Consultation

FRC Financial Reporting Council

25 UK CORPORATE GOVERNANCE CODE 1992-2017

December 2017

Proposed Revisions to the UK Corporate Governance Code

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CONTENTS

Executive summary ………………………………………………………………………………..1

Introduction ……………………………………………………………………………………….2

The consultation and how to respond …………………………………………...………………6

Consultation on changes to the UK Corporate Governance Code ………………………………7

Initial consultation on the future direction of the UK Stewardship Code ………………………..18

List of consultation questions ……………………………………………………………………26

External Appendices

Appendix A – Revised UK Corporate Governance Code

Appendix B – Revised Guidance on Board Effectiveness

Appendix C – Summary of changes from 2016 UK Corporate Governance Code

EXECUTIVE SUMMARY

The UK Corporate Governance Code (the Code) has been in place since 1992.

The Code has successfully helped to raise standards of governance in the UK, which has instilled confidence in our equity capital markets and underpinned domestic and overseas investment. The UK's approach has been copied and adapted by other major economies.

Over the last few years, governance within the largest companies has been subject to heightened public scrutiny due to their impact on a wide range of stakeholders globally, nationally and locally. In some high-profile cases the quality of governance has been poor.

Now is the right time to undertake a comprehensive review to ensure that the Code remains fit for purpose and continue to promote improvement in the quality of governance. We are not starting from scratch. We are retaining those elements of the current Code that are still relevant today, and adapting others to reflect the changing economic and social climate to ensure that UK-listed companies achieve the highest standards of governance.

The revised Code complements legislation and underpins improvements in best practice. It retains the flexibility that allows a company's specific circumstances to be taken into account. The Principles set out high-level requirements. The more detailed Provisions are generally 'comply or explain'. This consultation document and the Code emphasise that the Principles are to be applied in line with the Listing Rules requirements that companies report on them in a manner that shareholders can understand.

The revised Code acknowledges that the activities of companies have a wide-ranging impact and it is important that boards consider the way their companies interact with the workforce, customers, suppliers and wider stakeholders.

To achieve a wider stakeholder focus we have drawn on our Culture Report. The findings of this report demonstrated the importance of aligning company purpose, strategy and values in order to achieve long-term success. Successful companies should be open and accountable to their workforce. The revised Code is clear that two-way dialogue is necessary to achieve good governance, with companies putting in place practices and processes to achieve that.

We have also taken account of the Hampton-Alexander Review and Parker Review reports on diversity to ensure that the Code challenges directors to consider the composition of not only the board, but also the management pipeline. Effective policies in this area will benefit companies and increase trust in management practices.

We are also consulting on specific changes to the Code as requested by the Government's response to the Green Paper Consultation on Corporate Governance Reform. These are: for companies to have a method of consulting with their employees; extending recommended minimum vesting and post-vesting holding periods for executive share awards from three years to five years; that chairs of remuneration committees should have at least 12 months' previous experience; and specifying the steps companies should take when they encounter significant shareholder opposition to executive pay policies and awards.

The relationship between the board and investors is also very important. The UK Stewardship Code sets a framework for responsible engaged investors to work alongside company executives to achieve the long-term success of companies. We are taking the opportunity as part of this consultation to ask some high-level questions about the future direction of the UK Stewardship Code. We plan to consult on specific changes to this next year.

INTRODUCTION

General approach

1. The review of the UK Corporate Governance Code (the Code) has been wide-ranging; its structure, content and balance of Principles and Provisions have all been considered. One of the starting points for the review was the Cadbury Code, and a fundamental question was whether the aims of the first Code were still relevant. The growing demands of the corporate governance framework also led us to consider the balance between the Principles and Provisions.

2. The strengths of the UK's approach – the unitary board, strong shareholder rights, the role of stewardship and flexibility through 'comply or explain' in relation to the Provisions – are all still valuable today and have, therefore, been preserved.

3. The FRC led a coalition of parties that produced a report in 2016 on *Corporate culture and the role of boards* (Culture Report). This found that culture in business is a key ingredient in delivering long-term sustainable performance. The Code has been revised to include many of the findings, including that openness and accountability are essential for a healthy culture, and that good governance is demonstrated in the way the company conducts business and engages with stakeholders. This brings integrity, confidence, long-term success and ultimately trust.

4. The primary duty of directors is to promote the long-term success of the company. Companies can do more to recognise that other stakeholders, particularly their own workforces, play a significant part in that success. Therefore, the revised Code encourages corporate governance policies and practices that generate value for shareholders and aim to benefit society.

5. Along with responding to the recommendations made in the Government's response to the Green Paper Consultation on Corporate Governance Reform (published in August 2017), we have also taken into account issues raised by the House of Commons' Business, Energy and Industrial Strategy Committee's Report on Corporate Governance, published in April 2017.

6. The FRC has received input from a broad range of stakeholders representing a diverse spectrum of views, which have informed the drafting of the revised Code. We would like to take this opportunity to thank everyone who has contributed their time and expertise to support this review.

Structure

7. The Code encourages companies to achieve high standards. To do this it needs to be clear and concise. To this end we have looked to shorten and sharpen the revised Code. The supporting Principles from the current Code have been removed and, in some cases, been incorporated into the new Principles or Provisions, while others have been moved to the *Guidance on Board Effectiveness.*

8. The revised Code refocuses on the application of the Principles. The Provisions support these, but it should be noted that not all Principles have a directly associated Provision.

9. The revised Principles and Provisions address the elements of governance most important to board effectiveness and corporate purpose, including a new focus on stakeholders, integrity and corporate culture, diversity and how the overall governance of the company contributes to its long-term success.

10. The revised Code has five sections:

    1. Leadership and purpose
    2. Division of responsibilities
    3. Composition, succession and evaluation
    4. Audit, risk and internal control
    5. Remuneration

11. The majority of changes have been made to the first three sections of the current Code, which broadly correlate to Sections A (Leadership) and B (Effectiveness). Section E (Relations with shareholders) has been integrated within the revised Code, as shareholder engagement is a key aspect of good governance. Section 4, which deals with audit, risk and internal control, remains largely unchanged. This section is closely linked with legal and regulatory requirements, and, in the case of the role of audit and audit committees, the Code was amended recently. The current Schedule A has been removed and where appropriate incorporated into the Section 5 (Remuneration).

