

Response to the Financial Reporting Council's Consultation on proposed revisions to the UK Corporate Governance Code and initial consultation on the future direction of the UK Stewardship Code

West Midlands Pension Fund

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Introduction

The UK Corporate Governance Code, and its sibling the UK Stewardship Code, are considered to be world-leading. We appreciate the opportunity to provide input into the proposed improvements to the codes.

There is evidence that, over the long term, strong codes of corporate governance and stewardship can improve market outcomes and increase trust in financial markets. Such codes are not, however, a panacea and we welcome the renewed focus on the *application* of the code rather than routine compliance with the provisions. In addition, despite the merits of the UK codes, there are clearly aspects of UK corporate governance in need of attention. Accordingly, we emphasise support for the following suggested improvements to the codes:

- Focus on implementation of the code's principles, as opposed to fostering a compliance culture
- Increased consideration of the role of the workforce, through representation, consultation and the setting of executive pay
- Renewed attention to diversity of all forms including gender and ethnicity
- Increased focus on risks described as "non-financial": we recommend in particular that both codes incorporate the recommendations of the Taskforce on Climate-related Financial Disclosures ("TCFD")
- With respect to the Stewardship Code, we think that there should be one code, with variations in the guidance reflecting the application for different participants in the investment value chain

For further clarification of our response, please use the email address provided below.

Contact: responsibleinvestment@wolverhampton.gov.uk

UK Corporate Governance Code

Introduction and Guidance

Q1. Do you have any concerns in relation to the proposed code application date?

No.

Q2. Do you have any comments on the revised guidance?

We welcome additional disclosure on how directors have discharged their duties under section 172 of the Companies Act 2006. This, as with all disclosures within the codes, ought to avoid boilerplate and greenwash. We comment on the relevance of the UN SDGs below. In matters related to section 172, we strongly advocate for the use of consistent terminology, there being a wide range of terms in existence, which can lead to confusion and limitation. Examples of such terms include “non-financial”, “ESG”, “SEE”, “social impact”, etc, and are referred to in “soft” codes, regulation, statutory guidance and guidance from actors such as TPR. As users and preparers of disclosures that are controlled by a variety of different organisations, we recommend a multi-institution engagement to reach consensus on the use of consistent terminology. Related to this is the reference to a company’s “contribution to wider society”: this should be clarified such that companies are not disclosing irrelevant aspects of corporate social responsibility.

We are pleased that the viability statement has gained greater prominence but we are extremely guarded against the use of boilerplate language. The statements should refer to the (genuinely) long term, at least relating to the company’s investment planning horizon. Where companies list climate change as a risk factor, the viability statement should consider the climate-related impacts on viability.

We support the increased focus on the workforce in the guidance and consider this to have been a material omission hitherto. We support the broad definition of “workforce” to include, where relevant, contractors and agency workers.

Paragraph 22 in the guidance relates to “major shareholders”, which can lead to limiting or arbitrary engagement policies by boards of directors. For example, companies might choose to engage only the large index houses, who have built a large equity portion through the use of low-cost pooled funds, the clients of which typically have less inclination towards significant stewardship activities. We are concerned this could exclude from engagement long-term, strategic investors that might provide material stewardship contributions, despite a slightly lower equity share in the company.

Section 1 – Leadership and Purpose

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

We are in favour of the three proposals to recognise and engage the workforce. We recognise that flexibility (for a company to determine arrangements suitable to their business model) has been and continues to be a virtue of the code. There needs to be clear disclosure of: the rationale for which of the three avenues is chosen; electoral/ appointment

process (where worker representatives join the board); the terms of reference applicable to the chosen option for worker representation whether an advisory council, designated board member or employee representative. Where a particular director is assigned this responsibility, there should be due consideration of the director's skills and experience in these matters, the director's aggregate time commitments and the director's time on the board to date (as familiarity with the company is surely a pre-requisite for the role).

