IoD Ireland Response to Consultation on Proposed Revisions to the UK Corporate Governance Code

The Institute of Directors in Ireland (IoD Ireland) welcomes the opportunity to participate in the consultation process in respect of proposed revisions to the UK Corporate Governance Code. Issues of this nature are of considerable interest to IoD Ireland and our membership and we are therefore pleased to present our views in respect of the proposals.

We will not be focussing on the UK Stewardship Code questions in our submission.

About The Institute of Directors in Ireland

The Institute of Directors in Ireland is the representative body for over 2,700 directors and senior executives within the private and public sectors. As the leading voice in the debate on improving corporate governance standards, IoD Ireland is dedicated to developing and improving the effectiveness and performance of directors and boards throughout Ireland.

Response to Consultation: Initial remarks

This is a crucial and timely consultation and IoD Ireland welcomes the FRC’s desire to look at the effectiveness of the corporate governance regime.

IoD Ireland welcomes the opportunity to comment on the proposed revisions to the Code and views it as a positive development, given its emphasis on the importance of corporate culture and diversity, the need for companies to engage with all of their stakeholders, including their workforce, and the requirements for executive remuneration and workforce policies to be aligned with the company’s strategy and values.

We also value the new requirement that boards must consider more holistically how they apply the revised Code’s Principles and move away from undertaking a narrow exercise when reviewing compliance with the Code.
IoD Ireland is in favour of effective regulation and oversight. The current Code, which operates on a “comply or explain” basis has, in some instances, been weakened by the fact that it is a voluntary Code. There are limited means for it to be enforced.

**UK Corporate Governance Code and Guidance on Board Effectiveness Questions**

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

IoD Ireland welcomes the FRC’s decision to publish a final version of the Code by early summer 2018 and its intention that the revised Code will take effect for accounting periods beginning on or after 1 January 2019. We believe that this affords organisations sufficient time to apply the principles of the Code.

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

The FRC notes that many of the existing provisions within the Code have been retained or moved into the Guidance on Board Effectiveness. Particularly, the revised Guidance also now includes a new, detailed section on workforce engagement alternatives and on remuneration, which is welcomed.

IoD Ireland acknowledges that few of these existing provisions have been deleted.

**Section 1: Purpose and leadership**

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

*New Principle C* – “In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from these parties."

*New Provision 3* - "The board should establish a method for gathering the views of the workforce. This would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously...."

Of immediate note in Section 1 is Principle C, which explicitly requires engagement with "stakeholders" in addition to shareholders – particularly engagement with and participation by employees.

IoD Ireland welcomes the renewed emphasis and importance on shareholder and stakeholder dialogue and engagement. The revised Code is clear that effective communication between a company and its workforce is necessary to contribute to good governance, with companies putting in place practices and processes to achieve this.

As a key stakeholder in the long-term success of a company, the views of its workforce are important. Indeed, the findings of the FRC’s *2016 Corporate Culture Report* confirmed the voice of both employees and suppliers should be strengthened in the boardroom, and IoD Ireland supports this view.
In consideration of the requirements set out in Provision 3, direct employee representation on the board may be appropriate for some firms. However, it is our view that all directors must always act in the best interests of the company and therefore it is not appropriate that the onus of sharing specific stakeholder views should be delegated to, or fall under the remit of, specific board members.

We believe that Code revisions citing the appointment of a director from the workforce, or appointing a designated non-executive director, on a “comply or explain” basis, are not needed at present. Our rationale being as follows:

- A fiduciary duty of all board directors is to act in the best interests of the organisation. It is vital that board members who may be employees recognise that their obligation is to the company and its stakeholders as a whole, not just to the workforce. Companies who appoint employee directors should be confident that the directors’ prioritise the wider organisation as opposed to their own specific interests.

- Other board members and the board itself may have concerns about the independence of a director from the workforce which may result in concerns about the confidentiality of matters under discussion and consideration by the board.

However, it is noted in the Guidance, the Code requirements in Provision 3 will be met if a company facilitates regular two-way communication and dialogue as a means of listening to the workforce.

While the IoD Ireland recognises that the Code allows sufficient scope for individual companies to determine themselves what mechanisms work for them specifically, it should be noted that the chosen mechanism for gathering these views from the workforce will only be of value if a company is committed to such a process.

**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?**

We do not believe that inclusion of more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance, is necessary. The revised Code and the Guidance should both be autonomous documents and not require reference to other documents.