Compliance

12. Compliance with the current Code Provisions is high. Grant Thornton's annual review of FSTE 350 companies found that 66 per cent declare full compliance, while 95 per cent comply with all but one or two Code provisions.[1] This information can be further broken down. Table 1 shows that, in respect of board and committee composition, compliance rates across smaller companies remain on par with those of larger companies.[2]

Table 1: Compliance with selected provisions of the UK Corporate Governance Code

Code Provision	FTSE 350 companies		Smaller companies	
	2017	2016	2017	2016
A.2.1 – Separate chairman and CEO	99%	99%	98%	98%
B.1.2 – Met minimum provisions for number of independent NEDs	96%	93%	90%	89%
B.2.1 – Met minimum provisions for nomination committee composition	98%	99%	97%	95%
C.3.1 – Met minimum provisions for audit committee composition	97%	97%	93%	93%
D.2.1 – Met minimum provisions for remuneration committee composition	95%	95%	85%	86%

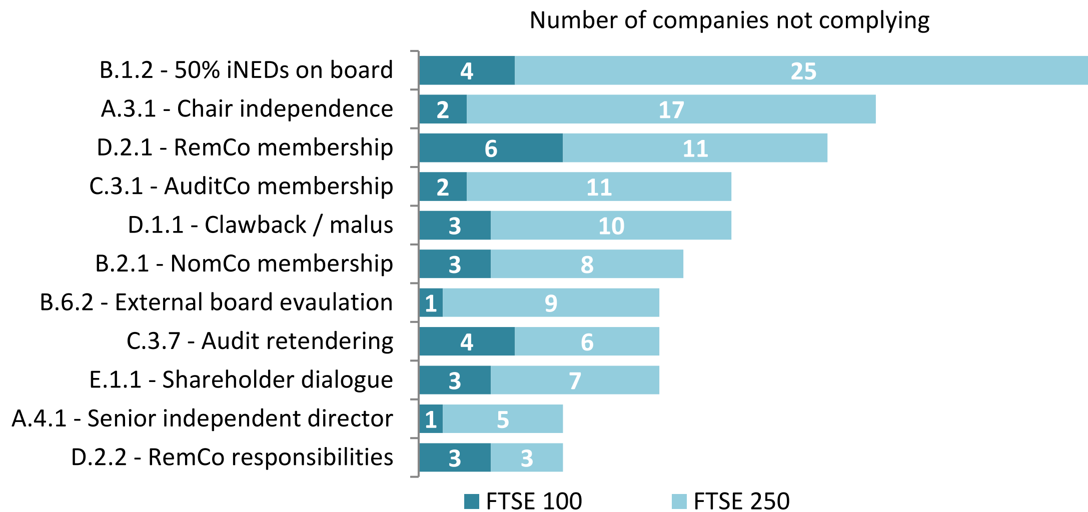
Source: Manifest (date range 1 September 2016 to 31 August 2017)

Note: The current Code has different requirements for FTSE 350 and smaller companies regarding the minimum number of independent directors and minimum requirements for board and committee composition.

13. Table 2 shows which Provisions are least complied with by the FTSE 350 companies. Current Code Provision B.1.2 is again rated as the lowest in terms of compliance; therefore the revised draft gives greater focus to the importance of independence (see page 12).

[1] Corporate Governance Review 2017; Grant Thornton; October 2017
[2] Manifest looked at 349 companies from the FTSE 350, 282 from the Small Cap and 68 from the Fledgling Index.

Table 2: Most frequent areas of non-compliance with the Code as reported by FTSE 350 companies in their 2016/17 annual report



Source: Extract of table from Practical Law's* Annual Reporting and AGMs 2017: What's Market Practice? *Paper published November 2017. Data as at 31 October 2017.

14. The revised Code builds on the success of the current Code by promoting best practice in areas such as culture, succession planning and promoting dialogue with wider stakeholders. Many of these concepts are contained within the new Principles.

15. Listing Rule 9.8.6 (5) requires all Premium-listed companies to disclose how they have applied the Principles in a manner that would enable shareholders to evaluate how these have been applied.

16. Over time Code compliance has focused on the 'comply or explain' aspects of the Provisions (LR 9.8.6 (6)) rather than the application of the Principles. Therefore, the revised Code emphasises the importance of applying the Principles. When reporting on these, the company should justify to shareholders why the board has implemented certain structures, policies and practices. The Principles should then be linked to the company's strategy and business model, and related to outcomes achieved.

17. The Provisions should be complied with or an explanation given. This is in line with current practice. It should be noted that, as with the current Code, some Provisions have specific reporting requirements.

18. The Corporate Governance Statement should also relate coherently to other parts of the annual report – particularly the strategic report, so that shareholders can assess effectively how the quality of a company's governance arrangements and the board's activities help it to deliver its purpose and strategy, and mitigate risks.

Application of the Code

19. Following the closure of this consultation we will consider the responses and make any appropriate amendments. We aim to publish a final version of the Code by early Summer 2018, to apply to accounting periods beginning on or after 1 January 2019.

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

Guidance

20. The *Guidance on Board Effectiveness* (the Guidance) has been amended to support the proposed changes to the revised Code. We recognise that further changes and refinement will be needed given the revised Code is subject to responses from this consultation. We will also consider appropriate amendments to other Code guidance.

21. The Guidance is intended to stimulate boards' thinking, including how they can carry out their role most effectively. It is not statutory, but should be read alongside the revised Code to add clarity and explanation. The board should also take into account additional specific guidance, such as the *Guidance on Audit Committees* and the *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*.

22. The structure of the Guidance follows the structure of the Code. Some elements of the current Code have been moved to the Guidance. This does not mean that they are no longer important, but that the practices are well embedded in company behaviour. The aim of the revised Code is to encourage companies to go further.

23. The board should use the questions posed in the Guidance to consider how they report on their application of the Principles.

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

THE CONSULTATION AND HOW TO RESPOND

We welcome comments on both the revised Code and Guidance. As we have had extensive discussions with the Government and have drawn upon a number of issues already raised as part of the Green Paper Consultation on Corporate Governance Reform, please bear this in mind if you are making general points.

We have also included an initial high-level consultation on the future direction of the UK Stewardship Code. Our aim is to formally consult on changes to the UK Stewardship Code in 2018. To achieve real change in corporate governance, and long-term success and sustainability for companies, it is important that investors play their part, which is why we are seeking views alongside the formal consultation on the revised Code.

A full list of consultation questions can be found at the end of this paper. If you wish to make general comments not relating to a specific question, please state clearly the Principle or Provision the comment relates to, so that these can be more effectively captured as part of the post-consultation review.

Comments on the questions set out in this consultation document are requested by **28 February 2018**. Responses should be sent by email to codereview@frc.org.uk.

or in writing to:

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Please note that it is advisable to send your response electronically. All responses will be acknowledged.

It is the FRC's policy to publish on its website all responses to formal consultations unless the respondent explicitly requests otherwise. A standard confidentiality statement in an email message will not be regarded as a request for non-disclosure. The FRC does not edit personal information (such as telephone numbers or email addresses) from submissions; therefore, only information that you wish to be published should be submitted.

