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Consultation on the UK Corporate Governance Code and Guidance on Board Effectiveness

Rolls-Royce welcomes the opportunity to respond to the consultation on the proposed revisions to the UK Corporate Governance Code and Guidance on Board Effectiveness. We set out below a number of areas where we would like to make comment. There are a number of proposals where we do not believe it relevant or appropriate for us to provide commentary and we have made it clear where this is the case. We hope our response is helpful.

Overarching comments

We understand and support the objectives of the reforms, however, we have some overarching concerns about the approach and, particularly, some of the language proposed, which we believe erodes the 'comply or explain' approach. It is important that the Code is not seen as mandatory but retains the 'celebrated core' of the UK Corporate Governance model. It is important that the Code is not seen as mandatory or over prescriptive. We believe the strength of the current Code lies in its flexibility and principles based approach.

We also have some wider comments on independence – which we have included in our response to question 7 below.

ANSWERS TO CONSULTATION QUESTIONS

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

No, no concerns.

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

Overall the Guidance seems rather long and a little over prescriptive.

- 2.1 Paragraph 10 – this paragraph refers to a director having a duty to preserve value in the long-term and then goes on to quote the current UK Companies Act requirements. However, the two do not quite align and this could cause confusion. The current legislation states that the duty of directors is 'to promote the success of the company', and then goes on to impose a duty to act in the way a director '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, amongst other things, 'the likely consequences of any decision in the long term'. In effect this means that a director can consider the long-term impact of a decision but can take action on the basis of short-term considerations if he, or she, thinks that is most likely to promote the company's success for its members.

In our view, unless and until secondary legislation is introduced it would be better to align the wording as currently drafted in legislation.

- 2.2 Paragraph 17 – it might be helpful to make it clear that this paragraph is just one example of many different approaches that may be taken.

- 2.3 Paragraph 20 – this is an example where the drafting appears prescriptive. This paragraph could be removed or the wording softened or amended.

- 2.4 Paragraph 21 – this seems overly prescriptive and would be better removed. Board's carry our annual board evaluations to review the effectiveness of their decision- making processes and in many cases will additionally include post investment reviews and operational updates that will review past decisions as part of the standard reporting.
- 2.5 Paragraph 26 – the first sentence of this paragraph seems to be inconsistent with section 172 and overstates directors' duties in relation to wider stakeholders, which must be placed in the context of directors' primary obligation to promote the company's success for the benefit of its members.
- 2.6 Paragraphs 50 & 60 – Paragraph 50 provides a description of the role of the Chair. It highlights the need for the chair to 'foster relationships founded on mutual respect and open communication – both in and outside the boardroom – between the non-executive directors and the executive team' and to develop 'productive working relationships with all executive directors, and the chief executive in particular, providing support and advice while respecting executive responsibility'. Paragraph 60 provides that 'The chief executive's relationship with the chair is a key relationship that can help the board be more effective'. We agree with these statements and believe that they reflect the nature of the Chair's role, however, they also highlight the difficulty for a Chairman to remain 'independent' as proposed in provision 15 of the revised Code.

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

Yes. However the new Code should set out more clearly the flexibility companies need to have to determine the most appropriate way to achieve meaningful engagement within their organisations. In particular, Provision 3 should explicitly state that companies are permitted to engage the workforce in a way which is not specified or through a combination of methods (as clearly provided in Paragraph 35 of the draft Guidance).

We would welcome further clarification or definition of the term 'workforce' and believe it would be helpful to have a definition as to scope. We receive questions at our AGM regarding employees of an outsourced service provider based at our premises and employees in our supply chain. We would not regard either of these to be part of our own workforce (particularly as they may be subject to workforce voice arrangements through their own direct employer).

4. 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?

We do not think that there is any need for more specific references to be made. Companies should continue to have the flexibility to approach this area in a way that best works for them and their stakeholders on a case-by-case basis.

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

While we agree that 20% is 'significant' in the context of a vote against we do note that, even for a special resolution to fail, it requires 25% of the shareholders voting to vote against - and it would seem this would be a more appropriate benchmark.

We do not believe that an update should be required within a six month period but that an update should be provided in the next annual report at the latest – giving flexibility to the company to provide an earlier update if they deem it appropriate.

6. **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.**

No comment

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

Independence generally

We do not believe that this should automatically be the case, however, as drafted the effect of the proposed changes to the Code on the determination of independence is likely to have this consequence.

We believe that it is important that the Board retains discretion to decide whether the test for independence is met, notwithstanding that any one of the indicators of non-independence is present. We believe the hardening of the language around this provision is a prime example of the erosion of the 'comply or explain' approach mentioned in our introduction.

Amongst other things, this could adversely affect the ability of companies to run balanced succession planning. For example, it will make it much more likely that boards will need to recruit their chairs from outside – a nine year time limit on independence will in practice make it more difficult for there to be internal chair appointments and will discourage this type of succession planning. It could also undermine one of the primary roles of the chair to be the steward of the company's long-term strategy if the board were required to assume that the chair would automatically not be independent after nine years.

Alternatively, if retained, it might be more appropriate for existing director promotions to the Chair to restart the time limit on initial appointment so that they serve as Chair for a maximum of nine years, although they may be on the Board for longer.