Q4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

The UN SDGs are a useful way for companies and investors to disclose impacts, and we would support reference to the SDGs in the guidance. This should be accompanied by clear instruction that SDG disclosure should be relevant and should not be used for greenwashing. We usually interpret undue levels of attention by companies on immaterial issues (as measured by lengthy disclosure that fails to relate to the business in question) as a signal of poor managerial practice. Comparative and verifiable standards should be established to guard against greenwash.

We are strongly supportive of the recommendations of the TCFD and think that both codes should integrate these recommendations. This is consistent with the UK government's approach. We are supportive of the Green Finance Initiative's promotion of the TCFD's recommendations.

Q5. Do you agree that 20 percent is 'significant' and that an update should be published no later than six months after the vote?

We support the "20% rule" as the "hard limit". This feels legitimised by the magnitude of votes against remuneration (remuneration votes being the context of the government's green paper utterances of this matter: it is not completely clear that 20% is the right figure for resolutions addressing other matters). We would expect engaged boards to adopt dissent guidelines suitable to their company context and to not treat a 19.9% rate of dissent as a success. Companies should disclose whether they have given consideration to dissent levels lower than 20%. The code and guidance should be clear that the 20% rule refers to the votes of minority shareholders. Companies' dissent guidelines should be aware of the volume of votes that failed to be voted through stock lending, and the influence of pooled passive funds where the beneficial owner is unable to articulate his or her voting preference.

We think that six months from the vote is too long, because at the extreme the update would be published almost as the turn of the next financial year. We would support either a limit of 3 months from the vote, or a limit of no later than 6 months from the financial year end.

Section 2 – Division of responsibilities

Q6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.

We agree with this idea. Owing to costs, we would encourage such companies to use the explain feature of the code if appropriate to their circumstances. We recommend the FRC review this feature two reporting cycles after adoption, to determine whether all such companies are using cost reasons in their explanations: it would be strange if all smaller companies found independent board evaluations too costly. Consistently with our views of

FTSE 350 companies, we think shareholders should be given the opportunity to feed into the design of the evaluation process.

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

We agree, provided that nine years is not interpreted as a limit beyond which a director should be forced out. Nominations Committees should achieve majority board independence – including the nine year rule as a criterion – while retaining directors whose contribution is particularly valued. Appropriate disclosures should be made in the annual report.

We note that the “six year rule” – where Nominations Committees should plan for succession once a director’s tenure exceeds six years – is scheduled for deletion as a provision. In its place, the guidance should (in “medium-term planning” for example) set the expectation that boards will consider composition and succession as tenure approaches nine years.

Q8. Do you agree that it is not necessary to provide for a maximum period of tenure?

We strongly agree but, where there is a director with (very) long tenure, a board’s composition should include a counterweight, perhaps two or more experienced directors with at least three years’ tenure, in order to dilute the influence of one long-serving individual.

Section 3 – Composition, succession and evaluation

Q9. Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

We think section 3 will address the issues at the board and executive layers. We are particularly supportive of Principle J, which refers to promotion of diversity. We are less clear as to whether section 3 supports the issues across the company as a whole.

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

We agree.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

We agree with this idea, and would expect companies to improve this aspect in time rather than overnight. We see no reason why ethnicity considerations ought not apply equally in scope to considerations of gender diversity. Therefore if the Hampton Alexander recommendation should apply to companies below the FTSE 350, the ideas in question 11 should too. Boards should be willing to engage shareholders on this issue.

Section 4 – Audit, risk and internal control

Q12. Do you agree with retaining the requirements included in the current Code, even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?

We would like these aspects to be retained, in spite of the apparent duplication. As users of these disclosures, we find utility in information being gathered in one place.

Q13. Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.

We support this. Despite its removal, it needs to be clear to companies that there is no excuse for not making terms of reference of the audit committee, including its role and the authority delegated to it by the board available to shareholders.

We think consideration should be given to expanding Provision 29 so as to include, where relevant, reference to climate change risks and a signpost to the TCFD (see above).

