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Dear Catherine,

### **GC100 response to the FRC's 'Proposed Revisions to the UK Corporate Governance Code'**

GC100 is the association for the general counsel and company secretaries of companies in the UK FTSE 100. Membership includes general counsel and company secretaries from over 80 companies listed in the FTSE 100. Please note that, as a matter of formality, the views expressed in this letter do not necessarily reflect that of each and every individual member of GC100 or their employing companies.

The GC100 welcomes the opportunity to respond to this consultation and we set out below our comments on it.

#### **Overall comments on the proposals**

We understand and support the underlying objectives of the proposed reforms. We do, however, have significant concerns about the way in which the FRC is hoping to meet certain of those objectives. We set out those concerns below.

##### **1. Negative impact on the competitiveness of the UK**

It is more important than ever that the FRC's reforms meet its and the Government's objectives in a manner which maintains the UK's competitiveness as a place in which to locate and to do business. There are frequent press reports which suggest that the UK's competitiveness is at risk.

We have serious concerns that a number of the proposed changes risk compromising the competitive position of the UK by reducing the key flexibilities that are available to the boards of issuers without delivering a commensurate benefit to shareholders and other stakeholders. Key examples include the proposal that the board should no longer be free to make its own judgement on the independence of directors and the need for the chair's independence to be assessed on an ongoing basis rather than just on appointment.

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## 2. Erosion of 'comply or explain'

The 'comply or explain' model is one of the greatest strengths of our corporate governance system. It recognises that each company is different and gives boards appropriate latitude to adapt or depart from provisions of the Code whilst still applying its fundamental principles. The flexibility that is necessary for the continuing success of this model is, however, under threat more than ever before as the principles and provisions of the Code, together with the related Guidance, are increasingly treated as having mandatory status by investors and proxy advisors. It is fundamentally important that 'comply or explain' does not become 'comply or else'.

We think it is vital that the FRC uses this opportunity for reform to emphasise what 'comply or explain' means and, in particular, to encourage investors to carefully examine and reflect on the explanations that boards provide since departures from the Code should not automatically be treated as breaches. We believe that the draft Code has taken an overly prescriptive approach and in doing so continued its move away from the original principles based regime. We believe that the draft Guidance, with its 113 paragraphs of 'suggestions', may well be viewed as requirements by investors and proxy advisors.

For the reasons mentioned above, we think that the FRC should reconsider its approach to the Guidance by making crystal clear that it is not prescriptive and replacing suggestions with further questions. We like the use of questions and believe they discourage a tokenistic, box-ticking approach and instead encourage the importance of careful reflection by investors that is most likely to increase the level of trust in this area. In our view, it would be much better if the draft Guidance was reformulated as a series of supplementary questions designed to help stimulate boards' thinking when framing and reporting on their own corporate governance practices. Such an approach would not only be more likely to lead to the desired cultural change but would also help to re-enforce, rather than erode, the all-important flexibility that the 'comply or explain' approach is meant to provide. GC100 is very happy, by way of immediate follow up, to provide the FRC with some sample wording to demonstrate how the Guidance might look if this approach was taken.

We also think that the FRC should take steps to further encourage shareholders and proxy advisors to properly evaluate the 'comply or explain' statement made by companies and encourage timely dialogue, especially where any concerns are likely to result in a vote against management's recommendations, or an abstention. We believe that this encouragement should be aimed at helping them to understand that non-compliance does not mean that the relevant corporate governance standards have simply been ignored.

We are happy to discuss this with you in more detail.

## 3. Incorrect interpretation of the Section 172 duty

An overarching principle should be adopted when considering changes to the Code and related guidance: that no such change should alter the current interpretation of the law. We are concerned that the tone, emphasis and content of the draft Code, draft Guidance on Board Effectiveness and the draft Guidance on the Strategic Report, when read together, might quite understandably make directors and stakeholders believe that the section 172 duty to promote the success of a company has changed from the original enlightened shareholder value model to a pluralistic, long-term model. Ultimately, this might influence how courts interpret that provision. If a change to the law is to be made, that is a matter for Parliament not for the FRC.