**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?**

Provision 6 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 shareholders in order to understand the reasons behind the result. An update should be published no later than six months after the vote. The board should then provide a final summary in the annual report, or in the explanatory notes to resolutions at the next meeting, on what impact the feedback has had on the decisions the board has taken and any actions or resolutions now proposed.”

IoD Ireland welcomes Provision 6, which goes further than E2.2 of the 2016 Code to outline more specific follow-up steps in terms of reporting back on engagement with stakeholders.
It is essential to align the interests of both directors and shareholders, which can only contribute to the long-term, sustainable performance of the company. As the AGM is the pre-eminent opportunity for shareholders to express their views, it is important that due consideration is given to any significant concerns raised therein and that a considered response to concerns is clearly formulated and communicated to the shareholders.

The FRC’s consultation document shows that last year’s (2017) AGM season resulted in a 79 per cent increase in the number of resolutions, with more than 20 per cent of votes against. There has also been a surge in votes against directors. Despite this, 27 per cent of companies still do not comment on significant votes against resolutions.

It is clear that greater action needs to be taken to ensure that adequate and timely discussions take place with shareholders in order to understand their concerns and to attempt to resolve them, preferably in advance of the AGM. If this is not possible, then we believe the requirement for boards to explain more fully their actions in the face of shareholder opposition is a positive step.

Conversely, there is potential for shareholders to engage in conflict and protest voting at AGMs. With Provision 6, the new requirement that companies should act to consult with stakeholders should contribute to measures to reduce such protest voting.

In respect of the further proposed change to Provision 6 – 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” – we believe that six months is a reasonable timeframe.

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.

Provision 21 states: “There should be a formal and rigorous annual evaluation on the performance of the board, the chair and individual directors. Companies should have an externally facilitated board evaluation at least every three years.”

The existing Code provides exemptions for companies outside of the FTSE 350 in the area of Triennial External Board Evaluations. Under the revised Code, these exemptions would no longer apply and all companies would be expected to meet the same standards as set out in the Code.

In principle, we agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years because independent board evaluation can inform significant improvements in corporate governance and overall board and organisational effectiveness.

In addition, best practice already recommends that companies meet the minimum obligation to be evaluated every three years.
Section 2 – Division of responsibilities

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

IoD Ireland welcomes the clarification added in Provision 15 that, “Individual non-executive directors, including the chair, should not be considered independent for the purposes of board and committee composition if any one of them has served on the board for more than nine years from the date of their first election.”

We believe that board tenure for more than nine years is an appropriate length of time for non-executive directors and chairs to be considered no longer independent. Particularly, IoD Ireland welcomes the removal of uncertainty within the Code regarding director independence and that the proposed nine-year term of office limit, is appropriate.

We acknowledge the Code’s recognition that, in some circumstances, companies can explain if they wish to retain a non-executive director and/or chairperson beyond nine years and we recommend that each company regularly reviews and considers board tenure as a matter of course.

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

IoD Ireland firmly supports the revised Code’s proposal that it is not necessary to provide for a maximum period of tenure.

We agree with 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.”

Director tenure, or “board rotation,” is a corporate governance issue that is under increasing scrutiny at present.

There is a need for boards to ensure that they remain fit for purpose and operate in the best interests of the company. We do not believe that it is necessary to provide for a prescriptive maximum period of tenure.

Director tenure is best evaluated on a case-by-case basis, both by the board itself and by the evaluation of individual directors. Indeed, succession issues can be best managed by the board with a regular board and director evaluation process, provided that directors are subject to best practice principle of the nine-year limit for board tenure as outlined above.
Section 3 - Composition, succession and evaluation

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

There are three parts to question 9, which are answered under (a) and (b), and (c) below.

(a) 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?

Overall, Section 3 of the revised Code asks boards to intensify their efforts in promoting and building diversity. We fully support diversity in the boardroom, including gender, and agree that the overall changes proposed in Section 3 will lead to more action to improve diversity in the boardroom.

The revised provision within the Code is welcome especially in consideration of the EU regulations‡ which came into effect in July 2017, requiring large listed companies to disclose the diversity policy that applies to their boards of directors. Such increased focus on the issue of monitoring and building diversity is timely.

Fundamentally, we believe that appointments to boards should always be made on the basis of merit and candidates having the skills required by the board, thus we agree with the new requirement (Principle J) that companies ensure that appointments and succession plans are based on merit and objective criteria in order to avoid groupthink in the boardroom.