We also think provision E.2.1 could be rephrased or clarified in guidance rather than deleted.

Section 5 – Remuneration

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

We agree with some aspects of the extended remit and disagree with others. We think the Remuneration Committee should be expected to engage with the workforce when setting executive pay. We think the Remuneration Committee should set executive pay (salary, pension contributions, bonus, incentive plan and additional benefits) in the context of, among other things, pay and pension conditions for the workforce. To this end we support Provision 41. We are reticent about the idea of the Remuneration Committee designing pay for the entire workforce, owing to possible skills/ expertise gaps in existing Remuneration Committees and potential limitations on the time commitments of Remuneration Committee members. However, if “oversight” is defined in an appropriate way, Remuneration Committee oversight of workforce pay might be acceptable.

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

We are mindful of the PLSA’s survey of pension fund investors on this topic, where 87% of respondents said they were concerned by pay gaps between the executives and the wider workforce. Pay should be set so as to avoid paying more than is necessary to recruit and retain appropriate talent: quantum has clearly breached this limit in the recent past. We support the 5-year vesting and holding period, but we feel strongly that remuneration should not be treated as one-size-fits-all and we are concerned that Remuneration Committees adopt a salary-bonus-LTIP straightjacket as a matter of routine. Consideration should be given to not using an LTIP structure, if appropriate. This would demonstrate the value of the fees paid to Remuneration Committee members and suggest that their decision making is not algorithmic.

We would support the greater proliferation of non-financial KPIs in variable remuneration design.

We are not convinced that provision d.2.4 (on shareholder approval new incentive plans) should be deleted rather than removed to the guidance section.

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

Yes, but we think the code could give more direction on the importance of quantum (i.e. total level of individual or aggregate executive pay). Egregious awards can be damaging and demoralising, even if made with reference to employee pay increasing.

We support the provision for the Remuneration Committee Chair having 12 months experience on the committee before appointment to the role of chair. We think that appointment should also be conditional on a valuable contribution during the tenure to date. Finally, we are pleased to see Remuneration Committee's being urged to override payouts in certain circumstances.

UK Stewardship Code: initial consultation on its future direction

Format

Q17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

We are firmly in favour of there being one code, with variations in the guidance aimed at the main types of actors in the investment value chain. A unitary code with a comply or explain feature would be optimal in our view. Defining in the guidance lots of investor types/intermediaries would be unhelpful, and there is a problem of providing clear and concise guidance to hybrid actors, for example asset owning pension funds that have internal asset management functions.

Our main comment on the future direction of the Stewardship Code is that it should be made clear that stewardship is relevant for all major asset classes (not just listed equities) and has global application (not just UK/ FTSE companies).

Q18. Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

We commend the model of the Corporate Governance Code ("CGC"), reinforcing the alignment and would support moving the structure of the Stewardship Code to principles with guiding provisions and guidance. We see the two codes as siblings and would encourage as much consistency and cross referencing as possible.

In terms of defining "best practice", we would encourage the FRC to engage bodies such as PLSA and asset owners who have found particular disclosures useful in manager selection or monitoring.

Q19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

In our view the tiering exercise was very useful to improve the worst performers, but perhaps did not stretch the leaders on stewardship. We think maintaining the tiering programme (with two tiers rather than three) would assist with the identification of the significant laggards, but we do not believe tiering is likely to facilitate differentiation between the good, the very good and great.

We note the "20% dissent" rule for the Corporate Governance Code mentioned above. We also note suggestions to have the two codes more closely mirror one another. Combined, these themes suggest an idea to elicit best practice reporting against the Stewardship Code. We would be interested to learn how investors voted on resolutions breaching the 20% rule, including a rationale.

Content

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

As mentioned above, we would welcome closer consistency between the two codes.

