Response to FRC Consultation on Proposed Revisions to the UK Corporate Governance Code
Steering Group of The Purposeful Company
Introduction

This document sets out the response of the Steering Group of the Purposeful Company Taskforce to the consultation questions on the draft revised UK Corporate Governance Code (‘the Code’), issued by the Financial Reporting Council (‘FRC’) in December 2017. We have responded in a separate submission to the questions relating to the proposed review of the Stewardship Code.

In July of 2017, we issued a submission to the FRC setting out our view on how the UK Corporate Governance Code could be reformed in order to put at its centre the encouragement of companies that think and act long-term in accordance with a clear purpose. We also issued a submission on Strengthening Board Accountability for Wider Pay Policy. Overall, across the combination of the proposed UK Corporate Governance Code, the draft Strategic Report Guidance, and the Government’s proposed regulation on section 172 reporting, we believe that substantial progress has been made, which will result in significant improvement in the UK Corporate Governance Framework.

Turning specifically to the UK Corporate Governance Code, we recognise that a number of areas where we made recommendations – in particular in relation to non-financial metrics and reporting on intangibles and stakeholders – have been reflected in the Strategic Report Guidance. We support the simpler more principles-based focus of the Code. We welcome the greater focus on the role of boards in establishing purpose, strategy and values and aligning culture with these. We also welcome the focus on the importance of understanding and engaging with stakeholders, and the recognition of board responsibilities to ensure alignment of people policies with purpose and culture, and the development of diverse leadership.

While there is much to welcome in the draft Code, we also consider there to be some opportunities for improvement, the principal ones being as follows:

- The Code could helpfully encourage boards explicitly to set out how it has considered and defined its purposes in relation to section 172, and in particular section 172(2). This would encourage boards to consider the full range of existing optionality under UK law, and would also help them think through the substance of their purposes and how this interacts with shareholder primacy. To achieve this we recommend introduction of a new Provision 2 is added to state that:

  ‘The board should consider and report on the extent to which the legal purposes of the company consist of or include purposes other than the benefit of its members, as provided for by section 172(2) of the Companies Act 2006’.

- The current provision on stakeholder voice confuses monitoring engagement with undertaking engagement activity. The board’s role should be to ensure that mechanisms are in place and then to monitor these. Requirements on stakeholder engagement should retain flexibility, particularly for multinationals, to establish insight gathering mechanisms and processes for meaningful dialogue that reflect their circumstances, recognising that to be effective, engagement must be tailored to local facts, circumstances and culture. The start of Provision 3 could be reworded as follows:
‘The board should ensure that mechanisms are in place to gather workforce views and engage in meaningful dialogue. The board should establish methods to monitor these and to ensure a flow of relevant information into board discussions. This could be through a director appointed from the workforce, a formal workforce advisory panel, or a designated non-executive director.’

- The combination of the requirements in Provision 6 and the Investment Association’s Public Register create an environment that risks a “one size fits all” approach to governance determined by Proxy Agency guidelines, which will stifle productive innovation. The key should be to highlight on the Public Register and to impose more onerous Code requirements, on those companies that do not respond to investor feedback. Therefore the focus should be on companies achieving a vote against above a certain threshold two years in a row. We give specific suggestions in our response to Question 5.

- While we welcome the inclusion of many aspects relating to reporting of intangibles in the Strategic Report guidance, we believe that aspects of boards’ responsibilities relating to strategic assets, intangibles, and performance measurement could helpfully be brought into the Code in order to strengthen the emphasis on them under a comply-or-explain regime. This could be through the introduction of new provisions as follows:

  In Section 1: ‘The board should oversee development of a performance measurement framework, not just according to financial accounting standards, but identifying the KPIs that reflect how the company is delivering benefits to its shareholders and other stakeholders in pursuit of its purpose.’

  In Section 4: ‘The board should oversee the establishment of KPIs and processes by which it monitors the health and development of the company’s strategic assets. These will include intangible as well as tangible assets and boards should give particular attention to how intangible assets are measured and valued and their health monitored. The board should identify the key risks to its strategic assets and achievement of its purpose.’

