



Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS
Via email: corporategovernanceprinciples@frc.org.uk
Att: Kristy Merrick

7 September 2018

Dear Ms Merrick

Response to the consultation on the Wates Corporate Governance Principles for Large Private Companies

We welcome the opportunity to respond to the FRC's consultation on the proposed Wates Corporate Governance Principles for Large Private Companies (the Principles).

By way of background, the Commonwealth Climate and Law Initiative (CCLI) is a research, education, and outreach project focused on four Commonwealth countries: the United Kingdom, Australia, Canada, and South Africa. The CCLI examines the legal basis for directors and trustees to take account of physical climate change risk and societal responses to climate change, under prevailing statutory and common laws. In addition to legal theory, we also undertake a practical assessment of the materiality of these considerations, in terms of the scale, timing, and probability of liability and the potential implications for company and investor decision-making.

Our recent publications include:

- *Directors' Liability and Climate Risk: United Kingdom – Country Paper*,¹ which provides a comprehensive assessment of the discharge of directors' duties in the climate context under prevailing UK law; and
- *The Climate Risk Reporting Journey: A Corporate Governance Primer*,² which is an 'Actionable Framework' for directors on how to integrate climate change issues into governance practice.

We commend the push to improve corporate governance standards across large private companies. However, we are concerned that the draft Principles and guidance:

- contain insufficient references to directors' duties, the fundamental framework against which standards of corporate governance behaviour are assessed; and
- do not reflect the governance, strategy and risk management oversight of environmental, social and governance (ESG) factors, including climate-related financial risk.

¹ Alexia Staker and Alice Garton, Commonwealth Climate and Law Initiative, *Directors' Liability and Climate Risk: United Kingdom – Country Paper* (April 2018) <https://ccli.ouce.ox.ac.uk/wp-content/uploads/2018/04/CCLI-UK-Paper-Final.pdf>.

² Centre for Policy Development, Commonwealth Climate and Law Initiative and Minter Ellison, *The Climate risk reporting journey: A corporate governance primer* (June 2018) published as Annexure B to Centre for Policy Development, *Climate Horizons Report: Scenarios and Strategies for Managing Climate Risk* (June 2018) <https://cpd.org.au/wp-content/uploads/2018/06/Climate-Horizons-report-2018.pdf> ('Actionable Framework').

Founders



SMITH SCHOOL OF ENTERPRISE
AND THE ENVIRONMENT



Partners



Centre for
Environmental Rights
Advancing Environmental Rights in South Africa



PETER A. ALLARD
SCHOOL OF LAW
THE UNIVERSITY OF BRITISH COLUMBIA





We set out our responses to selected consultation questions below. Where applicable, we have included in boxes our proposals as to how the text could be amended to address our concerns. We hope that our suggestions will assist with the progress of your work.

Q1 - Do the Principles address the key issues of the corporate governance of large private companies? If not, what is missing?

Directors' duties

We are concerned that the draft Principles contain insufficient references to directors' duties. The preamble to the draft Principles provides that '[n]othing in these principles overrides or is intended as an interpretation of directors' duties as set out in the Companies Act 2006'. A similar statement is in the preamble to the UK Corporate Governance Code for listed entities, yet the Code contains references to directors' duties.³ Directors' duties are the fundamental framework against which standards of corporate governance behaviour are assessed and it is crucial that the Principles and guidance both reflect and reinforce these duties.

Governance, strategy and risk management oversight of ESG factors, including climate change

The push to improve corporate governance in large private companies has arisen in the context of several recent high-profile corporate failures. As noted in the consultation paper, these have drawn attention to the substantial risks to a wide range of stakeholders, including customers, pension funds, the workforce, supply chains and the community. The Principles have been developed to improve corporate governance in large private companies so as to minimise the risk of these corporate failures and their impacts on wider stakeholders.

To achieve these goals, it is crucial that the Principles adequately address the risks to large private companies which threaten their long-term viability and success. There is increasingly widespread recognition that ESG factors can both drive long term value creation and present material risks to the performance and prospects of companies. In particular, climate change presents foreseeable and often material financial risks⁴ to the long-term profitability and viability of many, if not all, large private companies. ESG factors, and climate change especially, pose a fundamental challenge to the governance, strategy and risk management of large private companies and requires response across all facets of corporate governance practice.