The new CGC focusses on diversity at companies, and this topic equally applies to investors. We would recommend the FRC liaising with organisations such as the Women in Finance Charter (HM Government) and New Financial LLP to gain ideas as to how diversity within financial services can be improved. The point clearly applies to other aspects of diversity, such as ethnicity.

We would recommend that investors are guided to explain, with reference to their stewardship activities, how they hold boards to account regarding Section 172 duties.

Q21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

We advocate the integration of the TCFD recommendations into the Stewardship Code, as mentioned above.

Q22. Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

We would welcome this, providing it did not lead to boilerplate disclosure or greenwashing. Similarly to the objectives of the CGC relating to long term corporate success, any reference to wider stakeholders in the Stewardship Code should relate to investment outcomes, except for mission-oriented or faith-based investors.

As mentioned in previous answers, we wholly support the integration of the TCFD recommendations into the Stewardship Code.

Were this idea to be developed, we would strongly encourage the use of consistent terminology, in line with our answer to question 2 above.

Q23. How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

At present, compliance statements are not sufficient to assess the quality of investor's stewardship programmes. However, this question appears to concern disclosure outside of the compliance statement. In this regard, we would recommend (on a comply or explain basis) vote-by-vote disclosure, with a brief rationale on contentious issues justifying a decision to vote for or against. There should be a guideline time limit for disclosing voting outcomes.

Please refer to our answer to question 19.

Reporting might be more valuable were there to be robust vote confirmation processes in place. We recommend that the FRC work collaboratively with other regulatory and policy makers to this end. Further, in relation to pension fund investors, we would encourage the

FRC to collaborate with the Pensions Regulator on how to encourage further direct and indirect stewardship activities and to ensure that relevant guidance is complementary and not contradictory. We note that the FRC does not have a Memorandum of Understanding in place with the Pensions Regulator as it does with other key financial regulators and would suggest that further collaboration between the two bodies would be helpful in ensuring sufficient oversight.

Q24. How could the Stewardship Code take account of some investors' wider view of responsible investment?

Stewardship is one part of responsible investment. It would be useful to be provided with context, i.e. where and how stewardship fits into the broader responsible investment strategy. However, this aspect of the code should be limited in extent.

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

Australian code: Principle 6, "principles used for policy advocacy including participation with industry groups and associations"

Dutch code: use of independent monitoring committee

Japanese code: Principle 7, "institutional investors should have...[the] skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities."

Q26. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

We are not convinced that independent assurance provides a benefit over and above the cost of paying for that assurance. We would advocate the provision of internal assurance on a comply or explain basis.

Q27: Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

We think this should be included on a comply or explain basis. We recognise the main benefit of pooled funds is lower costs. Were asset managers to be expected to facilitate "split voting" in pooled funds, with all the due processes under an FCA regulated environment, this would add to the cost of the investment product, undermining its main objective. An alternative position for asset managers of pooled funds might be to engage clients on voting policies.

Related to the issue of cost, we would encourage greater fee transparency among asset managers and are pleased to see the broader adoption of fee transparency templates, as developed by West Midlands Pension Fund in collaboration with others.

Q28: Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

Yes. This also relates to our answer to question 20 and is an area where the two codes can more closely cohere.

Q29: Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

We would welcome regular disclosure on how investors have used stewardship techniques to mitigate the financial risks of climate change. As mentioned, we think the majority of climate-related disclosures can be solved by the adoption of the TCFD's recommendations.

Q30: Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

Yes, as part of the description of context we discussed in our answer to question 24. We would expect the purpose of stewardship and the brief description of the broader responsible investment programme to be explained within the same principle.

Q31: Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

We would welcome this and believe it should be detailed in the fund documentation. We would expect stewardship "leaders" to provide quarterly stewardship reporting against the parameters outlined in the fund documentation. Reflecting the CGC, the Stewardship Code should remain non-prescriptive on this matter, allowing investors to disclose in the manner most appropriate for their individual context.

Continued engagement on the codes

For further clarification of our response, please use the email address provided below.

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