

**Email** – London Finance & Investment Group plc

16 February 2018

Dear Sir

I am responding as a director of a small premium listed company, London Finance & Investment Group plc. I am also involved in preparing the QCA's response to this consultation so there will be many points of overlap, but there are also some key points of difference between these responses.

London Finance & Investment Group plc have a secondary listing on the Johannesburg Stock Exchange and so are aware of the King IV code which applies to companies with a primary listing on the JSE. While the structural changes in the UK Code are a step in the right direction, we believe that the FRC should have gone further and adopted the structure used in King IV. The Principles in King IV are more aimed at the governmental organisations and parastatals that are required to apply it, and so we do not think that they should be copied, but the structure, with its focus on explaining how principles are achieved, is more outcomes focussed than the draft UK Code.

We welcome the FRC's decision to reduce the length of the UK Corporate Governance Code. Corporate governance codes should be outcome-orientated; being principles-based is not sufficient. The focus of corporate governance should be creating and preserving value for shareholders and ensuring growth in long term shareholder value. Debates, codes and reports on corporate governance can too often be fixated on structures and processes. They should instead be focussed on having clear objectives and a group of people possessing an appropriate balance of skills and experience who can deliver those objectives. Individuals are particularly fundamental in setting the tone and culture of an organisation. Outcomes should not be sacrificed at the expense of structures and processes.

We have a number of concerns with changes to the current code in the draft that have not been specifically consulted on, and which in our opinion are sufficiently major as to require specific consultation before being changed:

We are very concerned that the current drafting of Principle A, extending directors' duties to include contributing to wider society, and other changes relating to interactions with the workforce, diverges from Section 172 of the Companies Act 2006 and risks inadvertently creating a hierarchy of stakeholders. The workforce should not be singled out as having preference over any other stakeholder group. We feel that the current drafting of Section 172 of the Companies Act 2006 strikes the right balance of having a duty to shareholders, whilst also having the responsibility to take account of other stakeholders who have an interest in the success of the company. Instead, we would support the Code stating that the board consider the company's contribution to wider society and engagement with its stakeholders in the context of its culture and strategy; this should not be inconsistent with directors' duties.

Previously the Code included a list of factors that **might indicate** that independence had been impaired. This has now changed in Provision 15 to a presumption that the existence of one of the factors on the list **precludes** independence. We believe independence to be a state of mind and that the factors listed should only be guidance for consideration of impairment. Moreover, Provision 15 is just guidance on the application of Provision 11, and a more appropriate positioning would be in the separate Guidance on Board Effectiveness document.

We also have concerns about the amalgamation of different Principles and Provisions within one paragraph. This can easily be a cause of sub-optimal reporting – only addressing one of the factors included in a Principle/Provision.

Principles that cover more than one issue should be disaggregated for clarity, and to avoid creating confusion in communication as a result of people not realising/understanding that a principle covers more than one issue. Alternatively, if the FRC believes that a principle only covers one issue, the wording of the principle should be improved to make this clear. We urge the FRC to review the Principles that are not currently expressed in one sentence. As a general rule, if Principles cannot be articulated in one sentence, then either a second Principle, or a Provision is being included. As it stands a company may report how it applies the first sentence of a Principle, but not the second.

Similarly, many of the Provisions are an amalgam of a number of different structures/processes which should be expressed separately. Provisions need to be reviewed so that each separate structure/process is a separate Provision. Where more than one requirement is in a single Provision, a Company might report compliance with the Provision despite only having complied with one part of the Provision. We also recommend that the FRC reconsiders the number of Provisions and whether more than one Provision is required in relation to each Principle. The excess number of Provisions over the number of Principles underpins our view that more than one point may be covered by one Principle.

### ***Responses to specific questions***

#### **A. UK Corporate Governance Code and Guidance on Board Effectiveness**

##### ***Introductory questions***

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

No. Best practice has not changed. A short time gap between publication and application should not be a problem.

##### **Q2 Do you have any comments on the revised Guidance?**

We expect boards to find the “questions for boards” sections to be particularly useful tools. All chapters should include such sections.

Our main concern is that, while the key element to all corporate governance systems is the people performing the governance duties, the guidance (other than 4 paragraphs on Culture) focusses on activities, rather than personal characteristics, skills and experience. It is right and proper that there should be appropriate structures and processes in place to constrain the opportunity for the “wrong” people to do harm. But more important is having the “right” people in the first place. The balance in the guidance with its emphasis on structures and processes rather than people is all wrong.