By way of illustration, Principle A of the Code is inconsistent with the section 172 duty. It suggests that directors are required to act in the long-term interests of a company. Section 172 in fact imposes a duty to act in the way a director '*considers, in good faith, would be most likely to promote the success of the*

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*company for the benefit of its members as a whole'* and in doing so have regard to, amongst other things, *'the likely consequences of any decision in the long-term'*. In effect this means that a director can consider the long-term impact of a decision but can take action on the basis of short-term considerations if he or she thinks that is most likely to promote the company's success for its members.

The FRC must ensure that the wording used in the final version of the Code and the Guidance is consistent with the existing law. As the FRC is aware, GC100 is preparing guidance on the section 172 duty and we suggest that there is a cross-reference to the GC100 Guidance as appropriate.

#### **4. Impact of proxy advisors**

It is clear that proxy advisors offer an important service to institutional investors. The size and spread of institutional investors' portfolios means that they do not always have the resources, nor do they find it cost effective, to monitor and evaluate every company they invest in, or to decide how to vote on every resolution. Our concern is that despite the call for increased engagement with investors alongside our members' ongoing efforts in this area, proxy advisors generally do not engage with our members in a meaningful or timely way.

In our experience, the advisor often only engages very late on in the AGM process and then typically it only amounts to a last minute opportunity to see the relevant report and correct factual errors. The time given to respond is not long enough to allow for proper engagement and potential revision of any voting recommendations. This means that the proxy advisors have a tendency to adopt a less nuanced and more one-size-fits-all, box ticking type model and that it can be very difficult to engage with them on specific situations. In addition, some proxy advisors will only provide the relevant report to issuers on the payment of a fee.

We believe that proxy advisors' current practices will make the Government's and FRC's work on promoting stewardship and issuer-investor engagement significantly less effective than it might otherwise be and will continue to compromise the integrity of voting decisions. What we now observe is a trend in which the views of investors, who have made the effort to engage with our members and to give themselves an informed view on a resolution, are increasingly being diluted by auto-votes cast on the basis of the views of those who have refused to engage. We believe that investors using proxy advisors should be required to satisfy themselves that the relevant proxy advisor is willing to engage with issuers in a meaningful and constructive way. It is crucial that the FRC reviews this area promptly and that proxy advisors are required to carry out their roles in a more responsible way.

#### **5. Timing and scope of the stewardship consultation**

Investors have a very important role to play in corporate governance and the FRC's work in this area is a critical part of the reform. We are concerned that the consultation on the Governance Code and the Stewardship Code are being run on different timetables. In our view both Codes must work together and the detailed consultations on them should have been run on a contemporaneous basis.

It is critical that when carrying out its review on stewardship the FRC considers the obstacle provided by the relatively low level of UK equity held by UK based institutional investors and, therefore, the limited number of asset managers who can be required to report against the Stewardship Code. Institutional investment is a global industry and given that ownership patterns in the UK are very different from those in the past involving non-UK based institutional investors and encouraging them to apply similar

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stewardship standards engagement is essential. Based on official government statistics<sup>1</sup>, as at the end of 2016, 53.9% of the value of the UK stock market was held by non-UK based investors. We are very happy to give you more up-to-date data on ownership patterns in the FTSE 100 if that would be helpful.

## Answers to consultation questions

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

No, subject to the FRC making the changes we suggest in our response to question 7 on independence.

### 2. Do you have any comments on the revised Guidance?

We are broadly supportive of the structure of the draft Guidance, save we believe that:

- it is rather long and would benefit from shortening;
- it would benefit from turning some text into questions;
- the use of 'should', 'can' and 'may wish' could usefully be reviewed in the light of these comments.

We have the following specific comments and would be pleased to work with the FRC on the wording of the draft Guidance over the coming weeks.