- We believe it is of the utmost importance that board structures – including how committees are organised – reflect and support a company’s specific purpose. A number of aspects in the Code set expectations for greater board accountability (for example in relation to diversity and wider people strategy). These responsibilities should be reserved at board level with flexibility as to the committee structure that the board adopts in order to implement them, rather than assuming a one-size-fits-all committee organisation. We provide some specific recommendations in relation to oversight required under Principle O in our response to Question 14.

- As shown in our Executive Remuneration Report, there is significant evidence that poor remuneration practices are a major factor in incentivising short-termism. The Code could create a stronger presumption that remuneration should be aligned with a company’s purpose and long-term value creation, even where this means moving away from current UK pay norms. We provide some specific recommendations in our response to Question 15.
Question responses

Question 1 – Do you have any concerns in relation to the proposed Code application date?

No.

Question 2 – Do you have any comments on the revised Guidance?

We believe that the Guidance is a helpful supplement to the Code, although its status requires clarification. For example, in relation to the oversight of remuneration and wider workforce policies and practices, the Code assumes this is achieved via the Remuneration Committee, whereas the Guidance accepts that other approaches to Committee delegation could be adopted. But in the latter case would a company have to disclose an explanation of non-compliance with the Code?

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

Yes, although it is important that flexibility is retained in the methods, particularly for multinationals. Employee concerns and cultural and legal norms relating to engagement vary by geography. As such, in order to be effective, employee engagement must take place locally. It is therefore likely that, in particular, multinationals will need to adopt a number of approaches and mechanisms in order to gather the views of the workforce in a meaningful way. A single centralised process is unlikely to be most effective, although it is clear that any approach should be meaningful and intentional. See also our comments above about separating establishment and monitoring of engagement methods.

We would also note that the definition of the workforce is broad. While we understand the rationale for defining this term broadly, and it will be particularly appropriate for certain organisations, we believe that it should be left up to boards to define the appropriate boundaries to workforce for the purposes of seeking views, consistent with their business and employment model.

The Code places particular weight on workforce engagement, which appears unbalanced in relation to other stakeholder groups whose views should be visible to the board. It is important that the board understands and stewards a range of key stakeholder relationships that are material to its purpose, and the Code drafting could be amended to reflect this.

Question 4 – Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

We support the UN SDGs and would encourage companies to consider how their activities support progress on this agenda for a sustainable future for society globally. Alignment of corporate outcomes with the SDGs are also a powerful way to rebuild trust, particularly for multinationals. However, we would caution against giving the SDGs a formal role in the UK Corporate Governance Code. The extent to which SDGs are relevant to a UK company’s purpose will be highly variable, and dependent on each company’s strategy and purpose, and the focus of the Code should be on aligning corporate governance to that corporate purpose. It would be a mistake to encourage support of the SDGs on a “box-ticking” basis. We would, however, suggest that reference to the SDGs in the Board Effectiveness Guidance and the Strategic Report Guidance would be helpful, in terms of contributing
to development of a framework in relation to board mapping of stakeholder interests, impacts, and sustainability goals (see response to Question 3 above). The UN SDGs have sufficient credibility and acceptance to warrant an explicit reference in this way through the guidance, although it should be non-prescriptive. We would not recommend inclusion of other NGO principles.

**Question 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?**

We believe that this part of the Code, and the related adoption of the Investment Association Public Register, is misconceived. Research shows that an ISS Against recommendation has a causal impact of 10% to 15% points on the vote on average in the UK, and can be higher. The corporate governance framework should be encouraging boards to think about the governance model, including remuneration, that best fits their purpose and strategy. However, proxy agency analysis pushes the market to a one-size-fits-all model. The proposed provision strengthens the stigma of a level of vote against that can be triggered purely by proxy agency action. Research set out in our Executive Remuneration Report showed that three quarters of companies who receive a vote against in excess of 20% in one-year increase that vote to over 90% in future years. In other words, the feedback loop of shareholder opposition generally works and brings about change. Furthermore, in terms of a vote threshold of 20%, we do not see the logic of adopting a threshold that is even more stringent than the 75% threshold required to pass a special resolution.