The list would appear to be drafted as an exhaustive list. There could be other circumstances which could impact on a director's independence. It may be more appropriate to continue to permit the board, as the body best placed to assess all factors relevant to a director, to exercise its judgement in making an overall assessment of independence.

Overall we believe that the approach to determining independence in the current Code should be maintained, namely that it remains a question of judgement for the board as to whether the test of independence is met, whether after nine years on the board or when one of the other indicators listed in Provision 15 is present.

Independence of the chair

We are not clear why the Code proposes to focus on the independence of the chair after appointment. The existing Code provides that the chair should be independent on appointment only. This is because the chair discharges a hybrid role, spanning the executive and non-executive teams – as stated in Paragraphs 50 and 60 on the Guidance. We can not see any logic or justification for now requiring the chair to be independent after appointment.

Paragraph 5.9 of the Higgs Review Report on the role and effectiveness of non-executive directors (January 2003) recommended that at the time of appointment chairs should meet the test of independence, as follows:

'5.9 Once appointed, the chairman will have a much greater degree of involvement with the executive team than the non-executive directors. Applying a test of independence at this stage is neither appropriate nor necessary.'

This is still the case, and we believe that the current position should be maintained.

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

Yes

9. 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?

Yes.

10. 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.

No comment.

11. 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 support this proposal in principle. However there are a number of practical difficulties with implementation that need to be considered:

- The collection of ethnicity data is more complicated than the collection of gender data. For example, what is meant by 'ethnicity' and how would it be determined? Would it be by reference to birth, race or association? How would second and third generations and mixed ethnicity be classified? Is this for the individual company to determine (and report on how they define it) or will it be more clearly defined in the Code? Also, what is the scope of the term 'ethnicity' – does it have global reach, reflecting the footprint of the company?
- Provided that the data can be collected anonymously and without contravening local laws there should be no issue with reporting on ethnicity, subject to the limitation that the usefulness of the data reported on will be entirely dependent on the extent to which the workforce is willing to volunteer their ethnicity (as you will see from our Annual Report we currently have a small number of employees who are not willing to provide us with their gender – we would anticipate higher numbers being unwilling to provide us with their ethnicity)
- We would need to take into account our obligations under data protection law when making any reports. To the extent that the data might identify a particular individual, which might be the case, for example, in the level immediately below board level where the number of employees reported on is small, we would need to consider whether we can lawfully make the disclosure.

12. 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?

No, in our opinion it would be better to remove all duplication.

We note your reference to the Government's plans to introduce secondary legislation to require all companies of a significant size to explain how their directors comply with section 172 of the Companies Act. We think it would be better to modify Provision 4 so that it simply cross-refers to the relevant legislative provision as and when it comes into force.

- 13. 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.**

Yes

- 14. 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 that, when setting the policy for directors remuneration, the remuneration committee should be asked to take into account remuneration and employee policies and practices within their company.

We understand that the intention in drafting the language of Provision 33 was to emphasise the need for the remuneration committee to have a full understanding of such policies and practices as guidance when developing a policy for director remuneration reflecting the culture and strategy of the company as a whole.

However we are concerned that the language used, in particular the adoption of the word 'oversee', could be construed as going significantly further than this and as implying a greatly expanded remit for the remuneration committee, akin to a general HR supervisory role. Apart from the very significant additional workload this would entail for the remuneration committee, there is a concern that this could encroach into operational responsibilities, which are properly a matter for executive functions and not for non-executives. We would suggest that a softening of the language and a clarification of the intention would help.

There does also seem to be some misalignment between the wording in Provision 33 and paragraph 104 of the revised Guidance and it would be helpful if these could be aligned.

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

We believe that the guiding framework set out in Provision 40 is sufficient and that there are disadvantages in trying to be too prescriptive. The best way of supporting remuneration committees in ensuring that executive remuneration drives long-term sustainable performance is to ensure that the Code does not mandate a 'one size fits all' approach. Remuneration committees should be permitted to adopt principles of remuneration that properly reflect the needs, culture and philosophy of the relevant company.

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

Our experience is that shareholder sentiment is the principal driver here.

UK Stewardship Code Questions

- 17. 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 don't have any particular comment to make. In our experience investors' expectations tend to vary, and will reflect the views of the ultimate beneficiary and the terms of the relevant investment mandate, as well as their differing strategies, investment horizons and business models and therefore anything but broad principles may be difficult to establish. We have concerns about the increasing impact of proxy advisors on corporate governance and stewardship and this is an area that may benefit from a separate code.

- 18. 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?**

No comment

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

No comment.

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

No comment.

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

No comment.

- 22. 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?**

It would be helpful if investors would disclose more systematically how they factor ESG factors into their investment strategies and business models.

- 23. 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?**

No comment.

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

No comment.

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

No comment.

26. 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?

No comment.

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

No comment.

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

Yes.

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

Yes.

30. 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. It would be helpful if the signatories could provide details of the person designated as a contact point for stewardship related matters and who will direct the way in which the investor's vote is cast at AGMs.

31. 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?

Funds can be established for different purposes. To the extent that this would, for example, allow asset owners, beneficiaries, and listed companies to easily determine the approach and purpose of a fund that might be helpful. For example, whether a fund was established for speculative or long-term purposes.

**Pamela Coles
Company Secretary**

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