- Paragraph 1 and 2 – We suggest inverting these and deleting 'intended to be' from paragraph one. The suggestions are very definitely not prescriptive.
- Paragraph 10 – In this paragraph the FRC refers to a director having a duty to preserve value in the long-term. Whilst our members understand the benefits and increased emphasis on taking a long-term, sustainable view, to avoid confusion on the part of investors it is important to note that for the reasons outlined in our introduction the duty of directors to promote the success of the company is not a duty to promote the long-term success of the company.
- Paragraph 12 – Whilst a formal schedule of matters for the board will be maintained, in our view it is inappropriate to require it to be made available on a company's website. This schedule may often reference confidential matters and, moreover, it is not clear how external publication of the schedule supports the aim of improving board effectiveness.
- Paragraph 17 – In this paragraph the FRC describes how a board can take steps to create the conditions for sound decision-making. We think that the FRC should modify this wording to make it clear that this is just one of many different examples of how a sound decision making process might work. This is an example of a suggestion that would best lend itself to a question.

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<sup>1</sup> <https://www.ons.gov.uk/economy/investmentpensionsandtrusts/bulletins/ownershipofukquotedshares/2016>

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- Paragraph 20 – In our view this paragraph is overly prescriptive. In certain sectors, for example financial services, more detail may be included in board minutes given the regulatory backdrop. We do not, however, think that it is appropriate for the FRC to impose this level of prescription on all companies. This paragraph should either be removed, or the wording should be softened and the judgement of the chair and company secretary as to what is contained in the minutes relied upon.
- Paragraph 21 – In this paragraph the FRC recommends that after a decision is made and implemented the board should review the effectiveness of its decision making process and the merits of the decision. In our view this is overly prescriptive and should either be removed, or at least qualified by the words *'From time to time and as the board considers appropriate'*. Boards make many decisions; as well as unnecessarily distracting them from overseeing the business of the companies they are involved with, in our view it is unrealistic to expect a board to regularly carry out a review like this. The annual board evaluation process required under Provision 21 of the draft Code in any case provides an opportunity for a board to review the effectiveness of its decision-making processes. Again, this may best lend itself to a question.
- Paragraph 23 – As currently drafted, we believe that this is too prescriptive. AGM formats vary between companies, and formats/timetables may not be able to accommodate statements from multiple committee chairs. In our view it is more appropriate to allow companies to exercise their discretion as to how best to present activities of board committees over the previous year in a manner that invites shareholder interaction. Again we would suggest that a question about this might suffice.
- Paragraph 26 – In our view the first sentence of this paragraph is inconsistent with section 172 and overstates directors' duties in relation to wider stakeholders, which must be placed in the context of directors' primary obligation to promote the company's success for the benefit of its members. The first sentence could instead be re-written to provide:

*'In promoting the company's success for the benefit of its members, directors should also have regard to a wide range of stakeholder interests.'*

- Paragraphs 31, 34 - 36 and 102 – 106 – These paragraphs all refer to the undefined term 'workforce'. They do so in various different contexts: (i) stakeholder engagement and awareness in general; (ii) specific workforce engagement activities (town halls, consultative groups etc); and (iii) the remuneration committee oversight proposals. In our view a very wide definition of workforce is not appropriate in all these contexts, including due to employment and tax regulations across the world and that, in the contexts of (ii) and (iii), workforce should be defined more narrowly.
- Paragraphs 50 and 60 – In paragraph 50 the FRC gives a non-exhaustive description of the role of the chair. We note in particular that it highlights the need for the chair to 'foster relationships founded on mutual respect and open communication – both in and outside the boardroom – between the non-executive directors and the executive team' and to develop 'productive working relationships with all executive directors, and the chief executive in particular, providing support and advice while respecting executive responsibility'. The description of the chair's role is rightly very different to and much more extensive than that of the non-executive given further on in the draft Guidance. In

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paragraph 60 the FRC also explains how ‘The chief executive’s relationship with the chair is a key relationship that can help the board be more effective’. We agree with the sentiment of all of these statements and believe that they reflect the hybrid nature of the chair’s role. In our view the FRC’s new proposal that the chair’s independence will need to be assessed on an ongoing basis is, however, incompatible with the job description given. If the FRC proceeds to implement that proposal, we believe that the description of the chair’s role will need to be modified.

- Paragraphs 96 – 101 – We think it would be better to move these paragraphs to the Audit Committee Guidance or Risk Management Guidance to avoid piecemeal coverage.

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

Yes. It is, however, not clear to us why the specific methods need to be set out in Provision 3. In our view there is no need for this level of prescription and it should be up to companies to determine for themselves, and report on, the engagement mechanisms that they have put in place for the workforce (and other stakeholders).