CONSULTATION ON CHANGES TO THE UK CORPORATE GOVERNANCE CODE

Section 1 – Leadership and purpose

24. This section of the Code brings together a number of concepts and makes it clear that the board should consider the culture of the company and wider stakeholder interests to achieve long-term sustainability. A healthy culture should mean one that reflects the skills and abilities of the workforce.

25. Appendix C explains where the current Code has been incorporated into the revised Code. The revised Code introduces new concepts and removes others. Some of the more procedural aspects of the current Code have been moved to the Guidance. These are still important, but are now common business practice and therefore are not included in the revised Code, which strives to raise standards.

Wider stakeholders

26. The revised Code includes references to the board's responsibility for considering the needs and views of a wider range of stakeholders. The Culture Report highlighted the need for companies to take into account the views of wider stakeholders, including the workforce. In addition, the Government's Green Paper Consultation on Corporate Governance Reform and the House of Commons' Business, Energy and Industrial Strategy Committee's Report on Corporate Governance found public support for this. The Government requested that the FRC consult on a specific Code Principle relating to companies taking into account wider stakeholder views and a Code Provision requiring the adoption, on a 'comply or explain' basis, of one of three employee engagement mechanisms.

27. This approach is in line with our findings that companies benefit when considering all stakeholders. Principle C incorporates responsibilities to wider stakeholders as well as shareholders. Provision 3 includes the Government's three options for ensuring the employee voice is heard in the boardroom; namely: a director appointed from the workforce, a formal workforce advisory council, or a designated non-executive director. We have included all three options, as the Government found that respondents to its Green Paper Consultation on Corporate Governance Reform 'agreed that companies should seek to strengthen the voice of stakeholders, but there was no consensus on which of the three proposed options would work best… Many responses emphasised that there should be flexibility for individual companies to choose the right mechanism or combination of mechanisms for them, because no single approach would be suitable for all.'

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

28. The *Guidance on Board Effectiveness* contains more information about how the views of a wider range of stakeholders might be heard in the boardroom. This complements our proposals for revisions to the *Guidance on the Strategic Report* and relates to the section 172 director's duty (to promote the success of the company) in the Companies Act 2006 and 'value generation'. ICSA: The Governance Institute and the Investment Association have also recently published guidance on boardroom engagement.

29. The independent Advisory Group to the Department of Culture Media and Sport and the Treasury recently published *Growing a Culture of Social Impact Investing in the UK*. The report recommends that social impact aspects in the context of the UN Sustainability Development Goals (SDG) should be included in the consultations on the Code and the UK Stewardship Code. For the former we have incorporated in Principles A and C the need for companies to consider their responsibilities to shareholders and stakeholders,

and the contribution made to wider society. In Provision 4 we ask companies to report on these issues and how this has affected board decision-making.

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?

Section 172, Companies Act 2006 (Directors' duties)

30. The Government plans to introduce secondary legislation to require all companies of a significant size (private as well as public) to explain how their directors comply with the requirements of section 172 of the Companies Act 2006, with regard to employee interests and to foster relationships with suppliers, customers and others.

31. Provision 4 makes reference to section 172, but we will keep the exact wording of this Provision under review, pending the outcome of the Government's legislation and any subsequent changes to the Guidance on the Strategic Report.

Workforce definition

32. The revised Code asks companies to take into account the views of the 'workforce'. This term has been carefully chosen to capture the complexity and diversity of modern contractual relationships between companies and individuals undertaking work for them. The culture of the company, its strategy and values, and decisions made by the board and senior management, will impact on all those paid to work for the company. In return, these individuals will have a direct impact on the success of the company.

33. By using the term 'workforce' we are encouraging companies to consider how their actions impact on all, not only those with formal contracts of employment. For example, this could include workers, agency workers and those providing services as a contractor (self-employed). While there has been a recent debate on employment status, we believe that the term workforce is widely applicable and will continue to be appropriate.

Shareholder engagement

34. The importance of company and shareholder engagement remains vital and, as such, we have placed a number of Provisions from Section E of the current Code within the first set of Principles and Provisions in the revised Code. Both Principle C and Provision 5 underline the importance the Code places on shareholder engagement. Provision 6 also includes enhanced transparency by companies in relation to shareholder voting.

Significant votes against resolutions

35. The Code was amended in 2014 in relation to voting practices, so that companies should engage with shareholders where they receive significant votes against any resolution. This change followed an initial request from Government relating to remuneration resolutions.

36. In our response to the Government Green Paper Consultation on Corporate Governance Reform, we proposed that the Code should be more specific about what should be expected of companies where they receive significant votes against resolutions at their annual general meetings (AGMs).

37. Table 3 below shows that this year's AGM season has resulted in a 79 per cent increase in the number of resolutions, with more than 20 per cent of votes against. Some of this increase has resulted from the next triennial approval of remuneration policies, but there has also been a large upswing in votes against directors. However, Table 4 shows that 27 per cent of companies still do not comment on significant votes against.

Table 3: Significant minority voting at FTSE 350 AGMs

Resolution type	Resolutions with 20%+ votes against		Number defeated	
	2017	*2016*	*2017*	*2016*
Audit and reporting	4	2	–	–
Director elections	25	13	1	–
Issue of shares and pre-emption rights	26	11	2	1
Remuneration – policy	28	9	1	2
Remuneration – report	30	26	2	3
Shareholder rights	5	5	1	1
Political activity	2	1	–	–
TOTAL	**120**	**67**	**7**	**7**

Source: Manifest (date range 1 November 2016 to 31 October 2017)

Table 4: Significant minority voting at FTSE 350 AGMs – information noted in AGM voting results

Resolution type	Resolutions with 20%+ votes against		Info in AGM voting results?	
	2017	2016	Yes	No
Audit and reporting	4	2	4	0
Director elections	25	13	18	7
Issue of shares and pre-emption rights	26	11	19	7
Remuneration – policy	28	9	20	8
Remuneration – report	30	26	22	8
Shareholder rights	5	5	3	2
Political activity	2	1	2	0
TOTALS	**120**	**67**	**88**	**32**

Source: Manifest and the FRC (2017)

38. In order to improve transparency in this area we have revised the relevant Code Provision. Provision 6 now states: 'When more than 20 per cent of votes have been cast against a resolution, the company should explain, when announcing voting results, what actions it intends to take to consult with shareholders in order to understand the reasons behind the result.' We have also included an interim action that, no later than six months after the vote, an update should be published before the final summary is provided in the next annual report. These actions are aimed at ensuring the company fully understands the reasons for shareholders voting against a resolution and that it can enter into dialogue with shareholders to discuss these matters further. We will be adding a footnote to the revised Code to highlight that the Investment Association's soon-to-be-launched public register will be available for reviewing these updates.