By focusing on companies receiving a vote against of 20% or more in any one year, the Investment Association’s Public Register will lose impact through capturing too many companies (with currently well over 100 companies on the register). Focusing instead on those companies that repeatedly get low votes – and so are not responding to shareholder feedback – would be far more impactful in driving behaviour change.

The six-month update is also unnecessary. Companies will generally take time for reflection following a low vote and may not consult with shareholders on the action they are taking until nine months or more after the vote.

Our proposed approach would be as follows:

- Retain the current requirement to give a statement at the AGM and in the subsequent annual report in the case of a vote against that the board deems to be significant, with significant normally representing vote against of 25% or more (aligned with special resolutions).
- In the situation where a company has received a 25% vote against any resolution two years in a row (not necessarily the same resolution), then the proposed provision, including providing an update no later than nine months after the vote.
- The FRC should then liaise with the Investment Association to amend the Public Register so that it focusses on those companies receiving 25% vote against any resolution two years in a row.
Question 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.

There is an advantage in a single set of governance requirements applying to all companies on the Premium List and we do not see the need for these exemptions.

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

We disagree with the proposed change to independence, which takes this part of the Code in a more prescriptive and ‘tick-box’ direction when the overall thrust of the Code is to become more principles-based. Indeed the provision on limiting the combined term of Chairman and any prior non-executive role to nine years could have the unintended consequence of limiting diversity in the Chairman role. Inevitably, groups where we are seeking to increase representation will currently be under-represented in current Chairman roles, and many in these groups will be seeking their first Chairman role. A route for many candidates from under-represented demographics to become Chairman for the first time will be to take on the role having established appropriate credibility and experience as a non-executive in the company. As such, limiting the combined term as a non-executive and Chairman could act against diversity in this regard.

Overall, we believe that the independence provisions should be retained as is, and instead a greater onus put within the Code on actively managing board succession and turnover in order to ensure diversity.

Question 8 – Do you agree that it is not necessary to provide for a maximum period of tenure?

We can see the benefit, in the context of our response to Question 7, in having an indicated maximum period of tenure for board directors (but with a lengthened allowance where a non-executive director has become Chairman). However, this should be on a comply-or-explain basis.

Question 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?

We welcome the additional focus on diversity in section 3. In practice, most organisations are actively working to improve diversity in board and management pipelines, but the provisions proposed will ensure that this is considered across the market. Greater transparency also allows investors, customers, employees, and other stakeholders to hold boards to account on this issue.

We note that there can be legal challenges relating to obtaining data on ethnicity and this should be acknowledged.
Question 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.

We agree with this proposal and we do not see any material reason why this should not be applied to all companies subject to the Code. We note that all companies with in excess of 250 employees are required to publish a gender pay gap, which is a much more onerous requirement.

Question 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.

The Principles and Provisions in the Code which reference diversity should promote a consistency of approach for gender, ethnic and social background. However, there are practical difficulties. Under UK law, companies cannot compel their employees to disclose their ethnic background; this information can only be provided on a voluntary basis by the employee. As such, companies would only be able to report on this area where they have received data voluntarily from individual executives. Therefore, although disclosures on the actions that are taken to improve the ethnic mix of executive pipelines may be appropriate, disclosing the numerical mix may not be practical.

Question 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?

Yes, because the Code applies to a broader group of companies and is voluntarily followed by some companies to which it does not formally apply.

Question 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.

We do not have a view on this.

Question 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 believe that the section on Remuneration creates confusion between the role of the Remuneration Committee in setting executive pay, and the responsibility of the board to oversee wider workforce policies and practices under the new Principle A. These requirements should be separated. We also have a concern that the phrasing of Principle A suggests a level of involvement in detailed policies that would result in over-reach into management responsibility.