If, nevertheless, the FRC decides that it is necessary to take this prescriptive approach, in our view the new Code should set out more clearly the flexibility companies have to determine the most appropriate way to achieve meaningful engagement within their organisations. In particular, Provision 3 should explicitly state that companies are permitted to engage the workforce voice in a way which is not specified or through a combination of methods (as clearly envisaged by paragraph 35 of the draft Guidance).

While we anticipate that many companies will want to use one or more of the specified mechanisms this will not be the case for everyone. For example, companies with complex global operations and diverse workforces may conclude that the three identified methods are unsuitable to achieve the intended overall outcome of continued improvements for the benefit of their workforce. We are concerned that the flexibility inherent in the word ‘normally’ could quickly become lost, which would make it harder for companies to choose a different approach. In addition, we think that the use of the word ‘normally’ might have the unintended consequence of limiting innovation in relation to workforce engagement as it could discourage companies from considering other methods of engagement. We think that this would not be the case if the language explicitly catered for exceptions.

A revised Provision 3 could read as follows:

*‘3. The board should establish a mechanism through which it gathers the views of the workforce. This mechanism could be made up of one or a combination of the following approaches: (i) a formal workforce advisory committee, (ii) a director appointed from the workforce, (iii) a designated non-executive director, or (iv) another appropriate method designated by the board. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously. The board should review this and ensure that arrangements are in place for the proportionate and independent investigation of such matters and for follow-up action.’*

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We understand why the FRC has chosen to use the term 'workforce' rather than 'employees' in Provision 3. However, we would welcome further clarification on the scope of this term. Companies will be anxious to ensure that the approach they have adopted does not comply with the provision because of a misunderstanding as to scope. In particular, we believe it would be helpful for the Guidance to specify categories of individual who would be excluded, for example, the employees of an outsourced service provider who provide services to the company, including at a company location.

**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?**

We are generally supportive of the way in which the SDGs and other NGO principles provide a route for addressing some of the world's most significant challenges and acknowledge the importance of them. We do not, however, think that there is any need for more specific references to be made to them. We believe that listed companies should continue to have the flexibility to approach this area in a way that best works for them and their stakeholders on a case-by-case basis.

**5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?**

Yes, we agree that 20 per cent is 'significant' in the context of a vote against.

We do not agree with the proposal that an update should be required within a six month period. In some situations, based on the experience of our members, there will not be a meaningful update to give after six months as post-AGM some investors can be unwilling to engage on the relevant point which can make it difficult to move things forward. In other situations where progress is being made, this requirement has the potential to unnecessarily prejudice the outcome of discussions around the relevant point. In our view, Provision 6 should therefore be reworded to provide that:

*'An update should be published in the next annual report, or at such earlier time as considered appropriate by the directors.'*

The suggested change would be more likely to produce a meaningful and positive result.

Please could the FRC confirm if this provision will be limited to board proposed resolutions, or whether it will also apply to shareholder proposed resolutions?

**6. 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.**

As representatives of the FTSE 100 we do not believe it is appropriate for us to respond to this question.

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

*Independence generally*

No, we do not accept that this should automatically be the case. But the effect of the proposed changes to the Code on the determination of independence is likely to have this consequence.

The ‘reversal of the burden of proof’ implicit in the move away from giving the board discretion to decide whether the test for independence is met, notwithstanding that one of the indicators of non-independence is present, will inevitably make it more difficult for such directors to remain on the board, even where the director’s knowledge, insight and independence of thought demonstrably point to it being in the interests of the company that this should be the case. Given the prevailing attitude of many of those responsible for determining how institutional shareholders vote (i.e. comply or vote against), we expect that the proposed approach will quickly result in an effective nine year time-limit on non-executive directors and chairs.

Amongst other things, this could adversely affect the ability of companies to run balanced succession planning, which is highly undesirable. For example, it will make it much more likely that boards will need to recruit their chairs from outside – a nine year time limit on independence will in practice make it more difficult for there to be internal chair appointments and will discourage this type of succession planning. It could also undermine one of the primary roles of the chair to be the steward of the company’s long-term strategy if the board were required to assume that the chair would automatically not be independent after nine years’ tenure. Equally, where there is a CEO change at the point where the chair has been in place for nine years, it will often be more sensible for the chair to stay on for a period to ensure that continuity is maintained.