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

Culture

39. The Culture Report found that culture in business is an important ingredient in delivering long-term sustainable performance. Where there is a healthy culture, the systems, procedures and overall functioning and mutual support of an organisation work effectively together. This brings integrity, confidence, long-term success and ultimately trust. A poor culture is a significant business risk in itself. Principles A and D, along with Provisions 2 and 3, link directly to culture. The concepts outlined in our report feature throughout the revised Code.

40. We found that in order to establish an appropriate culture, a board must define the purpose, strategy and values of the company, and consider the type of behaviours it wishes to promote in order to deliver its business strategy. This involves creating the right corporate culture, working with the wider workforce, and aligning the company values and purpose to the strategy. Paying due attention to the company culture helps to achieve long-term success and build trust. Grant Thornton's review of FTSE 350 companies[3] found that, although there has been year-on-year improvement, there is more to be done to explain how culture is integrated within a company. For instance, only 39 per cent provided a strong disclosure on company culture and only 29 per cent of chief executives referred to it in their annual report statement.

Whistleblowing

41. Current Code Provision C.3.5 requires the audit committee to review the arrangements by which staff are able to raise concerns about improprieties in matters of financial reporting or other matters. Provision 3 in the revised Code expands the emphasis of the whistleblowing provision by removing the specific reference to 'improprieties in matters of financial reporting or other matters' to allow the workforce to raise wider concerns.

42. We have also made this a responsibility of the board, rather than the audit committee, although the board may consider whether this is a task that could be undertaken by another committee and then reported back to the board, thus offering additional flexibility.

Section 2 – Division of responsibilities

43. This section of the revised Code considers the separation of duties within the board and between its various roles. It also deals with the importance of objectivity and challenge, as well how to define independent non-executive directors.

Board composition

44. Principle E sets out the broad role of the chair and draws on Principle A.3 in the current Code, which highlights the importance of the chair being able to demonstrate independent objective judgement. This should be demonstrated through actions and decisions made by the chair.

45. Provision 9 retains a number of concepts that are included in the current Code, with the revised Code going on to clarify the role of the chief executive in Provision 10 in proposing and delivery strategy. This change is in line with the emphasis the revised Code places on the importance of the strategy, and linking this with the culture and values of the company. Provision 10 also ensures that the chief executive is responsible for the board receiving the required information to inform its decision-making. This should be read alongside Principle H and the important role of the company secretary (see also Provision 16).

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[3] Corporate Governance Review 2017; Grant Thornton; October 2017

46. Composition of the board remains broadly the same in the revised Code. However, as the chair is now considered independent at all times (see below), we have amended the wording in what is now Provision 11. The requirement has changed from '…at least half the board, *excluding the chairman*, should comprise non-executive directors determined by the board to be independent' to now state: 'Independent non-executive directors, *including the chair*, should constitute the majority of the board.'

47. In addition, Provision 11 does not include an exemption for companies outside the FTSE 350. The current Code Provision B.1.2 (which is broadly in line with Provision 11) is the first provision in the current Code that offers smaller companies alternative arrangements. The current Code also offers similar exemptions in relation to board evaluation (B.6.2), annual re-election (B.7.1), and the composition of audit and remuneration committees (C.3.1 and D.2.1).

48. We have considered all of the exemptions for those companies below FTSE 350 in the current Code and as part of this consultation we are proposing the removal of these. We believe that the Code sets good practice and that even smaller companies should strive for the highest standards of corporate governance.

49. Although a company might be outside the FTSE 350 it may be of a similar size and structure. Equally, these companies may also have significant impacts on their workforce and wider stakeholders and as such they should be subject to the same levels of corporate governance.

50. Nevertheless, we appreciate that recommending an independent board evaluation for these companies has the potential for disproportionate cost and other burdens and we would welcome views about the effect of this proposal.

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.

Independence and tenure

51. The revised Code strengthens the Provisions on independence. The current Code Provision B.1.1 lists specific criteria that should be taken into account by the board when considering whether non-executive directors and the chair are independent. The revised Code changes the emphasis and states that where a non-executive director and/or the chair does not meet the stated criteria, they *should not be* considered independent.

52. The criteria in Provision 15 have not been amended, but we believe the change of approach sends a strong message that individuals should not be considered independent if they have a current or a previous relationship with company. This is in line with the importance placed on the role of independent non-executive directors and the need for boards to be exposed to challenges, new ideas and expertise from individuals without links to the company. Companies still retain the option of offering an explanation if they believe that an individual is still independent.

53. Provision 15 retains a time limit for independence by stating that where an individual has served on the board for more than nine years they are no longer considered independent. This is consistent with the revised Code's approach to succession planning and the importance of board refreshment.

54. While the current Code does not refer to tenure, we are aware that many companies and investors have used the 'nine-year' criterion for independence as a 'de facto' tenure period. This is the right approach, and in normal circumstances would not expect either an independent director or chair to be on a board for more than nine years in total, including in those circumstances where an independent non-executive goes on to be the chair.

55. The requirement in Provision 18 to submit all directors for re-election annually, combined with the criteria for non-executive directors and chairs to be independent, will lead boards and shareholders to carefully consider each individual director's contribution to the board, and their effectiveness and independence, without the need for setting a maximum period of tenure. We recognise that in some circumstances companies can explain if they wish to retain a non-executive director and/or chair beyond nine years.

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

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

Section 3 – Composition, succession and evaluation

56. This section considers the composition of the board, appointments and succession planning, which should ensure that board membership is diverse and relevant to the company's business, that boards operate effectively as a unit and that companies develop strong executive pipelines.

57. The boardroom is where strategic decisions are made, governance is exercised, and culture and risk are overseen. Inclusive and diverse boards will be better able to understand their customers and stakeholders, which leads to better decision-making. Board effectiveness is about the richness of the combined contribution of board members as a whole. Ensuring boards include individuals from a range of backgrounds who offer different perspectives will encourage a more rounded consideration of the issues, foster constructive challenge and guard against 'group think'. It is, therefore, essential for boards to be made up of competent, high-calibre individuals who, together, offer a broad mix of knowledge, skills, experiences, backgrounds and personal strengths, including women and individuals from different social and ethnic backgrounds.

58. There is clear evidence that greater female representation in the boardroom and senior management has a positive impact on performance.[4] More recently, research has found a statistically significant relationship between ethnically and gender diverse leadership teams and better financial performance.[5] Companies that focus on increasing diversity in the boardroom, in their executive teams and across their workforces as a whole can expect a positive impact on their performance.

59. It is, therefore, essential that board recruitment and succession planning processes and practices ensure that companies are identifying and considering a diverse pool of candidates and that appointments increase diversity over time.

