Catherine Horton  
Financial Reporting Council  
8th Floor  
125 London Wall  
London EC2Y 5AS  

Email: codereview@frc.org.uk  

28 February 2018  

Dear Catherine,  

Proposed Revisions to UK Corporate Governance Code  

Smith & Nephew plc welcomes the opportunity to comment on the proposed revisions to the UK Corporate Governance Code. Smith & Nephew is a FTSE50 listed company in the healthcare sector, employing over 16,000 people in over 30 countries worldwide. We are also listed on the New York Stock Exchange.  

Before we respond to the specific questions in your consultation, we would have the following general points to make:  

Changed Definition of s172  

The description of the S172 duty in Principle A, Provision 1 and paragraph 10 of the Guidance is subtly different from the definition in the 2006 Companies Act and we feel that it will lead to confusion. Section 172 imposes the duty on a director to act "in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard [amongst other matters] to the likely consequences of any decision in the long term etc." This is not the same as "to promote the long-term sustainable success of the Company" (Principle A) or "value over the long-term" (Provision 1). One could envisage a successful company, which generates benefits for its members as a whole which nevertheless has a short life. We feel that the wording in the Code should follow the wording in existing company law and not change it.  

Comply or Explain  

We are pleased to see that the principle of "comply or explain" has been retained as it recognises that not all companies are the same and that in some cases, there could be very good reasons for a particular company to adopt a practice which might differ from the standard practice. However, whilst we accept that Provisions are on the "comply or explain" basis, many users of our Annual Reports and proxy
advisors in particular (who tend to influence the bulk of overseas investors) take a “tick box” approach to disclosure and might not give companies credit for “explaining” non-compliance with a provision even though the company might be adopting a more appropriate practice for the business. This approach is a very real threat to the continued viability of the “comply or explain” principle. Proxy advisors generally follow the governance standards in the issuer home country, so holding UK issuers to far higher standards than issuers in many other countries. Unless users of accounts recognise and apply the principle of “comply or explain appropriately, some companies could choose to list elsewhere, where there are fewer constraints. This is the rationale behind some of our responses below.

We are pleased to enlose our responses to the questions where we have views as follows:

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

No. This is reasonable.

Q2 Do you have any comments on the revised Guidance?

In general terms, we find the Guidance to be useful, with some helpful suggestions. However, there is always the danger that over time “guidance” becomes “expected practice”. Bearing this in mind, there are some paragraphs which are overly prescriptive, where alternative processes might be more appropriate for certain companies. In many cases, the word “should” could usefully be replaced with “may wish to consider” to soften this. See our comment on “comply or explain” above.

Please also see our comment on SI72 above.

We support the removal to the Guidance of the requirement in C.3.3 of the current Code.

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

Whilst we recognise that the three options are taken from the Government’s proposal, it is possible that companies, over time, might wish to evolve alternative methods for gathering views of the workforce. International companies, such as Smith & Nephew with diverse sets of workforces across the world might need to employ different engagement methods in different parts of the world or at different sites. We feel that this provision could be reworded to enable alternative methods to be developed by replacing “would normally be” with “could include”. See our comment on “comply or explain” above.

Q5. Do you agree that 20 per cent is “significant” and that an update should be provided no later than six months after the vote.

In general terms, we would agree that 20 per cent is significant, whilst recognising that for some companies, for example those with a large controlling shareholder, a different percentage might be more appropriate.
We would also agree that the publication of an update within six months would normally be appropriate, again recognising that there could be particular circumstances where a company might need a longer period than six months. See our comment on “comply or explain” above.

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

We believe that independence of mind, thought and approach has very little to do with length of tenure. However, we do recognise the benefits of regularly refreshing the Board and bringing in people with a fresh way of looking at issues and therefore accept that nine years is a useful indicator when determining independence.

We also believe in the benefits of a having a diverse board and that one measure of diversity is having a Board with some new members who bring the fresh ideas to the table and other members who bring the wisdom of experience of the board, having seen it before and knowing why previous decisions had been taken. In a Board with a number of very recent Board changes or corporate challenges, it might be useful to retain a director with over 9 years’ service to provide continuity and stability.

We are however disappointed with the overall change in emphasis in Provision 15. Previously, the provision was worded so that the determination of independence was a matter for the Board, having regard to various aspects. The revised wording is more prescriptive and effectively curtails the Board’s flexibility in determining its composition. See our comment on “comply or explain” above.