Whether and how ESG factors such as climate change present *material* financial risks will depend on the unique circumstances of the company. However, it is recognised that climate-related financial risks affect nearly all industries and sectors within mainstream investment horizons,⁵ and are particularly acute in high-risk sectors such as fossil fuel extraction and combustion, transport, real estate and infrastructure, agriculture and financial services.⁶ In the UK, the risks and opportunities from climate change are more relevant for engineering and consulting, tourism, insurance and other finance products, agriculture, food and utilities sectors.⁷

Much of the attention on the impacts of ESG factors, and especially climate change, focuses on publicly listed companies.⁸ This particular focus is justified given the role of mandatory

³ See, eg, UK Corporate Governance Code (July 2018), Principle One, paragraph 5.

⁴ Climate-related financial risks can be classified as physical risks, economic transition risks, and liability risks: Prudential Regulation Authority, *The impact of climate change on the UK insurance sector* (September 2015) 4 <http://www.bankofengland.co.uk/pru/Documents/supervision/activities/pradefra0915.pdf>.

⁵ Task Force on Climate-Related Financial Disclosures, *Final Report: Recommendations of the Task Force on Climate-related Financial Disclosures* (June 2017) <https://www.fsb-tcfd.org/publications/final-recommendations-report> 5-8.

⁶ TCFD, n 5, 26-27.

⁷ Surminski, S., et al, *UK Climate Change Risk Assessment Evidence Report: Chapter 6, Business and Industry*, Report prepared for the Adaptation Sub-Committee of the Committee on Climate Change, London (2016) p 8.

⁸ For example, the UK Environmental Audit Committee has called for a new law similar to Article 173 of France's *Energy Transition for Green Growth Law* requiring mandatory disclosure of climate-related risks if listed companies and large asset owners are not reporting in line with the TCFD recommendations by 2022: UK House of Commons Environmental



disclosure in supporting the key function of capital markets to price risk for efficient capital allocation. Yet all companies which prepare a Strategic Report, and this includes large private companies, are already required to disclose the impacts of climate change, where such risks are financially material.⁹

Quite apart from the disclosure issue, risk management oversight of ESG factors such as climate change is just as important for large private companies. As noted in the consultation paper, the economic and social significance of large private companies can be as great as publicly listed companies. There is nothing special about large private companies that makes them immune to the impacts of climate change on their business. Directors of large private companies will need to steer their companies through the physical, economic transition and liability risks arising from the impacts of climate change and embrace the opportunities from new technologies and markets, just as the boards of publicly listed companies must too.

Just as the external risks and opportunities from climate change are no different in principle between public and large private companies, so too the same directors' duties apply. Directors' duties are broadly framed and designed to respond to evolving business norms and market dynamics. In our report, *Directors' Liability and Climate Risk: United Kingdom – Country Paper*, we find that directors risk breaching their duties if they fail to assess, manage and, where material report on, risks to the performance and prospects of their business arising from the impacts of climate change.¹⁰ Many directors are ill prepared to navigate this step-change in governance and disclosure expectations. Further, directors of large private companies are subject to the new reporting requirement to include a 'section 172 statement' in their Strategic Report 'which describes how the directors have had regard to the matters set out in section 172(1)(a) to (f) when performing their duty under section 172'.¹¹ These factors include the likely consequences of the decision in the long-term, the impact of the company's operations on the community and the environment, and the need to act fairly as between members of the company. As we show in our report, a failure to consider material climate risks may indicate the directors did not have regard to these s 172 factors.¹²

We appreciate that the Principles must be proportionate and practicable to apply to heterogeneous large private companies with a variety of different ownership and legal structures to enable widespread adoption. But our concern is that if the Principles and guidance fail to refer to the governance, strategy and risk management oversight of risks arising from ESG factors, and in particular climate-related financial risks, then they are not 'meaningful and robust' (as is your intention) given the scale of these risks posed to businesses. We set out some suggestions to address this concern in the next section.

Q2 - Are there any areas in which the Principles need to be more specific?

In light of the response to question 1, we suggest that the Principles need to be more specific in areas of corporate governance which most closely touch on the governance, strategy and risk management oversight of ESG factors, and in particular, climate-related risks.

Suggested amendments to the guidance to Principle Two - Composition

Principle Two should reflect the increasing recognition of the breadth of governance issues facing boards today, including ESG factors.

Audit Committee, *Report – Greening Finance: Embedding Sustainability in Financial Decision Making*, Seventh Report of Session 2017-19, 4 June 2018, recommendation 87.

⁹ The Environmental Audit Committee has called on the UK Government to issue guidance making clear this is an existing requirement under the *Companies Act 2006*: Environmental Audit Committee, n8, recommendation 87.

¹⁰ CCLI, n 1, p 21, 15.