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4 *Women Matter*, McKinsey and Company, 2007

5 *Diversity Matters*, McKinsey and Company, 2015

60. The market environment in which companies are operating is becoming increasingly diverse as a result of globalisation,[6] increased female participation in the workforce, and changing demographics. In order to ensure the continued strength and attractiveness of UK business, companies need to be proactive in considering how diversity and inclusion is relevant to the specific circumstances of their business, the markets in which they operate, the workforce on which they rely and the customers and communities which they serve. These considerations should be built into companies' strategic plans for meeting their corporate aims.

61. Companies need to take steps to build greater diversity among business leaders so that they are capable of understanding their market environment and securing the talent needed for long-term success.

62. Considerable progress has been made in increasing the diversity of UK boards since Lord Davies published his report into the gender balance of FTSE 100 boards, *Women on boards*, in February 2011. In 2017, women made up 27.7 per cent[7] on average of FTSE 100 boards, up from 12.5 per cent in 2010, demonstrating continued progress towards the target of 33 per cent by 2020, set by the Hampton-Alexander Review in 2016. Transparency has been an important driver of this change.

63. Progress at increasing the number of women in the executive committees of the FTSE 100 has been slower. Women account for an average of just 19.3 per cent of the members of the executive team in FTSE 100 companies in 2017, up from 12 per cent in 2011.

64. The Hampton-Alexander Review identified that further progress requires building diversity into the executive pipeline. The report, *FTSE women leaders: Improving gender balance in FTSE leadership*, recommended action for nomination committees and changes to the Code to support this. Sir John Parker's report, *The ethnic diversity of UK boards*, highlighted the low level of representation of people from ethnic minority backgrounds in boardrooms and also recommended action for nomination committees.

65. The revised Code, therefore, asks boards to intensify their efforts. While it continues to emphasise the importance of diversity in its broadest sense, Principle J aims to broaden boards' perceptions of diversity and to ensure appointment and succession planning practices are designed to promote diversity, not only of gender, but also of social and ethnic backgrounds.

66. The changes also broaden the focus of the Code, encouraging, for the first time, building diversity across the workforce and, in particular, in the executive pipeline. Provision 17 expands the remit of the nomination committee in order to provide oversight of the development of a diverse pipeline.

67. To enhance transparency in respect of progress on diversity, Provision 23 encourages reporting on actions taken to increase diversity and inclusion, and the outcomes in terms of progress on diversity. In considering what reporting to ask for, we took account of recent changes to the Financial Conduct Authority (FCA) Disclosure and Transparency Rules.[8]

68. Provision 23 also addresses the recommendation of the Hampton-Alexander Review that 'the FRC should amend the UK Corporate Governance Code so that all FTSE 350 companies disclose in their Annual Reports the gender balance on the Executive Committee and Direct Reports to the Executive Committee.'

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[6] Over half of sales of the FTSE 350 are generated overseas.

[7] Hampton-Alexander Review: *FTSE women leaders: Improving gender balance in FTSE leadership*, Nov. 2017

[8] DTR 7.2.8A(R)

69. This recommendation seeks to address inconsistencies in reporting on the gender of 'senior managers' as required under section 414C of the Companies Act. Differences of interpretation have resulted in information being reported that does not provide the insight into the gender balance in the executive pipeline hoped for and makes comparisons between companies and across sectors difficult. To address this the Code asks companies to report specifically on the gender balance in the first layer of management below board level and their direct reports. However, we are proposing that all companies, not only those in the FTSE 350, should be encouraged to increase transparency in this area.

70. Reporting on ethnicity is not currently required in law or by the Code. Sir John Parker noted in his report that the lack of publicly available data 'may present an unnecessary hurdle in tracking progress and being fully transparent to all stakeholders.'

71. The FRC believes that greater transparency around the makeup of a company's pipeline for succession would be beneficial. A focus now on building greater ethnic and other diversity in the pipeline for succession has the potential to make a meaningful difference to the overall diversity of senior management teams and boards over time.

72. Provisions 23 asks nomination committees to explain what action they have taken to increase diversity in the pipeline, but does not go as far as asking for data on levels of diversity other than for gender. We would, however, welcome views on whether the Code should encourage companies to provide data on levels of ethnic diversity in their pipelines.

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?

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.

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.

Section 4 – Audit, risk and internal control

73. This section of the revised Code retains many concepts contained in the current Code. We are aware that the FCA uses compliance with and reporting against the Code as a route for issuers to satisfy certain requirements of the Listing Rules and the Disclosure Guidance and Transparency Rules. Consideration was given to removing the duplication in these areas; however, feedback suggests that retaining the current requirements is a better course of action.

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?

Audit committees

74. We have retained the list of the main roles and responsibilities of the audit committee as currently required in C.3.2 of the current Code (now Provision 25). However, C.3.3, requiring the terms of reference of the audit committee to be made available, has been removed and will be referred to in the Guidance (which makes it clear that terms of reference for all board committees should be set out clearly and made publically available).

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.

Risk and internal controls

75. The Financial Reporting Lab report[9] on risk and viability reporting provides a helpful summary of where improvements in transparency can give greater meaning. The Lab found that companies and investors are clear that viability is a concept that is inherent to the decisions that each of them make. However, investors want company viability statements to explain more adequately the long-term prospects of the company and to communicate messages about its long-term future. Indeed, Grant Thornton reported that 51 per cent of FTSE 350 companies gave little or no insight into their long-term resilience.[10]

76. Some companies have used the viability statement to talk about long-term prospects, drawing on timescales used by the business in order to outline the planning and investment cycles used. This is consistent with what the 2014 Code envisioned for the viability statement – a wide-ranging discussion around the prospects of the company, and then a statement covering a period chosen by the directors for which they have a reasonable expectation of viability. When discussing the long-term prospects of a company, investors look for analysis of the sustainability of the business model as a key consideration, and expect the directors to be able to discuss its resilience to risk and adaptability to market challenges. However, investors have pointed to the confusion created by companies using a range of timescales over which they describe their prospects (e.g. in the annual report, investors' presentations and elsewhere) and they want to understand better how these periods affect the assessment of prospects. They also generally want companies, especially those making long-term investments, to discuss their prospects of long-terms success over periods going beyond their immediate strategy horizon.

77. We encourage companies to develop their viability statements in two stages – first by considering the prospects of the company over a period reflecting its business and investment cycles, and, second, by stating whether they have a reasonable expectation that the company will be able to continue to meet its liabilities as they fall due over the assessment period, drawing attention to any qualifications or assumptions. Indeed, Appendix B in the *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting* already states: 'The length of the period should be determined, taking account of a number of factors, including without limitation: the board's stewardship responsibilities; previous statements they have made, especially in raising capital; the nature of the business and its stage of development; and its investment and planning periods.'