If the FRC is of the view that the current approach to determining the independence of non-executive directors is not working, we believe that it should explain why it believes this to be the case, giving examples of where it believes the current approach has not delivered the appropriate result. Alternatively, if the FRC retains this proposal we would suggest that: (i) in relation to promotions to the chair, the ‘clock’ should begin again upon the chair’s first election to that role so that he/she can potentially serve as chair for nine years, and (ii) in relation to current chairs, the new Code should allow either for a grandfathering of existing chairs or a transition period for compliance.

On the linked point of testing the independence of non-executive directors by reference to the list of indicators in Provision 15, we believe the effective conversion of those indicators into requirements that each need to be satisfied in order for a director to be independent would cause uncertainty and inflexibility. Given the proposed change of approach, the wording is neither clear nor specific enough to enable these to operate as what would in effect become firm rules. The ‘material business relationship’, ‘significant links’, ‘additional remuneration’ and ‘close family ties’ factors are particular examples.

Unless accompanied by very clear additional guidance (such as that provided in relation to the tests for director independence under US securities laws, which set detailed financial thresholds and define close family relationships) and, where appropriate materiality qualifications, converting these factors into firm rules could have the unintended consequence of significantly

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curtailing a board's flexibility to appoint a director who might otherwise be validly judged as independent and thereby, in our view unnecessarily, limiting the pool of industry experts that can serve as independent non-executive directors.

By way of illustration, where a non-executive director as a result of a previous employment is a member of a company's pension scheme (which could be where that person has never been employed by the appointing company but where his or her former employer has been acquired by it), the proposed change could be interpreted to mean that he or she could never be treated as independent. This could even be the case where, on all other counts including the individual's overall financial position and other retirement planning arrangements, that would be the entirely wrong conclusion. This problem is particularly acute in industries where there has been consolidation over the years and in specialist sectors where people tend to move around a relatively small number of key players.

As we do not think it practical or necessary to anticipate all circumstances that could impact on a director's actual independence, we strongly believe that it is more appropriate to continue to permit the board, as the body best placed to assess all factors relevant to a director, to exercise its judgement in making an overall assessment of independence.

Therefore, for all the reasons given above, we believe that the approach to determining independence in the existing Code should be maintained, namely that it remains a question of judgement for the board as to whether the test of independence is met, whether after nine years on the board or when one of the other indicators listed in Provision 15 is present.

#### *Independence of the chair*

It is also not clear why the draft Code proposes to focus on the independence of the chair after appointment. The existing Code provides that the chair should be independent on appointment but is silent on status thereafter. This is because the chair discharges a hybrid role, spanning the executive and non-executive teams. We believe there is no logic or justification for now expecting the chair to be independent after appointment.

In this context, we note paragraph 5.9 of the Higgs Review Report on the role and effectiveness of non-executive directors (January 2003), which recommended that at the time of appointment chairs should meet the test of independence, stated as follows:

*'5.9 Once appointed, the chairman will have a much greater degree of involvement with the executive team than the non-executive directors. Applying a test of independence at this stage is neither appropriate nor necessary.'*

This is still the case, and we believe that the current position should be maintained. If the FRC decides to proceed with this proposal, we believe that the drafting provided in relation to it should be much clearer.

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

Yes, please see our response to question 7. We believe that the effect of prescribing a maximum period of independence is to impose a maximum period of tenure of nine years, which we do not believe to be appropriate.

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**9. 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?**

The fundamental issues underpinning a lack of diversity at board level, including the need to create a more diverse executive pipeline, present a significant challenge for boards and their companies and we are fully supportive of any measures aimed at resolving these issues. We agree that the changes proposed in Section 3 should in theory lead to more action to build diversity. We note, however, that the benefits of diversity are already widely understood and many companies have been working hard to increase diversity for a number of years. The proposed change will therefore not necessarily lead to 'more action' from them.

We would, however, like further clarity on the practical implications of the draft Code's requirement for the nominations committee to 'oversee the development of a diverse pipeline for succession'.