We are also very surprised to see that the Chair is also expected to be independent under the proposed Code (provisions 11 and 15). For a number of years, the Chairman has been expected to be independent on appointment, with the recognition that once appointed, that independence is lost. We have always, in line with the Higgs Report, regarded our Chairman to be neither executive nor non-executive, as he discharges a hybrid role leading both the executive and non-executive teams. Indeed, the Higgs report stated that after appointment “applying a test of independence at this stage is neither appropriate nor necessary.” We are not sure why this change has been made.

Furthermore, if the 9 year rule were to apply to the Chairman, we believe that this would inhibit a company from appointing an existing Non-Executive Director with say five years’ service on the Board who would only be able to serve for the remaining balance of four years. The unforeseen consequence of this would either be more external appointments to Chair roles or more short lived Chairs, neither of which would be beneficial.

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

Yes.
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?

We broadly agree and welcome the expanded role of the Nomination Committee to oversee succession planning below Board level to have regard to matters such as diversity in the pipeline and the gender balance in senior management. We still believe that Succession Planning should be a matter for the whole Board but the delegation of the more detailed oversight role to the Nomination Committee is a positive move to tackle these important issues.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines?

Whilst we are broadly supportive, we recognise that there could be some practical difficulties in defining and collecting ethnicity data and note that certain territories have legal restrictions on collecting this type of data.

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 have a number of comments on the expanded role of the remuneration committee. Firstly, whilst it is appropriate that the Remuneration Committee should continue to determine the policy for the remuneration of the Executive Directors and the Chairman, we do not feel that it is appropriate for a committee of non-executive directors to determine the pay policy for non-executive directors. We feel that this should remain the responsibility of the disinterested members i.e. the Chairman and the executive directors of the Board.

Secondly, we agree that it is appropriate for the remuneration committee to set the remuneration of senior management, although we would not necessarily agree with the definition of "senior management" in footnote 3 in Section 3. There may not necessarily be a correlation between the members of the Executive Committee and the first layer of management below Board level and their respective pay structures.

We would support the remuneration committee having oversight of the company secretary’s pay, given that the appointment and removal of the company secretary is a matter for the Board (Provision 16) but would not necessarily (although this will vary by company) include the company secretary as a member of senior management. The company secretary, as servant of the Board, reporting into the Board should maintain a certain independence and distance from management in order to be able to advise the board effectively.

We would support the remuneration committee overseeing the remuneration arrangements of employees across the company as this helps to ensure alignment between director and employee pay. However, we envisage practical difficulties in extending this oversight to a broader “non-employee workforce”. Many of
the people who work for us as contractors are employed by other companies and their pay arrangements are a matter between them and their employer.

We would also envisage practical difficulties in extending oversight to workforce policies and practices, although it is unclear what the term “policies and practices is meant to cover”. In an international company such as Smith & Nephew operating from multiple locations across many countries, there will be different legislative arrangements and local practices applying in different jurisdictions relating to holiday pay, hours of work, maternity leave, grievance processes, redundancy, pension and benefits cover, health & safety regulations etc etc. Getting into the detail of all these different policies and practices is really a matter for management and not for members of the Board. For significant policies and practices, it would be appropriate for the Board or a Board Committee to have oversight (for example, our Ethics & Compliance Committee has oversight of our Code of Conduct), but to have oversight of all policies and all locations in all countries would be impractical. It would be helpful for the Code to define precisely which policies are intended to be in scope here.

Comments on the Stewardship Code

We welcome the move to consult on the Stewardship Code. Regardless of whether an investor has signed up to the Stewardship Code or not, the quality and level of engagement with us as a Company can vary significantly. With a diverse shareholder base, we find that many overseas investors decline to engage on governance related matters and tend to follow the recommendations of proxy agencies. These proxy agencies, who have no economic interest in the companies they analyse, tend to make recommendations based on a governance point rather than within an investment context and this leads to a “tick box” approach, which is not aligned with the principle of “comply or explain”. We would have the following two points for you to consider when consulting on the Stewardship Code:

- Investors who hold above a certain (to be determined) percentage in a company should be required to engage with a company prior to voting against or withholding on a resolution. Engagement should mean contacting the company secretary with an explanation of the reason for the intended vote against or withheld.

- The Stewardship Code should apply not only to UK investors but also to investors in UK companies.

Thank you for the opportunity to contribute to your consultation. Please feel free to contact me on 07790 560673, if you would like to discuss any of the issues raised.

Yours sincerely

Susan Swabey
Company Secretary