Section 5 – Remuneration

78. Rising levels of executive pay have contributed to public mistrust in business. Concerns have also been raised over the complexity of remuneration schemes and that the incentives embedded in annual and long-term plans are responsible for behaviours and decision-making that do not support the success of the company over the longer term.

79. The Culture Report highlighted the important role played by incentives and rewards in driving behaviours that support the desired culture. Incentives and workforce policies and practices more generally need to be aligned with the company's purpose, strategy and values, and be properly embedded to achieve that.

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[9] Risk and Viability Reporting; Financial Reporting Lab, November 2017

[10] Corporate Governance Review 2017; Grant Thornton; October 2017

80. Companies can improve the experience of the workforce and increase productivity by developing working practices that engender trust, and provide security and stability. These include fair rewards and recognition, flexible working conditions, allowing the workplace to have a voice, the skills to do the job, and to develop potential and opportunities to be involved in securing business improvements.

81. Good work: the Taylor review of modern working practices, published in July 2016, emphasised that the best way to drive up the quality of work for individuals is 'not national regulation, but responsible corporate governance, good management and strong employment relations…'. The FRC believes that boards and remuneration committees have a vital role to play in overseeing pay, incentives and working practices, and in ensuring that these support the long-term success of the company.

82. The Government's response to the Green Paper Consultation on Corporate Governance Reform invited the FRC to 'consult on a revision to the UK Corporate Governance Code and its supporting guidance to give remuneration committees greater responsibility for demonstrating how pay and incentives align across the company, and to explain to the workforce each year how decisions on executive pay reflect wider pay policy'. We were also asked to consult on 'extending the recommended minimum vesting and post-vesting holding period for executive share awards from three to five years to encourage companies to focus on longer-term outcomes in setting pay'. We understand that market practice is already moving in this direction, with many companies already adopting a minimum five-year vesting and holding period. By updating this, we aim to raise standards for all.

83. An expanded remit for remuneration committees to engage with employees and oversee pay and incentives across the wider workforce should encourage greater focus on the strategic rationale for executive pay levels in a broader context.

84. The revised Code emphasises the role of the board in exercising independent judgement and discretion (Principle Q). Provision 37 requires schemes to make provision for boards to be able to override remuneration outcomes; for example, where the measurement of any performance condition does not reflect the actual performance of the company over the period or the performance of the individual director.

85. Provision 33 proposes that the remuneration committee should have an expanded remit, taking on responsibility for oversight of company remuneration and wider workforce policies. This enhanced remit will also have implications for the time the committee will need to devote to its role. Some companies may feel that it would be more appropriate to delegate some of the oversight for workforce policies to other committees where these exist as they might be better placed to deal with such matters. Examples include sustainability committees, corporate responsibility committees or people committees.

86. To respond to the Government's invitation, Provision 32 includes a requirement that the remuneration committee chair will have served for at least twelve months on any remuneration committee before taking on this role. Remuneration committees are required to demonstrate through improved reporting how company policies and practices incorporate the Principles and Provisions of this section. This includes the Government's request that the Code includes a reporting requirement for companies to explain what workforce engagement has taken place to explain how executive remuneration aligns with wider company pay policy (Provision 41).

87. The current Code's Schedule A has been integrated into the remuneration section which now includes a range of matters the committee will need to address (Provision 40). This section will be supported by information in the Guidance on the role of the committee and its new responsibility for wider workforce pay and policies.

88. We are aware that the Government plans to introduce secondary legislation on pay ratios and for clearer reporting on the range of remuneration outcomes from complex, share-based incentive schemes. We will keep abreast of these changes and may make consequential changes to this section of the Code, pending the outcome of the Government's legislation.

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?

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

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

INITIAL CONSULTATION ON FUTURE DIRECTION OF UK STEWARDSHIP CODE

1. Like the UK Corporate Governance Code, the UK Stewardship Code (the Stewardship Code) seeks to secure long-term value by enhancing the quality of engagement between investors and companies to improve long-term risk-adjusted returns to shareholders.

2. It was developed to help build a critical mass of investors willing and able to engage with the companies in which they invest, to increase the quantity and quality of engagement, and to increase accountability down the investment chain to clients and beneficiaries. Evidence from surveys, our discussions with market participants, and assessment of signatory statements shows there has been an improvement in the quantity and quality of stewardship since the Stewardship Code's introduction. However, it is five years since the Stewardship Code was last reviewed and it is appropriate to consider the role it can play in driving further improvements in best practice.

Background

3. The Stewardship Code was introduced as a result of Sir David Walker's *A review of corporate governance in UK banks and other financial industry entities* (the Walker Report). The Walker Report recommended the FRC's remit be extended to cover the development of, and encourage adherence by institutional investors to, best practice in stewardship of UK-listed companies. The *Code on the Responsibilities of Institutional Investors*, issued by the Institutional Shareholders' Committee, formed the basis of the 2010 Stewardship Code.

4. There are three signatory categories to the Stewardship Code: asset managers, asset owners and service providers. Signatories are expected to provide a public statement about their approach to stewardship using the Stewardship Code as their framework for reporting. It is voluntary. However, the FCA's *Conduct of Business Sourcebook* (COBS) requires investment managers to disclose the nature of their commitment to the Stewardship Code or, if this is not appropriate, an alternative investment strategy.

5. By early 2016 there were almost 300 signatories to the Stewardship Code across the three categories. However, the quality of statements varied and while there had been some improvement, this was not sufficient to demonstrate that all signatories were following through on their commitment to the Stewardship Code. As such, in 2016 we asked signatories to demonstrate their commitment by reporting more effectively on their approach to stewardship. Our tiering exercise distinguished between signatories that reported well and demonstrated a commitment to stewardship, and those where improvements were necessary. The exercise was designed to encourage signatories to improve their statements and thereby reaffirm their commitment to stewardship.

6. The tiering exercise has resulted in more transparency and improved reporting against the Stewardship Code. Inevitably there is a range of practice between and within the tiers, and we are now focusing on how we can encourage further improvements in reporting and drive best practice in stewardship. The tiering exercise was a first step and we are now consulting on the direction of travel for reform of the Stewardship Code. Below we pose broad questions that will guide our approach. We expect a detailed consultation on specific changes will be published in mid-2018, once the comprehensive review of the UK Corporate Governance Code has been finalised.

Options for reform

7. Following our work on tiering, and assessing external reviews and market views, suggestions on improving the Stewardship Code fall into two broad categories: format and content. We would welcome views on the broad questions below and on other ways respondents feel we could drive best practice reporting and stewardship activity.