We note that the removal of a board's discretion to determine that one or more non-executive directors are independent, notwithstanding the existence of cross-directorships from other boards, is likely to result in a loss of diversity in the short to medium term at least by unnecessarily impairing the independence of non-executive directors.

**10. 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.**

As representatives of the FTSE 100 we do not believe it is appropriate for us to respond to this question.

As a more general observation, we note that many companies have reduced the size of their boards over recent years because they have found smaller boards to be more effective. Whilst our members strongly support diversity, it is becoming increasingly difficult to satisfy the requirements of each committee while keeping board numbers low given all of the other requirements which nomination committees may have, for example, in terms of sector and functional expertise.

**11. 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 support this proposal in principle but note that there are a number of issues with the practical implementation of it which would need to be acknowledged and addressed before any requirement was introduced. Those issues include:

- The collection of ethnicity data is more complicated than the collection of gender data. For example, what is meant by 'ethnicity' and how would it be determined? Would it be by reference to birth, race or association? How would second and third generations and mixed ethnicity be classified? Is this for the individual company to determine (and report on how they define it) or will it be more clearly defined in the new Code? Also, what is the scope of the term 'ethnicity' – does it have global reach, reflecting the footprint of the company?

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- Provided that the data can be collected anonymously and without contravening local laws (which can be problematic and mean that some companies will, through no fault of their own, have incomplete data sets), there should be no issue with reporting on ethnicity, subject to the limitation that the usefulness of the data reported on will be entirely dependent on the extent to which the workforce is willing to volunteer their ethnicity.
- Companies will need to take into account their obligations under data protection law when making their report. To the extent that the data might identify a particular individual, which might be the case, for example, in the level immediately below board level where the number of employees reported on is small, companies will need to consider whether they can lawfully make the disclosure.

**12. 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?**

No. We think it would be better to remove all duplication.

We note your reference to the Government's plans to introduce secondary legislation to require all companies of a significant size to explain how their directors comply with section 172 of the Companies Act. We think it would be better to modify Provision 4 so that it simply cross-refers to the relevant legislative provision as and when it comes into force. We are concerned that listed companies may otherwise have to comply with two parallel, but not necessarily identically drafted, sets of rules which are each designed to achieve the same purpose.

**13. 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.**

Yes

**14. 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 agree that, when setting the policy for director remuneration, the remuneration committee should be asked to take into account remuneration and workforce policies and practices within their company.

Our understanding is that the FRC's intention in drafting the language of Provision 33 was to emphasise the need for the remuneration committee to have a full understanding of such policies and practices as guidance when developing a policy for director remuneration reflecting the culture and strategy of the company as a whole.

However we are concerned that the language used, in particular the adoption of the word 'oversee', could be construed as going significantly further than this and as implying a greatly expanded remit for the remuneration committee, akin to a general HR supervisory role. Apart from the very significant additional workload this would entail for the remuneration committee,

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there is a concern that this could encroach into operational responsibilities, which are properly a matter for executive functions and not for non-executives.

To make clear that this is not the intention, we think companies would find it helpful if the scope of the remuneration committee's role could be clarified by adjusting the language in the second sentence of Provision 33, so that it reads as follows:

*'It should ensure that it is provided with sufficient information to enable it to understand and take into account the remuneration of the wider workforce and workforce policies and practices when setting the policy for director remuneration.'*

In the existing Code the remuneration committee is expected to 'recommend' and monitor the level and structure of remuneration for senior management rather than 'setting' it and the definition of 'senior management' is left to the discretion of the board. In the proposed new Code 'recommend' has been changed to 'set' and senior management is defined as the executive committee or first layer of management below board level, including the company secretary. We do not believe that the remuneration committee should set remuneration for senior management and the company secretary. We do agree that they should set remuneration for the executive directors and the chair and recommend levels for senior management (as defined by the board).

Although this is a less material point than the concerns we have raised about the remit of the remuneration committee, we believe that the wording of Provision 33 could more clearly reflect the flexibility set out in paragraph 104 of the draft Guidance. The Guidance suggests that boards can reserve the responsibility for overseeing wider workforce remuneration, incentives and workforce policies to a committee other than the remuneration committee. However, this is not clear from the wording of Provision 33, which suggests that the delegation should be to the remuneration committee. The logical consequence of this is that a decision to delegate to another committee would need to be explained. Regardless of the final position adopted in relation to 'oversight', it would be helpful if the final versions of the Code and the Guidance could be more clearly aligned on the question of delegation.

