



THE THOUGHTFUL INVESTOR

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28/02/2018

Dear Catherine

## Response to FRC Consultation

Here at Castlefield, we take our responsibilities as stewards of client assets seriously. We are therefore pleased to be given the opportunity to share our views on the proposed revisions to the UK Corporate Governance Code and the UK Stewardship Code. We have chosen not to answer all the questions presented but instead focus on those where we feel we can offer the most insight.

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

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

None. In our view, it allows sufficient time for companies to adopt the revised Code.

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

We would welcome the inclusion of an explicit recommendation for companies to engage with all institutional investors to the extent that this is practicable, not just larger investment houses. This would enhance investors of all sizes the ability to discharge their stewardship duties effectively. It would also increase appetite for engagement among smaller investors that, collectively, may hold a substantial stake in a firm. In our experience, small investors often have in-depth knowledge of the companies in their portfolios but risked being overlooked by the continued emphasis on major shareholders. While we recognise that increased investor engagement may result in an increased workload for investor relations teams, there are methods of group engagement (shareholder roundtables or webinars for example) that can minimise the additional work involved.

We would also welcome more detailed guidance on overcommitted non-executive directors (NEDs). We recognise that directorships vary from company to company and from role to role, and thus do not lend themselves to simplistic rules of thumb. However, we are concerned that the informal norms created by proxy advisers allow for individuals to hold too many NED posts. Our preference would be for the Code to require any company employing a director holding more than three NED positions in total to provide an explanation for their appointment in the Annual Report and Accounts.

Continued overleaf ...

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

We agree that the three methods outlined provide workable options for companies. The methods will only deliver meaningful engagement if executed well by companies and their executive teams. This is particularly the case for companies with a large, global workforce or with a poor track record of employee relations. In addition, we anticipate that the role of representing employees' views on the board will be a substantial time commitment for the individual appointed (if this method is chosen). As such, companies will need to ensure they are not overcommitted and are well-supported by HR or other relevant teams. There is a need to provide the required training to ensure that the representative is appropriately prepared to take on the role and perform their duties effectively rather than just being a figurehead.

In addition, as an employee owned business with direct board representation, we know that direct employee representation is workable, provided that the selected employee is given appropriate training and support.

We believe that all three options could offer a solution to the problem of the workforce voice not being represented but guidelines on implementation would help to ensure meaningful integration of employee views into board decision-making.

We would also welcome a statement in the revised Code encouraging companies to report on the key issues raised by the workforce and any action that the board has agreed to take. This would help inform investors' views on how effectively a company is managing its human capital.

- 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?

In our view, adopting principles or codes of best practice developed by respected NGOs can help companies build stakeholder trust. Adherence to such codes or principles sends a powerful signal that companies are prepared to be held to account to a higher, external standard. As investors, we view this favourably. As such, we would encourage the FRC to include a general statement on the importance of using external principles or codes – whether developed by NGOs or others (such as the ISO series of accreditations) – and that companies should consider the use of such principles where relevant and particularly to address material ESG impacts

- 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?

We agree that companies should be required to publicly address the issue of a 20 per cent vote against and that 20 per cent is significant. However, we believe that there should be more structured guidance on how this update should be approached and what it should contain. We also query whether six months is too long to wait for an update. We would suggest that 3 months is ample time to canvas shareholders and report back. We believe rather than simply making a statement, companies should be required to:

- Outline the underlying causes of the issue
- Set timebound targets designed to address these causes
- Report on the achievement of those targets.

We believe that this would ensure that the problems identified by shareholders that have triggered the significant vote against are dealt with appropriately. Simply requiring the publication of an update following consultation may not, in fact, lead to the meaningful changes needed. We also feel that it should not only be major shareholders that are consulted following a significant vote, as minority shareholders will also provide valuable insight into the underlying issues. Of course, the "comply or explain" element of the code should also be upheld for the requirements listed above.

- 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.

Yes, we agree that adhering to the full UK Corporate Governance Code should be the aim for all companies regardless of size. We believe that the "Comply or Explain" element of the Code means

that there is sufficient scope to allow companies to share their rationale for non-compliance with shareholders. Shareholders can then consider carefully these reasons on a case-by-case basis. We think that by removing the exemption there will be greater motivation for smaller companies to achieve best practice whilst “Comply or Explain” policy provides the opportunity for flexibility where a strong case can be made that resource constraints have made compliance impossible. It may also be useful to include a provision that would mean that companies who don’t or can’t comply for valid reasons should outline the steps they intend to take in order to reach compliance within a defined time frame.

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

Yes, we agree that providing a guideline of nine years is appropriate. Again, companies have the opportunity to explain the retention of directors that may exceed this length of time so shareholders can give consideration to the continuing independence of that director.

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

We believe that the current provisions of the code in outlining a nine-year tenure in order to meet independence criteria is sufficient to provide shareholders with a guideline to work with when considering the re-appointment directors. If a maximum tenure is stated, then we believe the code runs the risk of falling into the trap of “Comply or Else” rather than the preferred “Comply or Explain”.

- 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?

Yes, we agree that the proposed changes should help to ensure a continuing focus on improvement of diversity, particularly amongst executive directors due to the focus on succession planning and pipeline development amongst the entire workforce. We also feel that by widening the scope of diversity to include, not only gender, but ethnicity and socio-economic background will help to further combat the problem of group-think.

- 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.

Yes, we believe that diversity and the benefits it offers to business and society extend to companies of all sizes and as a consequence so should the recommendations.

- 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 feel that reporting on workforce diversity is an important step towards greater transparency. We agree that broadening diversity reporting beyond gender to include ethnicity is a positive step to ensuring lots of forms of diversity are considered during succession planning.

