

Financial Reporting Council

By email to: [codereview@frc.org.uk](mailto:codereview@frc.org.uk)

5 February 2018

## **Response to the FRC Consultation on changes to the UK Corporate Governance Code**

Dear FRC,

Thank you for the opportunity to respond to the Consultation on a revised UK Corporate Governance Code. We are particularly interested in stakeholder representation in corporate decision-making<sup>1</sup> and will comment on Section 1, Provisions 3, 4 & questions 3 and 4 of the Consultation. We welcome the FRC's focus on wider stakeholder considerations in the context of the Corporate Governance Code and would like to point out the following issues.

### **Section 1, Provision 3 and Question 3**

First, we agree with the FRC's view that companies can do more to recognise that other stakeholders play a significant part in promoting the long-term success of the company. However, we do not support the primary focus of the new draft Code on the workforce (in passing, the change from 'employee' interests to 'workforce' considerations is a welcome development and should also be reflected in s 172 CA 2006). Although the revised Code acknowledges the importance of a wider stakeholder focus, in practice it concentrates only on one group, i.e. the workforce, by discussing the adoption of one of three employee engagement mechanisms – a director appointed from the workforce, a formal workforce advisory council, or a designated non-executive director (Section 1, Provision 3).

Answering **question 3** – Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement? – In principle, we support this provision as a tool for involving the

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<sup>1</sup> We recently conducted a significant empirical study where we measured compliance with the strategic reporting disclosure requirements of the FTSE 100 companies for 2015 and 2016 by way of compliance coding. The working paper is available here: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3049203](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049203) and the final version will be published in the European Business Law Review later this year.

workforce in corporate decision-making. In particular, the revised Guidance on Board Effectiveness contains very useful advice on gathering the views of the workforce (paras. 31-36). It seems that if the company follows this advice they are likely to engage meaningfully with the workforce. However, we strongly believe that the engagement methods suggested in Provisions 3 and listed above should apply to all stakeholders rather than only to one group. The revised Guidance on Board Effectiveness clearly refers to stakeholders more widely (paras. 26 – 30). For instance, it is stated at para. 27 that ‘boards should start by identifying their different sets of stakeholders’ and a few possible sources of information about stakeholders are listed here. Hence, the new Code should be in line with the Guidance.

We suggest the following changes:

- Provision 3 should state that ‘the board should establish a method for gathering the views of the stakeholders’ and all references to ‘workforce’ in this section should be replaced with ‘stakeholders.’
- We suggest combining an advisory stakeholder panel/council (including the representation of the workforce) and a designated non-executive director representing all stakeholders. The stakeholder panel can meet outside the board and report to the board through a designated NED. This could be a route to get views of all stakeholders heard at board level, whilst still achieving the aim to protect the workforce. Nevertheless, if required, companies can also appoint a separate director from the workforce or suggest alternative ways of stakeholder engagement.

The biggest challenge with regard to the stakeholder panel concerns setting out an effective mechanism to determine the composition of the panel and the representation of the interests of all stakeholders. To achieve this goal, for instance, companies could advertise recruitment to the panel on their websites or could publish surveys annually. Alternatively, stakeholders could be obliged/encouraged to create a central organisation (divided into sub groups) representing their interests, which could be a point of reference for the companies.

Other challenges include the role and working pattern of the advisory panel, cooperation between the panel and board and reporting of the NED to the board.

- The South African Social and Ethics Committee (SEC) is another, statutory solution and could be applied with adjustments.

In brief, based on s 72 Companies Act 2008 (read with Companies Regulation 43) every state owned company, every listed public company and any other company that has, in any two of the

previous five years, had a public interest score of at least 500 points (the number of employees and the turnover are some of the factors that will determine if a company is obliged to have such a committee) must appoint an SEC. The aim of this Committee is to draw certain matters to the attention of the board and to then report to the shareholders. These matters include: social and economic development, good corporate citizenship, the environment, health and public safety, consumer relationships, labour and employment.

This committee is dealt with in legislation in South Africa, but a similar committee can be provided for in the Code and subsequently formed by companies, on a 'comply or explain' basis. In other words, if a company opts not to have such a committee an explanation must be provided. This might fit better with the soft law culture of the UK.

