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Dear Sir or Madam,

Proposed Revisions to the UK Corporate Governance Code

Thank you for giving the Institute of Directors (IoD) the opportunity to provide written evidence in response to your consultation on proposed changes to the UK Corporate Governance Code. This consultation is of considerable interest to the IoD, its membership and the wider community of board members, and we are therefore pleased to present our views in respect of your proposals.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 30,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. IoD members are represented on a number of FTSE boards, but the majority of our membership, some 70%, are directors of small and medium-sized enterprises (SMEs), ranging from long-established businesses to start-up companies. IoD members' organisations are entrepreneurial and growth-orientated, and more than half (57%) export goods and services internationally.

Issues of corporate governance are of particular concern to the IoD. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings." We strongly believe that an effective system of corporate governance is a key underpinning of UK economic performance and business legitimacy. Our response to this consultation is divided into three sections:

i) Summary of our view

ii) Responses to the specific consultation questions

iii) Detailed comments relating to individual Principals and Provisions

Summary of our view

- We are supportive of this comprehensive revision of the UK Corporate Governance Code. Overall, we agree that the FRC has made the Code “shorter and sharper”. Furthermore, the Code now takes better account of a number of key governance issues, such as corporate culture, stakeholder engagement, boardroom diversity and the importance of a long-term business perspective.
- However, given the ambitious scope of this review, we do have concerns about some of the details. In some cases, these concerns relate to drafting and communication, whereas in others they are more substantive in nature.

New features of the proposed Code which we support include the following:

- The restructuring and simplification of the Code into 5 new sections, consisting of Principles and Provisions.
- A greater emphasis on reporting against the Code’s Principles, not just its Provisions;
- Incorporating the key findings of recent FRC work on the role of boards in developing and overseeing corporate culture;
- A greater emphasis on the need of the board to interact with, and take account of, stakeholders – particularly the workforce – and the desire to better align the Code with the general duties of directors which are defined in the Companies Act 2006;
- Highlighting the need of the board to take a longer-term perspective, including with respect to executive remuneration policy. In particular, we support a 5 year minimum vesting period for all share awards or incentive plans;
- Further development of the Code’s recommendations in respect of diversity, both within the boardroom and in the wider organisation.

However aspects of the proposed Code where we have concerns or differing views include the following:

- We are concerned about the moving of certain key recommendations from the current Code into the FRC’s Guidance on Board Effectiveness. We believe that this step will significantly reduce their visibility, and could have a negative impact on governance practices and behaviour;
- In particular, we strongly advocate the retention of supporting principle B.4., concerning the professional development of board members, in the main UK Corporate Governance Code. If anything, the role of director development in good governance should be more emphasized than currently;
- We disagree with the significant expansion of the role of the remuneration committee to oversee the entirety of workforce policies and practices. Although this is an important board-level topic, the Code is being too prescriptive in defining how it should be addressed by boards;
- We disagree with the new recommendation stating that Chairs of remuneration committees should have at least 12 months experience of serving on remuneration committees. We are not persuaded that this will improve remuneration outcomes;
- Although we support the new recommendation that remuneration policies should provide boards with discretion to override excessive executive bonuses, we are concerned that this may be difficult to implement in practice unless such policies are fully aligned with executive employment contracts.

In addition, we would like to see the Code addressing the following issues:

- In the wake of the Carillion collapse, we believe that the Code should more explicit about the circumstances in which clawback of executive bonuses should occur. As a minimum, clawback should be required in cases of gross misconduct, material accounting restatements and corporate insolvency;
- We recommend that remuneration reporting should include an indication of the extent to which executive remuneration outcomes have arisen due to share buyback activities.

Specific responses to Consultation Questions

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

No. We are happy with the timeline for Code implementation that is proposed, i.e. with finalisation of the Code in summer 2018, and implementation in respect of accounting periods beginning on or after 1 January 2019.

Q2. Do you have any comments on the revised Guidance?

Viewed on a stand-alone basis, the revised Guidance represents a significant improvement over the previous version. The latest edition has benefitted from the work undertaken by the FRC, ICSA and others on corporate culture, stakeholder engagement and other topics. We find the boxes containing questions and checklists for boards to be a particularly useful feature of the current text.

Our main concern about the Guidance is the extent to which it is likely to influence board behaviour, as compared to the main Code. We support the efforts of the FRC to make the Guidance more visible – however, its status as a non-statutory document may ultimately limit its impact in that respect.

