

Email – Dr Amama Shaukat and Professor Grzegorz Trojanowski

28 February 2018

The submission below is in response to the public consultation on the document titled 'Proposed Revisions to the UK Corporate Governance Code' (The Code), FRC, December 2017. This submission draws on the insights of our recently published research study:

Shaukat, A and Trojanowski, G. (2018), **Board Governance and Corporate Performance**. *Journal of Business Finance and Accounting*, 45(1-2), pp. 184-208, available at <http://onlinelibrary.wiley.com/doi/10.1111/jbfa.12271/abstract>.

This submission first addresses two specific consultation questions (Q15 and Q16) before making some additional comments on the proposed Code revisions.

Answers to Q15 and Q16. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance? Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

We welcome the revised Code's emphasis on engaging with the wider group of stakeholders including the workforce, in line with public expectations. However, in the light of our research (Shaukat and Trojanowski, 2018), we are concerned about the potential dilution of the independence of the remuneration committee by the proposed Provision 32 of the new Code which 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.*' (FRC, 2017; Section 5, point 86, p. 16). As the remuneration committee's independence remains an ongoing concern for responsible corporate governance and is potentially susceptible to managerial influence (as our study's evidence shows), we believe that it is important the chair's required prior experience should be on the committee of another company's board not of the same company. Such an amendment would still require the committee chair to have relevant expertise, yet it is more likely to foster his or her independence, which is vital in the light of the new roles that the committee is expected to play (in particular, following the votes on pay with substantial proportion of dissenting votes (cf. revised Code's Provision 6). An experienced and properly independent remuneration committee chair can better address these concerns, while also potentially having the independence to better tie executive pay with long term company performance.

Our concerns and consequent suggestion is further supported by the findings of Grant Thornton in the proposed Code revision document (FRC, 2017) which shows that 95% of FTSE 350 are compliant in all areas except one (or two) and that one is in the composition of the remuneration committee. These current trends are also entirely consistent with the findings of our study on the relation between board governance and corporate performance (Shaukat and Trojanowski, 2018). We also find (using a large longitudinal sample over a longer period) that compliance with the Code recommendation that remuneration committee be composed entirely of independent directors is the second lowest (53%). Moreover, while greater Code compliance is associated with superior operating performance, we also find that firms at times use the Code flexibility opportunistically. Firms at times decrease compliance which is followed by subsequent financial underperformance – thus suggesting that voluntary

deviation from compliance is not driven by efficiency considerations – would this be the case, subsequent firm performance should improve. Our analysis further reveals that the provisions most frequently sacrificed are those pertaining to the independence of remuneration committee - 35% of the companies decreasing compliance weaken this aspect. This is followed by appointment of non-independent chairs of key monitoring committees, i.e. nomination (23%), remuneration (21%), and audit (18%). Overall, we find that firms attempt to use Code flexibility opportunistically, especially in situations where managerial power is high.

The discussion of our research findings above provides evidence that the scope for managerial opportunism is substantial. The Code recommendations pertaining to board arrangements are voluntary in nature (as companies can choose not to comply and explain instead). Hence, the proposed enhancement of board discretion, specifically in relation to compensation matters, does not assure substantial improvements in governance standards in this area, unless it is coupled with stronger safeguards for board and particularly remuneration committee independence. In our opinion, while the revised Code acknowledges the importance of remuneration committee independence in principle (cf. revised Code's Principle Q), it does not appear to go far enough in practice to ensure such safeguards. If companies misuse Code flexibility (which we find they do at times), increasing board discretion over pay and/or other issues may exacerbate rather than mitigate governance problems.

Furthermore, the proposed enhancement of board discretion in relation to executive remuneration is also worrying in the light of the seemingly weakened shareholder oversight of the related matters. For instance, the Code revision proposes to delete some of the provisions existing in the 2016 version, which empower shareholders to have an oversight over governance matters (i.e. part of Provision D.1.3, Provision D.2.4, Provision E.2.1, and, to a lesser extent, Provision E.2.4 from the 2016 version of the Code).

Other comments on the proposed changes

We are concerned that the revised Code seems to disproportionately empower leading shareholders, potentially at the expense of other shareholders (see Provision 5 and particularly Provision 19 in the revised version of the Code). We strongly believe that the separation of CEO and Chair roles should be encouraged and our research (Shaukat & Trojanowski, 2018) provides evidence of the benefits of such a separation. However, we are less than convinced that the proposed safeguards in cases where the duality is to be implemented, i.e. consulting major shareholders ahead of appointment, are adequate. The proposed process poses a risk of major shareholder(s) exploiting their privileged position, particularly in situations where CEO/Chair are among the largest shareholders (or represent them or an entity related to them). Hence, we are concerned that Provisions 5 and 19 in the revised version of the Code could exacerbate the so-called Type-II agency problems (between large and small shareholders) and that Provision 7 does not appear to sufficiently mitigate such a risk.

Our concerns are further strengthened by the Code statement that an “alternative to complying with a Provision may be justified in particular circumstances based on a range of factors, including (...) and ownership structure of a company” (cf. Introduction, p. 2). Consequently, it seems that that the proposed Code wording provides ample latitude for companies to justify their deviations from compliance with what is regarded as the best practice in corporate governance, without much tangible consequences.