To work towards achieving this, IoD Ireland would recommend that boards use a competency and skills based assessment model, using a formal skills matrix, in order to identify skills gaps and highlight requirements for new board members. This will not only contribute to achieving broader board diversity, where appointments are linked to identified needs such as financial, risk, governance, IT, marketing, HR etc, but can also serve to increase confidence in the process when there is clear and demonstrable reasoning behind each appointment, directly linked to identified skills gaps on the board.

Skills matrices should be specifically tailored for each board and regularly reviewed and updated. IoD Ireland would strongly recommend that all board appointments should only be made on the basis of the skills needs of the board, as detailed in the skills matrix. It should be the responsibility of the chairperson of the board to develop, monitor and maintain such a matrix, and this information should form the basis for establishing a requirement for future recruitment to the board.

(b) 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 executive pipeline?

In respect of building diversity in the executive pipeline, we believe that the wording of the revised Code needs to be strengthened specifically with regard to provision 23, which requires that the board provides an explanation in the annual report of actions taken to ensure a diverse executive pipeline;

- for future possible succession to board and senior management appointments;

‡ The European Union (Disclosure of non-financial and diversity Information by certain large undertakings and groups) Regulations 2017

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- an explanation of how diversity supports the company in meeting its strategic objectives and;
- the gender balance of those in the senior management and their direct reports.

While Provision 23 is in accordance with the views of the quoted reports\(^2\), the requirements of this provision, specifically regarding future succession and diversity supporting the company in meeting its strategic objectives, are nebulous and complex, and reporting on these issues could potentially be difficult to manage.

In respect of the requirements of Provision 23, as the revised Code does not clearly set out the necessary information that should be reported in the annual report, in a detailed, precise way, the IoD would recommend that this is left to each company to assess and that close monitoring is put in place to ensure that companies sufficiently observe the provision’s requirements.

In terms of disclosing the gender balance of those in the senior management IoD Ireland is firmly in favour of the need for balance and diversity in the boardroom and in the company as a whole.

We recommend that the wording in the Code should be strengthened to reflect that in order to increase board and executive diversity, companies should broaden the pool of potential candidates to be considered.

This supports the approach of both the Parker Review and the Hampton-Alexander Review which make clear that talented individuals from a diversity of backgrounds must be identified at an early stage in order to give companies a deep pool from which a diverse board and executive team can be drawn.

(c) 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 company as a whole?

When concerted action is planned for, taken and measured with regard to building board diversity, together with an enhanced role of the nomination committee, as per Provision 17, and the board as a whole, we believe that this will assist in building diversity throughout the company.

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.

The revised Code implements the Hampton-Alexander Review recommendation 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’, and goes further by not limiting this recommendation to the FTSE 350.

We agree with extending the Hampton-Alexander recommendation beyond the FTSE 350. If companies disclose in their annual reports the gender balance on the executive committee and direct reports to the executive committee, comparisons can then be made between companies and across regions and industries. We believe this will ultimately inform broader insight into the diversity issue in respect of gender.

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

We appreciate the seriousness of the findings of Sir John Parker’s report\(^3\) that the lack of publicly available data 'may present an unnecessary hurdle in tracking progress and being fully transparent to all'.

We recognise that, at present, there is a lack of available data, rendering levels of ethnicity in executive pipelines undetectable, which means that the issue is currently not being addressed.

Additionally, in respect of executive pipelines, there is currently no expectation that companies focus on levels of diversity other than for gender and ethnicity. We recommend that the Code addresses within its wording that diversity extends beyond gender and ethnicity, to encompass, for example, education, race and age.

**Section 4 – Audit, risk and internal control**

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

Section 4 (Audit, risk and internal control) of the revised Code retains many aspects contained in the current Code. Although consideration was given to removing the duplication in the areas of Listing Rules and the Disclosure Guidance and Transparency Rules, we believe that it is important that the current requirements are retained, despite duplication.

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.

The 2016 Code Provision C.3.3 stated, “The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. The requirement to make the information available would be met by including the information on a website that is maintained by or on behalf of the company.”

We support the removal of this Provision to the Guidance.

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Section 5 – Remuneration

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

Provision 33 states: “The remuneration committee should have delegated responsibility for determining the policy for director remuneration and setting remuneration for the board and senior management. It should oversee remuneration and workforce policies and practices, taking these into account when setting the policy for director remuneration.”