We think that there should be more guidance on how a director appointed from the workforce – one of the methods presented in Provision 3 – could operate effectively as part of a unitary board structure.

## ***Section 1 – Leadership and purpose***

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

We support the objective that boards should establish a method for gathering the views of the workforce. We note that the proposed methods set out in Provision 3 were put forward in the government's response to its Green Paper in August 2017.

We are pleased to see that the current drafting of this Code provision indicates that the three options presented in Provision 3 are merely options and does not preclude another method being chosen, so long as it achieves the overriding objective of gathering the views of the workforce.

We think that there should be more guidance on how a director appointed from the workforce – one of the methods presented in Provision 3 – could operate effectively as part of a unitary board structure.

We strongly disagree with the apparent extension of directors' duties in Principle A to include contributing to wider society. We think that S172 of the 2006 Companies Act struck the right balance of having a duty to shareholders and a responsibility to take into account the interests of other stakeholders. No man can have two masters, let alone the number of masters that would be necessary to fulfil a duty to contribute to wider society. Including this additional duty is creating a hostage to fortune.

We also disagree with a promotion of the interests of the workforce above those of other stakeholders. We recognise that this is in response to government statements, but this type of fundamental change needs much wider and deeper consultation before implementation.

Whether any of the proposed methods in Provision 3 will "achieve meaningful engagement" will depend on their implementation.

### **Q4 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 do not think that the Code would be an appropriate place for more specific reference to the UN SDGs or other NGO principles. Companies should be able to assess how they need to understand and develop their contribution to society. More flexibility in this area would encourage a more considered and tailored response.

However – as we support the UN SDGs' overarching objective of the private sector (along with governments and civil society) playing its part in ending poverty, protecting the planet and ensuring prosperity for all – we believe that the Guidance would be a suitable place to refer to the UN SDGs. They could help support a company's understanding of the necessary environment and societal change agreed by governments and the associated opportunities, for businesses to align their practices with these expectations.

### **Q5 Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?**

A 20 per cent 'bright line' should not be included within a principle-based code.

We would suggest retaining the current phrase 'significant vote against' in the Code and refer to 20 per cent in the Guidance. This would help cater for companies with a concentration of shareholders – where the amount that is 'significant' should be assessed in relation to the number of shares in the hands of management or connected shareholders.

We agree that an update should be published no later than six months after the vote.

## ***Section 2 – Division of responsibilities***

**Q6 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.**

No – we do not agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years. We are similarly concerned at the decision to remove the exemptions in relation to annual re-election, and the composition of audit and remuneration committees, as this will lead to a one-size-fits-all approach. We do not consider such an approach to be conducive to encouraging smaller companies to seek capital from public equity markets.

In terms of the costs associated with the proposals to remove the exemptions for companies outside the FTSE 350, we consider that it is the audit committee composition provision – that is, the requirement to have three independent members rather than the current two – which will create the most significant ongoing cost. Our latest QCA/BDO Small and Mid-Cap Sentiment Index found that non-executive directors of small and mid-size quoted companies were currently paid, on average, £39,460 per year, although the range varies widely. In addition there are the supporting costs associated with induction, and maintaining an understanding of the business over time which need to be taken into account.

Annual re-election is unlikely to incur much additional cost, while the external cost of board evaluations is probably in the region of £20,000, if carried out once every three years, although this would depend on how comprehensive an evaluation was undertaken. This does not take account of the time commitment for board members.

Therefore, placing additional obligations on smaller, growing companies will result in significant added costs (on a relative basis for small companies) and compliance burdens and remove the incentive for small, growing companies from using regulated markets and thus access to a deeper pool of potential investors. This will also significantly reduce the pool of potential investments open to investors whose mandates require investment on regulated markets only.

Furthermore, the UK Corporate Governance Code's "comply or explain" approach would result in many smaller quoted companies explaining why they were not compliant with the Code. A large number of explanations of why there is non-compliance risks annual reports sounding excessively negative.

**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 do not believe that the UK Corporate Governance Code should apply an arbitrary time period to a non-executive director's independence; being independent is a state of mind. Being able to objectively demonstrate the ability to be independent in character and judgement to shareholders relies squarely on the quality of the individual.

Companies should consider independence every year and not wait until nine years have passed. They should clearly explain both in their annual report, as well as in their discussions with shareholders, why a non-executive director and/or a chair is considered to be independent in character and judgement.

Companies should also clearly outline the qualities of each director, including an assessment of independence and a statement of the relevant skills and experience that they bring to the board. This will help to cultivate a greater level of trust and understanding among shareholders.

