



The Law Society

Law Society response to the Financial Reporting Council's proposed revisions to the UK Corporate Governance Code

February 2018



Preface

1. The Law Society ('the Society') is the professional body for solicitors in England and Wales, representing over 170,000 registered legal practitioners. The Society represents the profession to parliament, government and regulatory bodies and has a public interest in the reform of the law. The proposed new UK Corporate Governance Code ("Code") and related consultation documents have been considered by the Company Law Committee of The Society.

Introduction

2. We welcome the opportunity to respond to the Financial Reporting Council's ("FRC") proposed revisions to the Code and Guidance on Board Effectiveness, as well as a number of high-level questions on the UK Stewardship Code. Our response will focus on the relationship of the Code with the law as it currently stands and as it may become in the years ahead. We will respond to those questions which are relevant to matters of law and practice.
3. We would also be happy to meet with the FRC to discuss any of the matters raised.

General Comments

4. The Law Society is a strong advocate of good and effective governance, sound ethics in business and legal certainty. The on-going debate as to the future of company law and corporate governance is an important one, especially at the moment when we want to ensure that the UK remains one of the world's top jurisdictions for businesses to choose for their incorporation.
5. We are supportive of the FRC's continued focus to encourage greater precision in governance disclosures and to support the development of a good governance culture within businesses. The decision to reduce the length of the Code and to render it a more focussed document is welcome.
6. There are three broad issues that we believe the FRC should consider before finalising the Code. These are:
 - the position of the Code within the wider legal framework;
 - the proposed prescriptive approach to independence; and
 - the possible interpretation that workers should be elevated to a level that is above the interests of other stakeholders.

The position of the Code within the wider legal framework

7. We have concerns with the drafting of the section of Principle A in bold below. These concerns are heightened by the fact that this is the text of a principle, rather than one of the supportive provisions.

*"A successful company is led by an effective and entrepreneurial board, **whose function is to promote the long-term sustainable success of the company, generate value for shareholders and contribute to wider society.** The board should establish the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned."*

8. We consider the text to express laudable aims and it may reflect what enlightened companies would consider to be best practice. However, in our view, it does not reflect the current legal position. Previous versions of the Code have respected the legal duties of directors and we think it is important that it should continue to do so. The Principles (being mandatory) should not impose changes on the legal position as to do so would usurp Parliament. For so long as Section 172 of the Companies Act remains in its current form those duties do not include a general duty to take stakeholder interests into account and the Code should encourage companies to take more account of wider stakeholder interests through Provisions and not through Principles. We question whether it would be a proper use of the FRC's powers to override the statutory requirements in the way that is proposed. The Law Society expresses no view on whether the law on the duties of directors should be developed in the way the Principle is drafted.
9. The legal framework for directors' duties rests on the primacy of shareholder interests. In most cases, the interests of shareholders will be best served if the board has a long-term vision and strategy for the company and is a good corporate citizen, cognisant of the role the company must play within the community. However, the law does not require the board to prioritise long term consequences over other matters and there may be situations in which the focus of the directors must be short-term. Nor does the law require the board to introduce the principle of making a positive contribution to society as an organisational aim. Instead the law sets out the duties directors have to their shareholders to promote the success of the company for the benefit of its shareholders as a whole, and has codified certain stakeholder interests as amongst the factors the board must consider when seeking to do so. As currently drafted, the section of Principle A we highlight risks creating difficulties for directors in trying to reconcile the Principles with their statutory duties.
10. We set out below revised wording for Principle A that would respect the legal position:

"A successful company is led by an effective and entrepreneurial board. The primary function of the board is to promote the success of the company for the benefit of its members as a whole. In doing this, the board must have regard to a number of factors, including long-term consequences, interests of employees, the importance of relationships with customers, suppliers and others and the position of the company within wider society. The board should establish the company's strategy and values, and satisfy itself that these and its culture are aligned."
11. Alternatively, if this is not acceptable, we would at least suggest that the words "whose function is to" in Principle A be replaced with the words "which should".
12. The objections to the drafting of Principle A also apply to Principle C, which assumes "responsibilities" to stakeholders other than shareholders and imposes an obligation to engage with such stakeholders. There is no legal basis for this and these requirements should be expressed in a Provision and not in a Principle.
13. We also believe the words "encourage participation from these parties" in Principle C are overly directive. It may be that certain stakeholders have no desire to participate, or certain objectively-defined stakeholder groups are not relevant to a particular company. Furthermore, the statutory stakeholder factors contained in

section 172(1)(a)-(f) of the Companies Act 2006 are not always represented by legal persons.

The proposed prescriptive approach to independence

14. In relation to Provision 15 (in section 2 of the Code), we do not think it would be helpful if the existence of one of the listed relationships or circumstances were to automatically mean that a director would not be considered independent. This is the implication of the wording in the proposed revised Code (although we note this appears inconsistent with the intent stated in paragraph 52 of the consultation document).
15. The wording of the current version of the Code provides helpful flexibility, as there can be circumstances in which the presence of such a relationship or circumstance is not incompatible with a director's independence. It also focuses on the principle of the other directors making a proper informed judgement as to whether a particular director is or is not independent in character and judgement, taking account of the listed factors (and any other relevant factors).
16. Changing the way independence is defined in this way could lead to the judgement of independence being less considered, and more a "tick box" exercise, and to directors losing their status as independent for the purposes of the Code when this is not appropriate. We do not object to a change in emphasis on independence, provided it is clear that flexibility remains for the board ultimately to determine a director's independence.
17. As well as impacting on the independent/non-independent balance of the board itself, the change implied by the wording of revised Code Provision 15 would be likely to affect the balance of a company's committees, and this could lead to a number of companies having to "explain" rather than "comply" with this part of the Code. Although companies can explain non-compliance, that non-compliance in practice comes with a suggestion that the company is not aligned with good governance practice.
18. We also question the change subjecting a chairman to the independence criteria on an on-going basis. This is a significant change from the current Code, which makes it clear that the independence criteria are only relevant to the chairman on appointment. In particular, we question whether it is appropriate or necessary for nine years of board service by a chair to render them automatically not independent for the purposes of the Code. This could deter the appointment of a chair from among the existing directors. Long-term experience on the board can be an important factor for a new chairman, so flexibility within the Code should be maintained.

The possible interpretation that workers should be elevated to a level that is above the interests of other stakeholders

19. We are concerned that, taken together, some of the proposed changes could elevate the standing of the workforce to being a superior stakeholder to others. Balancing the interests of stakeholders is a fundamental skill for the leadership of all organisations. It is important that organisations have the flexibility to implement measures in a manner which is appropriate to their particular circumstances. This includes weighing the interests of different stakeholder groups.

20. Principle D¹ emphasises the ethical elements of being a company director and reflects the fact that the interests of good governance extend beyond the boardroom. The second sentence of Principle D should be in a separate Provision (perhaps Provision 3) and should not be a Principle.
21. We have a concern about how Provision 3 gives specific consideration to the views of the workforce. This will encourage companies to mainly focus on engagement mechanisms with the workforce rather than other stakeholders as well (as section 172 of the Companies Act requires).
22. In our view a board position could potentially be less effective at ensuring the voice of the worker is considered than Works Council or similar arrangements. Such an appointment could also create deeper issues in relation to conflicts of interest. Matters to be considered by a company's board will often be commercially sensitive or confidential and it may not always be practicable or appropriate for those issues to be discussed with all groups of stakeholders.
23. We appreciate that this directly reflects what was set out in the Government's 2017 Green Paper response on the issue of corporate governance, though the Government has yet to proceed with any legislation on the matter. It is not clear from the Code how the "workforce" is defined. Section 172(1)(b) of the Companies Act 2006 refers to employees, rather than the workforce.
24. Provision 4 refers to the board explaining in the annual report how it has engaged with stakeholders and how their interests and the matters set out in section 172 of the Companies Act 2006 influenced the board's decision making. This is something that the Government has stated that it will address by way of regulation. It is not appropriate to pre-empt any such regulation, or have similar requirements in the Code as well, as this would either just replicate the requirements of the regulations, or risk being inconsistent with them (at least until such time as the Code is adapted to be consistent). Also, it will not work for non-UK companies that are listed in London and are complying with the Code. In our view, this provision should just refer to a requirement to explain how the board has engaged with stakeholders. In addition, we note that the Companies Act already contains a requirement to report against section 172, this being (under section 414C) the purpose of the strategic report. We would therefore suggest that the better place for a provision of this nature would be the FRC's Guidance on the Strategic Report.
25. Provision 7 refers to a requirement for the board to "eliminate" conflicts of interest. This is not possible. Instead the provision should refer to conflicts being disclosed and managed.