Under the revised Code, the remit of the remuneration committee will be expanded to take on responsibility for oversight of wider workforce pay policies; to be attentive to the interests of and provide explanation to the “wider workforce” on how executive remuneration aligns with wider company pay policy and promotes long-term value generation and "oversee remuneration and workforce policies and practices".

On one hand, it is pragmatic that the remuneration committee has sight of overarching principles with regard to setting pay policies.

On the other hand, the wording in Section 5 appears to be assigning the remuneration committee with more of a management, rather than a governance, role. The requirement that remuneration committees “should oversee remuneration and workforce policies and practices” could lead to committees crossing into matters that are normally reserved for management. Consequentially, the application of these additional duties may be problematic on a practical basis.

Furthermore, the updated Guidance on Board Effectiveness expands on the wider remit for remuneration committees in respect of workforce policies and practices, which go beyond pay and include policies on recruitment and retention, promotion and progression, performance management, training and development, reskilling and flexible working. We recommend that companies are cognisant of the following issues that may arise from the remuneration committees' broader remit:

- The role and composition of the remuneration committee will be fundamentally changed and it is vital to ensure that it has the correct levels of expertise and necessary time and support to carry out its responsibilities. However, remuneration committee members may feel that some of these issues are outside their areas of expertise and/or experience and they may not have the time to engage in these additional duties.

- At many FTSE companies, remuneration committee members may find the required engagement with (and explanation to) employees quite difficult. If the "wider workforce" includes those people providing outsourced services to the company, effective engagement with them would be even more difficult. Committees will be potentially expected to engage with contractors on whether working practices include “fair rewards and recognition.”

- Provision 41 in Section 5 requires that there should be a description of the work of the remuneration committee in the annual report. Remuneration committees may find such expansive explanation difficult – especially using a ‘tick box’ approach within the annual report.
Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

Generally, we believe that applying good judgement and discretion to executive remuneration is the best way of ensuring executive pay is aligned to long-term sustainable performance.

It is clear that a propensity to reward short-term achievements emerged within many listed companies in recent years, which ultimately led to cases of insufficient links between director pay and performance. Executive directors are often granted monetary rewards that seem excessive in a broader performance context. Failure has sometimes been rewarded, and use of median comparators has driven disproportionate rises in executive remuneration. This is ultimately damaging to the listed company sector.

Indeed, in January 2018, the Irish Congress of Trade Unions published findings of a survey, which examined the remuneration of chief executives in 20 of the largest companies listed on the Irish Stock Exchange, along with CEO pay at the 12 largest commercial state companies. The report reveals pay increases for some chief executives of up to 100 per cent between 2015 and 2016, along with a near doubling of cash bonuses for some. It also reveals immense disparity between senior executive pay and average earnings.  

In consideration of this, IoD Ireland welcomes the FRC’s decision to add the term ‘discretion’ in Provision 37; “Remuneration schemes and policies should provide boards with discretion to override formulaic outcomes.”

Remuneration policies should be designed with the long-term objectives of the company in mind and remuneration should not solely be set against the parameters of attracting, retaining and motivating executive directors. Principle 37 now supports this.

In respect of remuneration, IoD Ireland also welcomes Provision 36, which recommends that the minimum-vesting and post-vesting holding periods for executive share awards have been extended from three to five years.

Rising levels of executive pay have contributed to public disquiet, as well as protest voting from shareholders. Consequently, we consider that this new proposal is a positive step.

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

Overall, yes we believe that the changes proposed will give meaningful impetus to boards in exercising discretion, but we would like to question how that discretion will be monitored. Additionally, it may be difficult to revise employment contracts and bonus schemes.

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4 Because We’re Worth It: The truth about CEO pay in Ireland (January 2018): https://www.ictu.ie/download/pdf/because_were_worth_it_ceo_pay_survey.pdf

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Conclusion

The IoD Ireland is broadly supportive of the new proposals, which highlight the need for boards to demonstrate effective leadership or “tone from the top”.

We believe that the revised Code’s emphasis on director independence, setting pay in the context of company-wide pay, and highlighting how companies engage with all their stakeholders, will ultimately enhance governance practices in the UK and the Republic of Ireland.

We appreciate the opportunity to present our views and would be delighted to discuss the issues raised in greater detail or to make any further contributions as necessary.

Yours sincerely

Maura Quinn
Chief Executive