For that reason, we are nervous about the fact that a number of important Code Principles and Provisions are being removed from the Code and placed into the Guidance. Important examples of where this is proposed include the following current Code recommendations:

- “The chairman is responsible for setting the board’s agenda and ensuring that adequate time is available for discussion of all agenda items, in particular strategic issues.” (Supporting Principle A.3).
- “Non-executive directors should undertake that they will have sufficient time to meet what is expected of them. Their other significant commitments should be disclosed to the board before appointment, with a broad indication of the time involved and the board should be informed of subsequent changes.” (Provision B.3.2).
- “The company should provide the necessary resources for developing and updating its directors’ knowledge and capabilities.” (Supporting Principle B.4).
- “The board should ensure that directors, especially non-executive directors, have access to independent professional advice at the company’s expense where they judge it necessary to discharge their responsibilities as directors.” (Provision B.5.1).

We are not persuaded by the argument, advanced in the consultation paper, that these recommendations are no longer needed in the main Code as they are well embedded in company behaviour. We would be interested in seeing the evidence for this assertion. Furthermore, we come across many instances where it is crucial to have these matters formally addressed in the Code if they are to be taken seriously. Explicit Code provisions or recommendations on these issues often provide essential support for those board members who are seeking to advance good governance in what may be difficult or contested boardroom scenarios.

We are particularly concerned that the Code's main current recommendation with respect to the professional development of board members (Supporting Principle B.4) is to be relegated from the Code to the Guidance.

The boards of many major UK companies have yet to embrace the full potential of board level professional development. Our experience is that, following their elevation to the board of a FTSE 350 or FTSE 100 board, this particular sub-group of directors often feel that they are the "finished article" in terms of knowledge and expertise, and can be reluctant to further invest in developing their competence in governance and other key boardroom topics.

We believe that this attitude needs to be challenged. The achievement of improved standards of corporate governance at UK Plc will require a more systematic approach to director education and professional development. The role of a director is increasing complex and specialised, and is not merely an extension of a senior executive role. Particularly in respect of large and complex listed companies, it requires specific training, mentoring and skills development.

For these reasons, we strongly advocate that the importance of professional development for board members remains a prominent feature of the main UK Corporate Governance Code. If anything, its role in good governance should be further emphasized and developed rather than placed in the background.

We do, however, recognise that the retention of the above Principles and Provisions will make it more difficult for the FRC to achieve its laudable aim of a "shorter and sharper" Code. For that reason, we feel that some re-thinking will be needed in order to define a more justifiable basis by which certain recommendations are placed in the Code and others are placed in the Guidance. At the moment, the current basis for this allocation is somewhat arbitrary.

Ultimately, we would not view it as a disaster if the Code were 2-3 pages longer if it meant that the above key recommendations were retained in the main body of the Code.

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

The likely impact of this new Provision is uncertain. This recommendation is one of the most significant additions to the new Code, and embodies a new approach to board-workforce engagement, which we support. However, we expect that it may take time for boards and the workforce to fully understand and operationalise the potential of these new engagement mechanisms.

We acknowledge that the proposal embodied in Provision 3 provides boards with some flexibility over which form of workforce engagement that they adopt. This is a welcome feature of the current proposal relative to earlier more prescriptive government plans. However, the success of each of the proposed options will be crucially dependent on the good-will of both sides. There may be a need to provide support and training to assist in the implementation process.

Furthermore, we are concerned that several of the proposed options could give rise to their own governance issues, which may require further thinking through. For example:

- To what extent would a director appointed by the workforce be subject to general legal duties of directors, i.e. to promote the success of the company in the interests of the shareholders?
- Could such a “worker director” be removed from the board by a majority vote of shareholders, which is the current situation according to UK company law, or only by the workforce?
- How would a formal workforce council be elected and interact with the board?
- To what extent would assigning workforce engagement duties to a specific non-executive director affect his/her current role and responsibilities on the board?

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?

No. We feel that the UK Corporate Governance Code should seek to be a primary source of guidance on good governance rather than a derivative of other initiatives. Hence we would seek to keep cross-referencing of non-regulatory sources of this nature to a minimum.

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?

Yes, we agree with the use of this 20% disapproval threshold – which we see as representing a significant level of shareholder dissent - and with a six month deadline for a company response. More broadly, we are supportive of the overall procedure described in Provision 6 concerning the way in which a board should respond to significant shareholder disapproval of a General Meeting resolution. Overall, we feel that it will help increase the accountability of boards to shareholder concerns.

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.

We are broadly in agreement with this change to the Code. However, we also recognise that some smaller premium-listed companies may reasonably choose to not fully comply with Provision 21, but rather provide an explanation of their preferred approach in their annual report. Investors should consider these explanations on their merits, and be ready to acknowledge that such a formal and rigorous board evaluation process may not always be appropriate for smaller listed companies on an annual or, in the case of external evaluations, tri-annual basis.

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 are broadly in agreement. To some extent, the period of 9 years is an arbitrary period of time with which to define director independence. However, the 9 year limit has been used in the Code for a number of years, and we find no compelling reason to change this limit at the current time. In addition, we feel that it is logical to apply the same time limit to the independence of the Chair as to the other non-executive directors. Any time periods where the Chair has served as regular non-executive director (e.g. prior to his/her appointment as Chair) should also count towards the fulfilment of this limit.