¹ Principle D: All directors must act with integrity and lead by example in the best interests of the company. The workforce should be able to raise concerns in relation to management and colleagues where they consider that conduct is not consistent with the company's values and responsibilities.

Consultation questions

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

If the Code is now to apply in its entirety to companies below the FTSE 350 then thought should be given to having a longer transitional period for some of the more onerous requirements, such as restructuring the board and board committees to achieve the requisite majority of independent directors.

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

The FRC needs to ensure that the Guidance is consistent with directors' duties at law both in terms of the expectations and also the way in which directors' duties are described in the Guidance.

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

We are content with the proposed methods and consider that the FRC is correct to be agnostic as to method. However, as we have noted above, we do have significant concerns about an apparent elevation of the workforce above other stakeholders.

We consider it should be equally valid for a board to extend the remit of one of its committees to employee engagement, rather than only reference individual non-executive directors. The use of the word "normal" in the Code suggests that one of the three suggested methods should be chosen, which would unnecessarily restrict organisations.

We are supportive of boards gathering the views of the workforce as part of both good governance and good employment practice, though are sceptical as to whether a special regime or status is required to make feedback loops effective. Organisations should have the flexibility to decide how best to hear the voice of the worker.

In relation to the reference in Provision 3 to there being a means for the workforce to raise concerns, we consider that this should be (and already is) a matter for legislation or regulation, rather than the Code. There is also a need for flexibility, given that whistleblowing regulation varies by jurisdiction.

More generally, it is not clear what the reference to "workforce" is intended to encompass. As stated in our introduction, it may be clearer to refer to employees given this is the stakeholder group that is referred to in section 172. The Government's Green Paper from last year also referred to employee engagement mechanisms rather than workforce. If the FRC want to refer to workforce, then maybe this should be addressed in the Guidance rather than the Principle to avoid a suggestion that there is one size that fits all.

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 would not be in favour of including more specific references to other principles or guidance in the Code itself (or indeed in the Guidance that is attached to the Code) as that risks creating more scope for confusion and conflicting guidance.

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 agree that to set a precise level will assist companies, investors and others considering the company. To depart from the subjective word “significant” reduces the risk of poor practice.

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.

We believe that an independent board evaluation is a positive step and a necessary health check for a company. However, we anticipate that some smaller companies (for which cost will be relevant) will be resistant to this being mandated.

Although this consultation question refers to an “independent” board evaluation, we note that in fact there is no requirement for the third party provider of the evaluation to be independent – instead there is a requirement to disclose any connection with the company.

This raises an important question as to whether the FRC sees a future for small and micro caps on public markets and, in particular, what size of company is appropriate for a Premium Listing where complying or explaining against the Code is mandatory. We would suggest that at the very least the preface acknowledges that for certain companies it will not be possible or practicable to comply with all Code requirements, but it is vital for all companies to be cognisant of each requirement and to specifically consider how to deliver good governance notwithstanding non-compliance with a requirement, through the lens of clear adherence to the principles.