- Changes regarding the Guidance on Board Effectiveness in the context of Provision 3:
  1. At para. 29 the Guidance on Board Effectiveness refers directors briefly to the Guidance prepared by the ICSA and IA ("The Stakeholder Voice in the Board Decision-Making").<sup>2</sup> There should be a clearer link between the two documents. At least 10 Core Principles from the ICSA & IA Guidance should be repeated in the Board Effectiveness Guidance. Ideally, both documents should be merged to make the guidance more accessible as currently there is some repetition between them (i.e. Core Principle no 1 is repeated at para. 27 of the Guidance on Board Effectiveness).
  2. The advice on gathering the views of the workforce (paras. 31-36) should be applicable to all stakeholders.

#### **Section 1, Provision 4 and Question 4**

Provision 4 provides that the board should explain, in the annual report, how it has engaged with the workforce and other stakeholders and how their interests and the matters set out in s 172 influenced the board's decision-making. In principle, this provision, although clearly written, does not specify how these goals should be achieved.

However, our main critique regarding stakeholder considerations in the new draft Code concerns the lack of clear and coherent treatment of these issues. Clearly, there is an overlap between Provision 4 and the strategic report requirements (s 414ff CA 2006) as the aim of the former and latter is to

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<sup>2</sup> ICSA and the Investment Association, *The Stakeholder Voice in Board Decision Making: Strengthening the Business, Promoting Long-term Success*, (September 2017), [www.theinvestmentassociation.org/assets/components/ima\\_filesecurity/secure.php?f=press/2017/2017-09TheStakeholderVoiceinBoardDecisionMaking.pdf](http://www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=press/2017/2017-09TheStakeholderVoiceinBoardDecisionMaking.pdf).

provide details on how s 172 CA 2006 has been applied.<sup>3</sup> Also, Provision 4 stipulates only that this information should be included in the annual report, but it is not clear whether it refers to the governance or strategic report section of the report.

We strongly believe that reporting on compliance with s 172 CA 2006 should take place only within the strategic report. It is not clear why it has to be dealt with in the Code, especially, if the Government is planning to introduce secondary legislation where the aim will be to specifically report on s 172 and where the application will be wider (not just quoted companies, but all companies of significant size). Overall, we are against Provision 4 as it will be an additional layer of disclosure which seems to be excessive in view of the current legislation. If, however, the Government decides to keep Provision 4 in Section 1, the annual reporting requirements proposed in the revised Code should be linked to these strategic reporting requirements.

Although not specifically relevant, in the context of the revised Code, we are not particularly convinced that the introduction of the secondary legislation on the reporting of s 172 CA 2006 will be beneficial. The law is already quite complex and any additional legislation should aim only at clarifying reporting requirements. Hence, we would support any additional legislation, only if it is improving the current strategic reporting provisions. In our recent paper,<sup>4</sup> we suggested that the strategic report could be used to demonstrate compliance with s 172 CA 2006, ideally by putting a stronger emphasis on consideration of stakeholders' interests (this could be done by incorporating all factors listed in s 172 into s 414C) rather than only concentrating on shareholders' interests.

With regard to **Question 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? – the answer is no. It is argued here that sustainability should be achieved by compliance with s 172 CA 2006 and the strategic reporting provisions, rather than by the reference to the UN SDGs or other NGO principles in the Code. These principles might be unknown or without any practical importance to many companies and crucially could make reporting more cumbersome.

To summarise our comments on the revised Code, to avoid confusion and cross-reporting, reporting on compliance with s 172 CA 2006 should take place within the strategic report. The Code could be used solely for explaining how the company has engaged with all stakeholders (e.g. through the advisory stakeholder panel or designated board committee). Finally, the Board Effectiveness

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<sup>3</sup> However, it should be noted that the scope of the application of the Code and the strategic report is slightly different. The Code applies to all companies with a premium listing of equity shares and the strategic report requirements apply to quoted companies.

<sup>4</sup> *Supra* note 1, see especially p 48.

Guidance should be amended to reflect the interests of all stakeholders and should be better linked with the ICSA/IA Guidance.

We are looking forward to the results of the public consultation on the revised Corporate Governance Code.

Best wishes,

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