- 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.

In answer to questions 12 and 13, we believe it is beneficial to retain all the guidance and requirements in one document. This means that all necessary governance considerations can be found within the code and are not spread between different documents which may mean that the required information is less easy to locate and the recommendations less easy to implement as a result.

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

We strongly support the proposed wider remit for the remuneration committee. Our view is that decisions around executive remuneration should be set in the context of pay across a company’s wider workforce. Co-locating decisions around executive and workforce pay within one centralised

committee will force companies to address anomalies that we, as investors, regularly see in executive remuneration – for example, pay rises and pension contributions for executives that are far more generous than those awarded to the wider workforce. As such, we do not think it would be appropriate for issues around workforce pay to be devolved to another committee such as a sustainability committee: executive and workforce pay need to be addressed, and justified, by one, single committee.

We are cognisant of the additional time commitment that will be required by Remuneration Committee members to carry out their expanded workload. We would encourage the FRC to include a statement on ensuring that Remuneration Committee members have sufficient time to take on these responsibilities, particularly in the early years where we would anticipate significant extra work in familiarising the committee with its expanded remit.

Secondary legislation requiring companies to publish pay ratio data comes into effect in June 2018. In our view, the revised Code should require the Remuneration Committee Chair to comment on company pay ratio data in their remuneration reports. The commentary should provide context for the figures and state whether there are plans to alter key ratios over the medium to long term.

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

We support the inclusion of a five-year holding and vesting period in the revised Code. Given that the average CEO tenure is now under five years\*, we are keen to see remuneration measures that extend the horizons of the CEO beyond their tenure, for example, requiring a significant holding for a number of years post-employment.

As investors, we regularly see bonus and LTIP awards with threshold vesting for less than median/target performance, which we find unacceptable. We agree with provision 40 of the revised Code which states that “outcomes [of remuneration schemes] should not reward poor performance and total rewards available should not be excessive”. We would welcome a strengthening of this statement to require Remuneration Committees to justify remuneration schemes that allow partial awards to be made for below target performance.

Overall, we feel that there is a need for simplification of remuneration and a strong desire from a shareholder perspective to see simple, clear and stretching pay plans rather than the opaque and complex ones we are often presented with. We would also suggest that as well as stretching targets, the metrics selected as an assessment tool should be appropriate. For example, we would like to see with a greater emphasis on the likes of cash flow and Return on Capital Employed (ROCE) measures rather than simple EPS measures. We would welcome steps that move companies away from short-term EPS targets and into longer-term and more robustly earned rewards.

\* <https://www.ft.com/content/ded1823a-370e-11e7-99bd-13beb0903fa3>

## 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?

With regard to question 17 and 18, we disagree with the suggestion of different codes as we feel it is beneficial to retain all the guidance and requirements in one document. However, separate provisions outlining the distinct roles of proxy advisers, investment managers and asset owners may be helpful when it comes to interpreting the Code. For example, notes on how certain guidelines should be applied by different parties could serve to ensure that the recommended actions are implemented most effectively depending on function. In short, whilst we agree that a revised Stewardship Code could set out expectations of best practice when it comes to “Comply or Explain” for different members of the investment chain, these should be contained within a single document rather than creating different codes depending on role.

- 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?

An annual publication showcasing stewardship trends and best practice would be useful for investors looking to improve their activity in this area. This could include a section on smaller firms to set an expectation that stewardship can and should be undertaken by investors of all sizes.

Should the FRC decide to repeat the tiering exercise undertaken in 2016, we would urge the FRC to publish its criteria for inclusion in each tier. If the FRC decides to introduce another system of recognition for stewardship good practice, we would encourage the FRC to ensure that the criteria needed for inclusion in the highest tier/ranking are stretching but still achievable for smaller investors.

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

We welcome the greater focus on culture and diversity in the UK Corporate Governance Code and we would like to see a similar focus in a revised 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?

As specialist sustainable and responsible investors, we understand the importance of ESG considerations. However, with in-depth ESG not a widespread practice, we are concerned that the inclusion of ESG criteria in the code might see lip-service paid to the issue in order to meet Code recommendations, which might not be positive for the ESG sector as a whole. It may encourage signatories to use a very loose definition of "ESG considerations". This distorts the definition of responsible investing in order to tick a box and achieve compliance rather than a way of investing in sustainable businesses.

We do not think the Code should mandate how investors should look at ESG as we worry it may have a diluting effect on the responsible investing sector and may lead to confusion for end clients who are less equipped to differentiate between ESG specialists and those who are offering a light touch approach in order to meet a stipulation in the Stewardship Code.

- 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?

We feel that the expectations laid out in questions 28 and 29 should be linked to the tiering system. Where investors publish evidence of dialogue with companies on the topic of board and workforce diversity then this could be included in the criteria to be considered a Tier 1 signatory of the Stewardship Code. Similarly, this could also be the case for climate change engagement. It could also be suggested that investors in companies with particular climate change risk should be held to "comply or explain" standards if they choose not to consider climate change reporting. Again, this could also be considered in answer to question 28: investors who do not report on engagement with companies with low board diversity must explain why.

- 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?

Requiring signatories to publicly explain their approach to stewardship seems like a reasonable step both at the fund and organisational level.

Additionally, at a recent event held by the FRC in conjunction with the Alliance Manchester Business School, an address by David Styles of the FRC highlighted the laudable point that the UK Corporate Governance Code is held as the "Gold Standard" in other countries. It is impressive that, despite this achievement, the FRC has chosen not to rest on its laurels and instead continue to forge ahead with changes that will hopefully serve to benefit business and society.

Kind regards,

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