Format

Relevance to different signatory categories

8. Some signatories feel the Stewardship Code is not explicit enough about the expectations of best practice stewardship applicable to different elements of the investment chain. As a result of the 2012 review, the Stewardship Code references different parts of the investment chain, but it appears that expectations could be clearer.

9. One of the ways in which it has been suggested that expectations could be clarified is the publication of separate codes for different signatory categories. We have heard differing views about whether separate codes would be helpful. Some feel that different codes would help organisations focus on expectations specific to them; for example, the requirement for pension funds to decide whether they consider environmental, social and governance (ESG) factors to be material to their investment, and, if so, to act accordingly. Other organisations believe that an overarching framework for stewardship more clearly shows that responsibilities flow through the investment chain. There appears to be some support, at least, for the signatory categories to be renamed to reflect those investing directly or indirectly, rather than their organisational form.

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?

Best practice format

10. The UK Corporate Governance Code acts as a best practice document by outlining specific roles, structures and expectations with which those reporting against it are expected to ‘comply or explain’. The Stewardship Code instead focuses on disclosure and transparency. A revised Stewardship Code could provide more specific expectations about best practice investor behaviour in a more traditional ‘comply or explain’ format.

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?

Shareholder Rights Directive (SRD)

11. The UK’s decision to leave the European Union may have an impact on UK company law and corporate governance regulatory frameworks. While the Government’s negotiations with the European Union are underway, it is important to consider how the measures introduced in the 2017 amended SRD could best be transposed. The SRD covers a range of policy areas, including: identification of shareholders and facilitation of the exercise of rights attached to those shares; executive remuneration; transparency requirements on institutional investors, asset managers and proxy advisors; and rules on related party transactions. The SRD section of most relevance to the Stewardship Code is Chapter 1b, specifically Article 3g, which requires institutional investors and asset managers to provide

on a ‘comply or explain’ basis, disclosure about specific elements of their approach to investing. Many of these are similar to provisions in the current Stewardship Code; however, there are additional content elements, including the requirement for institutional investors and asset managers to publicly disclose their engagement with investee companies and how they integrate shareholder engagement into their investment strategy (including an annual disclosure of their voting behaviour, an explanation of significant votes, and the use of proxy advisor services).

12. The approach to implementation has not yet been finalised. It could mirror the current regulatory structure for asset managers, with underpinning for a code (covering the ‘requirement’ to disclose) in the COBS, with the Stewardship Code itself requiring disclosure on a ‘comply or explain’ basis. The SRD may also impact on proxy advisors by requiring them to publicly disclose reference to a code of conduct, and publicly disclose on an annual basis information relating to the preparation of the research, advice and voting recommendations. These will be implemented through a separate code of practice; however, the Stewardship Code will need to be amended as appropriate. This may raise questions about the inclusion of a ‘service provider’ signatory category within the Stewardship Code.

13. A requirement for a larger group of asset managers and other institutional investors to report on their stewardship activities is likely to affect the FRC’s ability to assess statements in order to tier them. We are interested in views on the value of considering a greatly increased number of statements, especially of those signatories that have only chosen to become signatories because of a regulatory requirement and are likely to explain more than they comply. We have been considering alternative methods of tiering signatories; for example, whether it may be appropriate to highlight a select group of signatories that report in a best practice way against the Stewardship Code or provide innovative reporting, rather than individually assessing every statement.

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?

<u>Content</u>

Amendments to the UK Corporate Governance Code

14. Our revisions to the UK Corporate Governance Code attempt to drive best practice in governance and focus the activities of boards on the elements most important to their investors. The revised UK Corporate Governance Code includes greater reference to the importance of culture and diversity. Relevant amendments could be mirrored in future changes to the Stewardship Code and we would be interested in views on whether any specific elements from the UK Corporate Governance Code consultation should be referenced in the Stewardship Code.

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

Long-term factors and other issues relating to investment

15. In 2014, Tomorrow's Company and Standard Life Investments published a report: *Building the Momentum for Effective Investor Stewardship: Recommendations for change*. This report was intended to drive better stewardship through the investment chain and made some specific recommendations regarding the Stewardship Code. The report noted: 'Institutional investors are not required to describe their role in contributing to the promotion of long-term success of companies and although some may do so, many do not.'

16. The Investment Association's (IA) *Productivity Action Plan*, released in 2016, covers a range of factors related to long-term success. It makes a series of recommendations regarding the integration of long-term value creation, productivity drivers and capital management issues in the Stewardship Code.

17. In the context of productivity and long-term considerations, it has been suggested to us that the Stewardship Code might encourage disclosure of approaches to share buybacks and the payment of dividends. We would expect each investor to apply this approach on a case-by-case basis according to their duty to the client, but the consideration of the links between these points and wider financial integrity may be of interest to those using stewardship statements.

18. ESG factors have, for a number of investors, taken on more prominence over recent years. Both the Task Force on Climate-Related Financial Disclosures and the EU's High-Level Expert Group on Sustainable Finance have published reports recently outlining suggestions about company and investor activity in this area. The FRC's proposals for updating the *Guidance on the Strategic Report*, encourages companies to report fully on the broader non-financial matters that impact a company over the longer term.

19. In 2012, Professor John Kay published a review of the UK equity market, recommending the Law Commission review the legal concept of 'fiduciary duty' to address uncertainties and misunderstandings on the issue. Of particular concern was the legal duties of pension trustees, and whether trustees should consider interests beyond the maximisation of financial return, including broader environmental and social impact. In noting the ESG label as 'ill-defined' and inconclusive, the Law Commission stated that trustees, when investing in equities over the long-term, should assess which risks they consider to be material, including risks to a company's long-term sustainability, and act accordingly.

20. It has been suggested the Stewardship Code could more explicitly address the importance of investors considering long-term sustainability issues, including factors relating to ESG and the broader social impact (particularly in response to the release of the Government's report *Growing a Culture of Social Impact Investing in the UK*). Many of these factors link closely to the long-term success discussion above; however, the Stewardship Code recommends that investors consider a range of issues related to investment, including strategy, capital allocation and culture. We feel that the Stewardship Code should not only be relevant for ESG decision-making; however, we are interested in views about how it could be amended to refer more effectively to ESG factors and integration.

21. As part of the recent corporate governance reform discussions there has been increasing focus on the role of section 172 of the Companies Act 2006, which requires a director to act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard to a range of matters.

22. It has been suggested that if boards are to be required to report on the way in which they have carried out their duty under section 172, then investors should also be encouraged to monitor and engage on these issues. The FCA sets the duties of asset managers, and is currently considering regulatory amendments in light of its Asset Management Market Study.