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

We believe that the guiding framework set out in Provision 40 is sufficient and that there are disadvantages in trying to be too prescriptive. The best way of supporting remuneration committees in ensuring that executive remuneration drives long-term sustainable performance is to ensure that the Code does not mandate a 'one size fits all' approach. Remuneration committees should be permitted to adopt principles of remuneration that properly reflect the needs, culture and philosophy of the relevant company.

**16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?**

We believe that shareholder sentiment is the principal driver here. We do not expect the proposed changes would give any further impetus to boards on this point over and above that already being given to companies by their investors.

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## UK Stewardship Code questions

- 17. 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?**

In practice it may be difficult to produce text that goes much beyond the basic and established expectations in this area. Investors' expectations tend to vary, (and indeed can often conflict) not just in accordance with the views of the ultimate beneficiary and the terms of the relevant investment mandate, but also in accordance with their differing strategies, investment horizons and business models. By way of illustration, we find that the expectations of an investor which chooses to hold for the short-term and makes trading decisions on the basis of an algorithm is likely to be different to those of a pension fund that chooses to hold shares on a long-term basis. The inclusion of some broad consensus based wording might nonetheless provide a helpful benchmark around expectations.

Whilst having separate codes for the different intermediaries in the investment chain sounds like a sensible proposition, subject to our comment in the introduction on proxy advisors, we think that for the most part this would be an unduly burdensome exercise which, for the reasons mentioned above, is unlikely to achieve the FRC's objectives.

Please note our comments in the introduction on the need to consider the impact of proxy advisors on corporate governance and stewardship. We are very happy to discuss this issue with you in more detail. We would also encourage a review of conflicts of interest at proxy advisers. For example, the emerging practice of some of them of requiring listed companies to make a payment to their 'commercial arm' in order for the listed company to see the reports they intend to make to their client groups (or the models driving those reports).

We would like more information on how the UK plans to implement the relevant provisions of the Shareholder Rights Directive.

- 18. 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?**

We support the existing 'comply or explain' regime. In our view this provides the flexibility required to accommodate the fact that individual situations and circumstances will vary. Whilst the presence of clearly defined stewardship principles provides a useful road map for market participants, we observe that for the 'comply or explain' regime to work effectively it presupposes a market where it will have an impact. A critical mass of the underlying beneficiaries and clients of the institutional investors must therefore monitor the reports produced by them and challenge the institutional investors as necessary. Without this the 'comply or explain' reporting regime lacks a proper means of enforcement. We think that the tiering exercise carried out by the FRC has been helpful in this respect.

In our view it is not easy to define, or clearly state, what constitutes a good explanation in this context as there are elements of subjectivity. We understand that some investors look to the 2012 FRC Guidance on the 'Comply or explain' regime for listed companies.

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**19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?**

In our view the tiering exercise was a useful way to distinguish between those who report well and those where improvements could be made. As such it may have helped asset owners and others to assess stewardship performance in, for example, the selection processes they run when awarding investment mandates. Whilst the reports are undoubtedly useful, our main focus, however, is on the quality of the stewardship by investors rather than the way that it is reported.

Alternative, or additional, options which the FRC may want to consider are the publication of:

- a simple guide for investors on good reporting; and/or
- an annual or periodic report on the best practices that the FRC sees in this area (alongside reporting on concerns it may have).

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

Yes, we believe that institutional investors should be required to report on how they, or their proxy advisors, have engaged with their investee companies in the same way that listed companies are required to report on how they have engaged with the workforce and other stakeholders.

At the moment, in our members' experience, even some of the largest investors can be reluctant or unwilling to engage with them (including when they have already, or intend to, cast a vote against a particular resolution). Absent clear reporting from investors on their engagement the incorrect assumption from the media can be that it is the company that has been unwilling to engage. The same point applies to proxy advisors who, as outlined in our introduction, are often unwilling to engage.