We note that Provision 15 includes a major change from the existing Code which has neither been highlighted nor specifically consulted on. Previously, the Code included a list of factors that might preclude that independence had been impaired. As we state above, we consider independence to be a state mind and that the factors listed should only be guidance for consideration of impairment.

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

Yes. Imposing a maximum period of tenure goes against the UK Corporate Governance Code's principles-based approach and will restrict the options available to companies for their governance arrangements.

***Section 3 – Composition, succession and evaluation***

**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?**

Overall, the changes proposed in Section 3 of the revised Code may help to encourage more action to build more diverse boards, both in the executive pipeline and in the company as a whole, depending on how they are applied.

Board succession planning is an important part of ensuring economic growth by companies remains sustainable in the long-term and is sufficiently flexible to face their future challenges. No one individual should be indispensable. How succession planning is managed is a key measure of the effectiveness of a board.

While all board appointments to the board must be made on merit, the promotion of greater board diversity must be seriously considered by public companies, including in the context of succession planning.

The sequence of words in Principle J should be revised to emphasise that diversity of gender, social and ethnic backgrounds should not be at the expense of cognitive and personal strengths.

**Q10 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.**

Yes – we agree with extending the Hampton-Alexander recommendation beyond the FTSE 350, so that companies of all sizes disclose the gender balance on the executive committee and direct reports to the executive committee.

However, we note that the Companies Act 2006 requires the reporting on the gender of “senior managers”. With the government due to publish legislation which will amend the strategic report requirements (that is, where the statutory disclosure sits) later in 2018, we encourage the FRC to ensure that the UK Code aligns with statutory requirements and does not cause duplication in reporting.

**Q11 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.**

While we support the principle of encouraging companies to report on levels of ethnicity in executive channels, we believe that incorporating specific reference to the need to report on levels of ethnicity in executive channels will be challenging as gathering this data can be extremely complex and sensitive. It is also worth adding that ethnicity is not always disclosed to companies on appointment.

#### ***Section 4 – Audit, risk and internal control***

**Q12 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?**

Yes, since the UK Code should be a “one stop shop” for guidance on what is considered common practice.

**Q13 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. However, committee terms of reference are an important element of board governance arrangements and we recommend that the Guidance document calls for all board committee terms of reference to be made available on the company website.

#### ***Section 5 – Remuneration***

**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?**

Yes – we generally agree with the wider remit for the remuneration committee as outlined in Principle O and supported by Provision 33.

However, we would encourage Principle O to refer to “workforce policies and practices on remuneration”. This would ensure that it is clear that, for example, all aspects of employee policies are not in the scope of the remuneration committee’s oversight.

Similarly, Provision 33 should be clarified to refer to “workforce policies as regards to remuneration”. We consider that workforce policies regarding other non-remuneration matters should be managed through the proposed methods for gathering the views of the workforce suggested in Provision 3.

With regards to Provision 32, we suggest that the necessary qualification for appointment of a remuneration committee chair is considered in relation to relevant experience rather than requiring service on a remuneration committee for 12 months.

This could be demonstrated, for example, by being a remuneration consultant or from a similar, relevant profession.

**Q15 Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?**

Executive remuneration is a challenge facing companies of all sizes. Companies should approach matters of remuneration in a way that is proportionate, rational and measured. Incentives should be commensurate with prospective value creation for shareholders.

Companies should be open and transparent when setting executive pay, in order to nurture the development of trust between companies and shareholders. Remuneration models should support the sustained alignment of interests between directors and shareholders which should help to deliver long-term growth in shareholder value.

A meaningful proportion of an executive's remuneration should be performance based over the long-term. This can be done by linking pay to strategic milestones, key performance indicators (KPIs) and value drivers that incorporate challenging and transparent targets related to corporate and individual performance. Long-term incentives should be equity-based and thus structured to reward long-term growth in shareholder value.

We also believe that shareholders should take an active interest in every company in which they have significant shareholding. Their involvement can encourage a company to improve its corporate governance measures and thus lead to the company enhancing its performance.

Overall, the revised UK Code strikes an appropriate balance between executive remuneration and long-term sustainable performance – particularly in the statement in Principle P regarding the linkage of performance related pay to delivery of a company's strategy.

However, we are concerned that the "3+2" holding period being specified within the Code at Provision 36 is too inflexible, particularly for smaller companies with limited liquidity. To date, this pay design feature has been effectively introduced by force of argument by the investor community in the UK as a "best practice" matter. We think that having the requirement codified will make its operation too inflexible. In addition, timelines for smaller quoted companies may be very different from those of the FTSE 100. Small and mid-size quoted companies may go through a number of different growth phases which a "3+2" holding period cannot adequately recognise.