23. We are unable to impose a duty on asset managers, but we believe that a greater focus on how investors assist companies to build long-term success would be helpful and would be interested in your views about how this could be better reflected in the Stewardship Code, including through the use of a 'section 172' for asset managers.

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

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?

Best practice content elements

24. There is a regulatory underpinning for the disclosure by asset managers, but otherwise all reporting against the Stewardship Code is voluntary. The tiering exercise improved reporting against the Stewardship Code and was successful in encouraging more disclosure about stewardship approaches to allow clients to make more informed choices. The FRC sets and monitors the Stewardship Code, but we do not have a specific oversight role covering implementation. While we have the capacity to consider the quality of statements, this is in many ways a proxy for the assessment of the quality of stewardship activities. It has been suggested the Stewardship Code should be more explicit about best practice expectations for particular activities. This could include, for example, best practice reporting on voting disclosure, as opposed to suggesting only that such votes be disclosed publicly.

25. We are interested in views on how to encourage reporting on outcomes of stewardship activity, as opposed to processes and inputs. One suggestion is for the Stewardship Code to refocus on expectations around reporting on engagement, rather than just voting. We are not in a position to assess the quality of engagements; however, we are interested in how we could direct the Stewardship Code towards reporting on implementation as opposed to processes.

26. The House of Commons' Business, Energy and Industrial Strategy Committee Inquiry on Corporate Governance was launched in 2016 after the Committee identified a series of corporate governance failings. There were a number of suggestions made to the FRC about both Codes. The recommendations stated that we should review the Stewardship Code to provide 'more explicit guidelines on what high-quality engagement would entail; a greater level of detail in terms of requirements; and an undertaking to call out poor performance on an annual basis'. It also suggested that we should include 'stronger provisions to require the disclosure of voting records by asset managers and undertake to name those that subsequently do not vote'. The points about explicit expectations and detail are addressed above. However, as outlined, we are unable to address poor performance against expectations as our remit does not extend to assessing implementation. We are also unable to set 'requirements', as the Stewardship Code operates on a 'comply or explain' basis. We consider this flexibility to be a central tenet that should not be compromised.

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?

Asset classes

27. The Stewardship Code was envisaged as a complement to the UK Corporate Governance Code in the Walker Report. As such, the focus of the Stewardship Code is on the role of shareholders in publicly listed companies. However, some signatories consider themselves responsible investors, as opposed to responsible shareholders. We are interested in how we could address the fact that investors view their responsibilities in different ways.

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

Content elements of other Codes

28. There has been a proliferation of codes internationally since the Stewardship Code was introduced in 2010. Many investors want to encourage responsible behaviour in all markets in which they invest, and so report against a number of codes. In the FRC's view, if signatories meet the reporting requirements of the Stewardship Code, we are comfortable for their statements also to address the requirements of other codes. However, the Stewardship Code could be more explicit about the ability for signatories to make statements applicable to a range of codes.

29. International stewardship codes include a range of elements different to those included in the Stewardship Code. For example, the International Corporate Governance Network's (ICGN) Global Stewardship Principles set out the ICGN's view of best practice in relation to investor stewardship obligations, policies and processes. The most obvious points of difference with the ICGN Code relate to internal governance structures and the explicit reference to ESG factors and their integration. The recently published consultation on the Dutch Stewardship Code, for example, includes more specific expectations around the use of, and disclosure around, stock lending. Other international stewardship codes are more explicit about different elements, including the importance of a long-term investment view, and the disclosure of voting and engagement records.

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

The role of independent assurance

30. Independent assurance of asset managers' engagement and voting processes is a 'comply or explain' element of Principle 7 of the Stewardship Code. This is intended to provide assurance that the system and processes outlined in the statement are being adhered to. It has been suggested that expectations around the use and frequency of independent assurance should be more explicitly stated in the Stewardship Code. However, we have heard differing views about the effectiveness and usefulness of independent assurance.

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?

Voting in pooled funds

31. Some asset owner signatories using pooled funds have questioned their inability to direct the vote in such funds given their wider stewardship responsibilities. A number of organisations are also looking at this issue, including the Association of Member Nominated Trustees 'Red Lines' campaign. We held roundtables in 2013 on this topic, but at the time decided not to change the Stewardship Code to recommend disclosure of the approach to directed voting in asset managers' statements. In this context we are also conscious of the need to ensure that voting decisions are appropriately linked to investment decisions.

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

Diversity

32. The Hampton-Alexander Review report, *FTSE Women Leaders: Improving gender balance in FTSE Leadership*, last year suggested that 'progress on gender balanced boards and in the leadership ranks of FTSE 350 companies should be assessed [by investors] as a key corporate governance issue when considering their responsibilities under the UK Stewardship Code'. The UK Corporate Governance Code (subject to this consultation) has been amended to broaden references to relevant diversity characteristics in the appointment, succession planning and evaluation of corporate boards.

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

UK Committee on Climate Change

33. In June 2017 the UK Committee on Climate Change released its report *Progress in Preparing for Climate Change*. Within the report, the Committee noted that the investment community is becoming increasingly interested in the effects of climate change on risk-adjusted returns, making the recommendation that Government promote the voluntary disclosure of climate change risks by both large and small companies, including the risks in relation to supply chain. Specifically, the Committee stated the Stewardship Code should be amended to ask investors to consider company performance and reporting on adapting to climate change.

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

Purpose of stewardship

34. It has been suggested the Stewardship Code could better recognise the diverse nature of stewardship and encourage improved outcomes if the different stakeholders along the investment chain defined the purpose of stewardship as it relates to their specific activities. This could encourage a focus on the behaviours that reinforce the role of stewardship within organisations.

35. Currently, as signatories to the Stewardship Code, asset owners, asset managers and service providers disclose a commitment to stewardship. However, we have received feedback from stakeholders that such broad commitments by asset managers does not provide the necessary disclosures and transparency to asset owners at a fund level. While we do not see merit in requiring differing funds to become signatories to the Stewardship

Code (as this would likely result in a significant administrative burden) there are strong arguments for promoting greater transparency for asset owners by encouraging reporting against the Stewardship Code at a fund level. This would ensure asset managers remain signatories to the Code, while requiring them to define a fund's purpose and its specific approach to stewardship, and how this contributes to the asset managers' overall approach to stewardship.

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?

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?

LIST OF CONSULTATION QUESTIONS

If you wish to make general comments not relating the following questions, please state clearly the Principle or Provision the comment relates to, so that these can be more effectively captured as part of the post-consultation review.

UK Corporate Governance Code and Guidance on Board Effectiveness Questions

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

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

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

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?

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

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.

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

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

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

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.

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?

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.

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?

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

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

UK Stewardship Code Questions

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?

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?

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?

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

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

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?

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?

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

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

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?

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

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

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

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?

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?

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