To resolve this, we would suggest:

- Principle O be redrafted to read: ‘The board should satisfy itself that the company’s People Strategy is aligned with its purpose, strategy, and values, and is implemented in a way that supports the desired culture.’
• The second sentence of Provision 33 be amended to read: ‘It should take into account wider workforce remuneration policies when setting the policy for director remuneration.’
• The fifth bullet point of Provision 41 be amended to read: ‘what engagement with the workforce has taken place to explain how executive remuneration aligns with wider company policy’.
• A new provision added, linked to Principle O, to state that: ‘The company’s annual report should include a description of the key principles of the People Strategy, how it is aligned to the company’s purpose, strategy and values, and the governance that exists to ensure it is implemented in a way that supports the desired culture.’

Overall, our view is that the Guidance is better structured in this area than the Code itself. These changes would enable a board to deal appropriately with People Strategy, either directly at the Board, or via a Board Committee, which might be the Remuneration Committee or the Sustainability Committee, for example. This also avoids confusion between the direct decision-making responsibility of the Remuneration Committee under Principle P and the strategic oversight of People Strategy by the Board under Principle O. The obligations under Principle O could then be fulfilled in an integrated way with the requirements for gathering the views of the workforce, creating meaningful, informed discussion and challenge at Board level.

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

In our view, executive remuneration is most likely to drive long-term sustainable performance if it involves the executive holding significant value in shares over the medium to long-term. The Code Provision requiring a five-year period between award and realisation (and longer periods where appropriate) is therefore to be welcomed (although the application of this provision should be clarified so that it applies to long-term incentives, or equivalent, and applies on an average basis for phased awards, for example, an award vesting over 3 to 7 years).

However, our Executive Remuneration Report provided compelling evidence that traditional remuneration plans are not conducive to supporting long-term purposeful companies but instead can create powerful incentives for short-termism. Particularly problematic is over-use of target-based pay plans which create incentives for short-term behaviour to hit targets. The Code should not be prescriptive on remuneration design but could helpfully reinforce the growing flexibility being shown by shareholders to look at simpler, long-term structures. As part of this, the Code could helpfully reinforce the work of the Investment Association’s Executive Remuneration Working Group, which encouraged greater diversity in plan design and greater use of plans that use are based on long-term shareholding rather than targets to create alignment.

The place to achieve this would be in provision 40, which could be amended as follows:

‘Executive remuneration should support long-term company performance and value generation. Remuneration committees should consider the behavioural risks that can arise from target-based plans, and how these are mitigated. In certain circumstances, simpler arrangements based on long-term stock awards may be more effective than target-based long-term incentives.’
The Guidance could reference the final report of the Investment Association Executive Remuneration Working Group and the range of alternatives considered there, including restricted stock and performance-on grant schemes, which promote long shareholding through simple structures.

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

Although many companies have already provided for the remuneration committee to have the discretion to adjust outcomes, having an explicit Code Provision requirement that boards must have the ability to override formulaic outcomes will empower the remuneration committee to make adjustments that may be unfavorable to executives. In particular, the provision will encourage remuneration committees to check that award documentation, particularly of long-term incentives, provides them with sufficient powers to over-ride formulaic outcomes where appropriate.
Contact Details

Big Innovation Centre
8th Floor Penthouse
20 Victoria Street
London SW1H 0NF

info@biginnovationcentre.com
www.biginnovationcentre.com

Launched in September 2011, Big Innovation Centre is a hub of innovative companies and organisations, thought leaders, universities and ‘what works’ open innovators. Together we test and realise our commercial and public-purpose ideas to promote company and national innovative capabilities in a non-competitive and neutral environment. We act as catalysts in co-shaping innovation and business model strategies that are both practical and intellectually grounded. Our vision is to help make the UK a Global Open Innovation and Investment Hub by 2025, and to build similar initiatives internationally. For further details, please visit www.biginnovationcentre.com

All rights reserved © Big Innovation Centre. No part of this publication may be reproduced, stored in a retrieval system or transmitted, in any form without prior written permission of the publishers. For more information contact h.lawrence@biginnovationcentre.com. Big Innovation Centre Ltd registered as a company limited by shares No. 8613849. Registered address: Ergon House, Horseferry Road, London SW1P 2AL, UK.