**Q16 Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?**

We consider the ability of boards to exercise their discretion on remuneration is becoming increasingly important. Shareholders will hold directors to account for the outcome of their decisions rather than formulaic outcomes. Directors and committees should ensure there is scope for discretion.

We believe that the extensive detailed requirements in the Provisions may lead to a formulaic approach, rather than a consideration of how best to achieve the desired outcome: that is, the remuneration of executive directors and senior management is proportionate to pay elsewhere within the Group and rewards for success are fairly shared between executive directors and senior management, the workforce, and shareholders.

## **B. UK Stewardship Code**

Companies seek to have shareholders that will provide constructive feedback on matters such as a company's strategy and the composition and remuneration of the board, and who will be available to engage on key issues when directors feel the need to consult with shareholders. Beneficial owners will have their own desired outcomes from their perspective at the other end of the ownership chain. Combined, these are the outcomes that the Stewardship Code should promote consistently along the chain of intermediaries. These desired outcomes should be clearly spelt out in the Stewardship so that there is no misunderstanding.

Good corporate governance is essential to success of a business over the medium to long term. What constitutes good governance evolves over time and is particular to the state of a business at a point in time and to its strategy. Assessment of the quality of corporate governance cannot therefore be performed independently of an assessment of the state of a business at a point in time, and to its strategy at that point in time. While separate corporate governance teams can provide a useful knowledge pool, ultimately the judgement about whether certain corporate governance practices are appropriate in the circumstances should only be made by the persons making buy/sell decisions.

Attached as an appendix are more detailed comments on the draft UK Code.

Kind regards

Edward Beale

## **Appendix – Detailed points regarding the draft UK Code.**

Page 2 – 3<sup>rd</sup> paragraph – engagement should not be restricted to “any departures from recommended practice” but should encompass “how the principles have been applied”.

Page 2 – final paragraph – should also reference QCA Code for companies that are not Premium Listed.

Sections 1 & 3 are about value creation and should be consecutive. Sections 2 & 4 are about value protection and should go together.

### **Section 1**

Principle A: See comment above about extending directors duties to wider society

The second sentence is either a separate Principle to the first sentence, or should be subsumed within Provisions

Principle B: The second sentence is either a separate Principle to the first sentence, or should be subsumed within Provisions

Principle D: The second sentence is a separate Principle to the first sentence

Provision 2 – first sentence- this is a Principle not a Provision

Provision 3 – the Guidance on Board Effectiveness should give more consideration of how a director appointed from the workforce could operate effectively as part of a unitary board structure.

Provision 6 – the 20% hurdle creates a bright line which is not appropriate in a principles based code, particularly where there are shareholders with significant stakes, particularly if these shareholders are also directors.

### **Section 2**

Principle E: The second sentence is a separate Principle to the first sentence

Principle F: The second sentence is a separate Principle to the first sentence

Provision 9 – The first sentence is a duplication the second Principle included within F

Provision 15 – Previously the factors identified were indications that independence had potentially been impaired. This presumption has now been reversed without any discussion or being highlighted in a consultation question. This is actually guidance on the application of Provision 11, so better fits as part of the Guidance on Board Effectiveness. If this has to be in the UK Code, then it should be part of Provision 11.

### **Section 3**

Principle I: The second sentence is a separate Principle to the first sentence

Principle J: The second sentence is a separate Principle to the first sentence

Principle K: The second sentence is a separate Principle to the first sentence

#### **Section 4**

Principle N: The second sentence is a separate Principle to the first sentence

Principle N – the second sentence is a duplication of the second sentence in Principle B. These should be amalgamated.

Provision 25- final bullet point on reporting audit committee activities. There should be similar requirement for Nomination and Remuneration Committees.

Provisions 30 & 31 – There is a significant degree of overlap between these Provisions. They need to be either amalgamated or redrafted as separate provisions.

#### **Section 5**

Principle P: The second sentence is a separate Principle to the first sentence

Principle Q: The second sentence is a separate Principle to the first sentence

Provision 32 – A new Remco. Chair should be required to have suitable experience. 12 months service on a Remco should not be the only way to gain such experience.

#### **Guidance on Board Effectiveness**

The most important part of any governance system is the people. Do they have between them the relevant skills and experience? Will they work together? This draft guidance totally omits a section on this.