there is a business case for saying that greater diversity at board and executive level improves the governance of the company. In our opinion there is, and we would therefore support the emphasis placed on diversity in the new Principle J. We do not, however, believe that the Code is the right place for more detailed requirements intended to promote a public policy objective, no matter how legitimate that objective. If more detailed requirements are needed, they would be more appropriately implemented through legislation.

Remuneration (Section 5)

As noted in our general comments, our view is that the balance between the high-level principles and detailed provisions in this section are out of kilter with the other sections of the draft revised Code, and with the FRC's objective to refocus the Code on the application of the principles. The level of detail in this section – for example, specifying minimum vesting periods in new Provision 36 - goes beyond what is necessary to support and underpin the principles. While a greater degree of prescription can perhaps be justified in sectors where the systemic risks are high, such as banking, we do not believe this is the case generally.

In addition, we are not persuaded that greater standardization of existing remuneration policies is necessarily beneficial; as already noted, that trend has arguably contributed to some of the problems we see today, and may be unproductive for some business models or at certain points in a company's development.

Remuneration Committees (Question 14; Provisions 32 and 33)

However, we welcome the proposed extended remit of the remuneration committee in new Provision 33.

We believe that potentially the most productive approach to reducing pay gaps within companies would be to embed them in an explicitly broader board responsibility for strategic H.R. In other words, it is the board that should be “nudged” to address these issues rather than outside stakeholders whose agendas vary and whose toolkit may be quite limited. Instead of focusing solely on the pay and performance of their senior executives, as is the current norm, boards should also develop a dialogue with employees and acquire a more in-depth view of people issues in their organisation.

As part of this focus, boards could expand the mandate of the remuneration committee to include relationships between the company and its employees, turning it into a remuneration and human resources committee.

We also welcome the proposed new Provision 32, which recommends that remuneration committee chairs should have served for at least twelve months on a committee before taking on this role. While not wanting to overstate the potential impact of this proposal, having a committee chair who understands their role and the sort of judgements the committee needs to make can only be beneficial.

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