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 agree that this remains an appropriate period of time after which a company would need to question whether a director could still be seen as independent of character and judgement. However, we do not agree with the proposed approach in the revised Code in requiring the independence of the chairman to be tested on an on-going basis. We do not see any basis for changing the position under the existing Code, where this is tested at the time of appointment but after that the chairman is not regarded as independent given the hybrid nature of the role.

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

Yes. It is important for a principles-based approach to ensure that a company can continue to determine appropriate governance arrangements.

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 do not think that changes to the Code will, of themselves, deliver greater diversity in the boardroom, in the executive pipeline and in the company. However, it is important for the FRC to support and encourage this and therefore the change is welcome.

Board succession planning has been noted to be an area of structural weakness within many organisations. The role of the nominations committee is important and bodies such as ICSA: The Governance Institute have carried out important work to highlight the significance of this (for example, the nomination committee – coming out of the shadows report it prepared with EY, prefaced by the chair of the FRC:

<https://www.icsa.org.uk/assets/files/policy/research/ey-nomination-committee-digital.pdf>).

Initiatives to promote greater diversity throughout UK business should be coordinated with initiatives which seek to make boards less susceptible to shock upon the departure of any single individual. Greater diversity should erode the force of personality, thereby supporting more sustainable company performance.

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.

Yes. We think that it will be healthy for companies of all sizes to provide this additional disclosure.

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.

This might prove challenging as ethnicity is not always clear cut and represents a sensitive issue. Organisations have different approaches to performance management and succession planning, so it may be hard to understand what the reporting means. For example, there may not be a single identified “pipeline” as such within a business, with people being promoted through a variety of routes and roles, so it could be difficult to report on this matter.

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 otherwise the Code would be less easy to read as it would become harder to navigate.

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 are generally supportive of the proposed expansion of the role of the remuneration committee, but it should be done in conjunction with the executive directors for colleagues below board/exco level. The remuneration committee should not set non-executive pay given the remuneration committee members themselves will all be non-executives.

An effective remuneration committee should not make an award without considering the wider context of remuneration arrangements elsewhere within the organisation.

The issue around defining the "workforce" identified in our response to question 3 also applies here. In addition, the wording of Provision 33 should be clarified – presumably the committee will oversee workforce remuneration policies and practices, not all workforce policies and practices.

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

We do not think that it is appropriate for The Law Society to respond to this question.

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

We do not think that it is appropriate for The Law Society to respond to this question.

UK Stewardship Code

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?

The services provided by governance advisory firms are an area of sensitivity. We consider that it would be unhelpful for the FRC to create a standard separate from the Best Practice Principles Group. It would be better for the

FRC to work with the structures that are already in development by supporting and challenging the work of that group to ensure that a single Stewardship Code drives good practice for shareholder voting advisory firms.

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?

Whilst conceptually attractive, this would be difficult, because shareholder engagement may present itself very differently in relation to different companies.

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?

The FRC could promote a competition or award to highlight examples of outstanding stewardship and stewardship reporting.

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

The more the Stewardship Code is developed as the “other side of the same coin” as the Code, the more effective the two codes will be.

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

We do not think that it is appropriate for The Law Society to respond to this question.

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?

We do not think that it is appropriate to consider this issue until the major point we have raised at the beginning of this response is fully considered. This should only be considered upon a change of primary legislation.

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 do not think that it is appropriate for The Law Society to respond to this question.

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

We do not think that it is appropriate for The Law Society to respond to this question.

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

As per our response to question 4, we believe that setting the Stewardship Code in a wider international context would be helpful.

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?

We do not think that it is appropriate for The Law Society to respond to this question.

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

We do not think that it is appropriate for The Law Society to respond to this question.

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

There is an appeal to such a requirement, which may encourage investors to consider diversity issues within their own businesses as much as applying pressure on investee companies to do so.

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

We do not think that this needs to be explicit as (at least where the investor is a UK preparer) the investor itself will need to consider such issues as part of its annual report and financial statements.

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?

We are neutral as to this but do have some concerns that this might give rise to anodyne disclosure which will be of little benefit.

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?

We do not think that it is appropriate for The Law Society to respond to this question.