¹¹ The Companies (Miscellaneous Reporting) Regulations 2018, reg 4 inserting new s 414CZA into the *Companies Act 2006*.

¹² CCLI, n 1, p 13-18.



We suggest the guidance to Principle Two reflect the increasing recognition of the breadth of governance issues facing boards today:

All directors should collectively demonstrate a high level of competence relevant to the company's business needs and stakeholders, and to enable them to deal with new and emerging business and governance issues.

...

Companies should demonstrate a commitment to the ongoing professional development of their board so that each director has an appropriate level of skills, experience and knowledge, and directors should engage with such opportunities to fulfil their legal duties.

Suggested amendments to the guidance to Principle Three - Responsibilities

The identification, assessment, management and reporting of the impacts of climate change involves a confluence of scientific, economic, financial and technological matters for senior management and the board, and which often necessitates input from professionals. This responsibility to proactively seek information on the impacts of climate change should be brought to the fore.

We suggest the guidance to Principle Three specify information relating to the impacts of climate change on the business:

Boards rely on a broad range of information sources, including by not limited to:

- *Financial reporting;*
- *Key performance indicators;*
- *Workforce data;*
- *Environmental data, including the projected impacts of climate change on the business;*
- *Stakeholder engagement feedback; and*
- *Consumer data.*

Suggested amendments to the guidance to Principle Four - Opportunity and Risk

The guidance to Principle Four is very brief. At a minimum, we suggest the guidance articulate the different sources of risk to a company which must be addressed through corporate governance practice and enterprise risk management.

We suggest the guidance to Principle Four reflect the increasing recognition of the breadth of financial risks to businesses:

These responsibilities include:

- *Developing appropriate risk management systems that identify the risks facing the company and enable the board to make robust decisions concerning the principal risks, both established and emerging, including risks arising from environmental, social and governance factors which have an impact on corporate performance and value via, at a minimum, impacts on reputation or social licence to operate.*

Suggested amendments to the guidance to Principle Six - Stakeholders



Principle Six conceives 'stakeholders' as persons only. We are concerned that this is too narrow. The 'enlightened shareholder model' embodied in s 172 of the *Companies Act 2006* requires directors to have regard to the impacts of the company's operations on the community and the environment in promoting the success of the company. The guidance to Principle Six should be consistent with this duty.

We suggest the guidance to Principle Six be consistent with directors' s 172 duty:

... Sustainable business benefits wider society, and large companies have a responsibility to create and sustain long-term value for a variety of stakeholders. This could include consideration of how a company's activities may impact future stakeholders, the community and the environment.

Q7 - Do you agree with an 'apply and explain' approach to reporting against the Principles? If not, what is a more suitable method of reporting?

While we think an 'apply and explain' approach is useful, it is not clear how reporting against the Principles will be implemented in practice for the different types of entities, recognising the heterogeneity of large private companies. It is envisaged that not all entities which implement the Principles will be subject to the new requirement to report on corporate governance arrangements. For those entities that must publish a statement of corporate governance arrangements, it is not clear how the 'apply and explain' approach of the Principles interacts with the option to depart from the corporate governance code and explain the departure in the statement.¹³ For those entities that do not need to publish a statement of corporate governance arrangements, it is not clear how this reporting will be done in practice.

Q8 - The Principles and guidance are designed to improve corporate governance in large private companies. What approach to the monitoring of the application of the Principles and guidance would encourage good practice?

It is not clear who will oversee and monitor the application of the Principles. Is it intended that non-shareholder stakeholders, particularly those material stakeholders referred to in the guidance to Principle Six, will have a role in monitoring the application of the Principles? It would be somewhat incongruous to provide a framework against which a company is to report without a clear monitoring and oversight mechanism. We suggest this should be addressed in the final Principles and guidance.

We have no response to questions 3, 4, 5, 6, 9 and 10.

The CCLI congratulates the Coalition Group and the FRC on the draft Principles and guidance. We hope that our suggestions will assist you to provide large private companies with useful guidance on how to navigate the step change in corporate governance practice. If we can be of any assistance or you require additional information, please do not hesitate to contact us.

Yours sincerely

Ellie Mulholland
Director
CCLI
ellie@commonwealthclimatelaw.org

Dr Ben Caldecott
Director, Oxford Sustainable Finance
Programme
ben.caldecott@smithschool.ox.ac.uk

¹³ The Companies (Miscellaneous Reporting) Regulations 2018 item 14 amending Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Sch 7, Part 8, especially item 26(1)(c).