**21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?**

Greater emphasis could of course be given on this in the Stewardship Code. In our experience, there are, however, limits on what can be achieved by the Stewardship Code in this area and wider cultural change is required. This is largely because of the challenge presented by the fact that institutional investors often operate to a different time horizon than their investee companies, even where the ultimate beneficiary wants to hold the shares for the long-term. This can be for a range of reasons including the tendency for the market to define their performance relative to benchmark indices (even where they are active managers); the basis on which asset managers are monitored by asset owners and advisers, and the actual asset manager selection process. By way of illustration, if an asset manager is only instructed for a limited period of three to five years and is required to provide quarterly, or even monthly, performance reports, it may feel pressurised to look at short-term performance to keep its mandate even though it would prefer to focus on long-term performance. This can also mean that our members have additional short-term outlook pressures placed on them by market participants.

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Whilst of course our members understand the benefits and increased emphasis on taking a long-term view, to avoid confusion on the part of investors it is important to note that the duty of directors to promote the success of the company is not a duty to promote the long-term success of the company. Please see our answer to question 2 for further details on this.

**22. 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?**

Yes, we support the promotion of the importance of ESG factors and the notion that engagement is no longer just about financial return but is instead also about wider issues to the extent they affect the success of our members. We also observe that there is a growing view that institutional investors recognise and have an obligation to include considerations of sustainability as part of their duty to their beneficiaries and clients. We do, however, understand and acknowledge that their position can be tied by the objectives and perspectives of their underlying beneficiaries whose views can vary on the relative importance of ESG and similar factors.

It would be helpful if investors would disclose more systematically how they take into account ESG and similar factors into their investment strategies and business models. This transparency would help our members and the institutional investors’ clients and beneficiaries to make more informed decisions. Unfortunately, in our experience the portfolio managers and the corporate governance professionals at the same asset manager can have a divergence of opinion on the relative importance of ESG and similar factors. This means that our members can receive differing views depending on who they speak to. It would be helpful to have some clarity on this from the institutional investors.

**23. How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?**

We believe that investors should be required to report on their, or where relevant their proxy advisor’s engagement, with investee companies. Please see our response to question 20 for more details on this. The FRC could include more explicit requirements around this in the Stewardship Code or, equally, could use an FRC Financial Reporting Lab type approach in this area

**24. How could the Stewardship Code take account of some investors’ wider view of responsible investment?**

No comment.

**25. Are there elements of international stewardship codes that should be included in the Stewardship Code?**

We believe that the most significant international stewardship codes have not been in existence for long enough to allow us to accurately gauge the impact of provisions included in them but not in the Stewardship Code. For example, the ISG stewardship framework in the US only took effect from the start of this year.

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The areas that the FRC has asked content questions about in this consultation broadly reflect the key additional areas that we think should be explored. In our view when approaching this topic, the FRC needs to resist the temptation to extend the scope of the Stewardship Code too much. Our concern is that if the level of changes is disproportionate it risks indirectly encouraging institutional investors to delegate stewardship to proxy advisory services and to take a box ticking approach.

We believe that the main challenge is not identifying the provisions covered in other codes that are not covered in the Stewardship Code. Instead as mentioned in our introduction, it is dealing with the obstacle provided by the relatively low level of UK equity held by UK based institutional investors.

**26. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?**

No comment.

**27. Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?**

No comment.

**28. Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?**

Yes. Please refer to our answer to question 22 for details of our views in this area.

**29. Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?**

Yes. Please refer to our answer to question 22 for further details of our view in this area.

**30. 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?**

Yes. We generally agree that this would be a positive development and would give the relevant organisation the opportunity to put their report in context. It would be helpful if the signatories could provide details of the person designated as a contact point for stewardship related matters and who will direct the way in which the investor's vote is cast at AGMs.

**31. 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?**

Funds can be established for different purposes. To the extent that this would, for example, allow asset owners, beneficiaries, and listed companies to easily determine the approach and purpose of a fund that might be helpful. For example, whether a fund was established for speculative or long-term purposes.

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Thank you for the opportunity to share our views on the consultation. We would be happy to discuss our response in further detail should that be useful.

Yours sincerely,

Mary Mullally  
Secretary, GC100

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