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

We agree. Judgements concerning the tenure of directors on specific boards are best left to each board and its nomination committee. Such bodies are well-placed to make the trade-off between retaining key skills on the board versus the need to refresh board composition and maintain a sufficient proportion of independent board members. Shareholders should be willing to accept that, in some cases, it may be in the interests of the company for a director to remain on the board for some time after they have passed the 9 year limit for director independence.

Q9. Do you agree that the overall changes proposed in Section 3 of 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 agree they are likely to be supportive of progress towards greater diversity, and send an important signal on this issue to boards and wider society. The IoD believes that boardroom diversity across various dimensions – including but not limited to gender, social and ethnic background, and diversity of cognitive and personal strengths – can exert a positive impact on board decision-making.

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.

We agree. It is important for all companies – and certainly those with a premium listing - to consider how they can develop greater gender diversity in the executive pipeline and incorporate more ethnic and social diversity into board composition.

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.

We feel that this would be a useful step for listed companies above a certain size, e.g. in the premium-listed segment. It is, however, important to avoid imposing costly reporting burdens on smaller enterprises.

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?

We agree with retaining these requirements in the Code. One of the challenges facing directors is the increasing fragmentation of the regulatory landscape. In order for board members to gain an appropriate overview, it is useful to have key governance regulations summarised in one place even if they replicated elsewhere in other regulatory frameworks.

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.

We have significant reservations about a number of Principles/Provisions that have been removed from the Code and placed into the Guidance (for a detailed discussion of this issue, see answer to question 2). We see the removal of this specific requirement (relating to the terms of reference of audit committees) as less deleterious compared to some of the other removals. Nonetheless, we believe that the basis on which some recommendations have been removed from the Code should be re-evaluated by the FRC. We are not persuaded by the consultation's assertion that certain recommendations are now "well embodied in corporate behaviour" and can now be removed from the Code. There is a material risk that the removal of recommendations from the main Code could exert a detrimental impact on governance practices and behaviour.

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

We do not agree with the prescriptiveness of this new remit for the remuneration committee. The Code is effectively directing remuneration committees to consider issues which extend well beyond board and executive pay. Effectively, the remuneration committee is being asked to oversee all workforce policies and practices – both pay and non-pay related – across the entire organisation.

This change would represent a transformation in the role of the remuneration committee. It would hugely increase their workload, and could easily divert the focus of their limited resources from addressing what is already a challenging task – namely, defining pay policies for senior executives and board members that enjoy the support of both shareholders and wider society.

Although we accept the finding of the Taylor Review - that the oversight of modern working practices is a key task for corporate governance and the board of directors - boards should be able to determine their own ways of addressing this issue. For the Code to specifically mandate the remuneration committee in this task is too prescriptive, and may dilute the accountability of the remuneration committee in respect of an already challenging role: namely, the oversight of executive pay.

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

The Government has recently announced an investigation into the impact of share buybacks on corporate behaviour. Without pre-empting the findings of this review, we believe that the Code could fulfil a useful governance role by recommending that companies report on the impact on total executive remuneration outcomes that has arisen due to share buyback activities and policies.

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

We have some doubts about how the intention behind Provision 37 will be achieved in practice. Our discussions with major institutional shareholders have suggested that individual employment contracts can be inconsistent with declared remuneration policies. Consequently, in cases where companies may wish to correct egregious remuneration outcomes or prevent rewards for failure on a discretionary basis, it may be difficult for them to do so. We would suggest that the company should also be required to declare that there are no contractual barriers to the implementation of its stated remuneration policy.

Detailed comments on individual Principles and Provisions

Introduction

1st paragraph

We strongly support the continued use of the statement from the Cadbury report that “Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.” This is an essential reminder of a basic principle of corporate governance that should remain at the forefront of the Code.

Section 1 – Leadership and Purpose

Principal A

Although we agree that the boards of private sector companies should direct their enterprises to be responsible corporate citizens and take account of a range of stakeholders, we feel that it is imprecise to state that the board’s proximate role in a private sector company is to “contribute to wider society”. The specific concern of the board is to promote the success of the company – a concept which is captured in doctrine of enlightened shareholder value (section 172 of the Companies Act 2006).

We would suggest the follow kind of alternative wording for Principal A, which we feel is a more accurate description of the role of a private company board: “A successful company is led by an effective and entrepreneurial board, whose function is to promote the long-term success of the company. The board should define the company’s purpose, strategy and values, and satisfy itself that they underpin a corporate culture which contributes to the sustainable success of the company.”

Principal B

We don’t agree that it is for the board to “establish” a framework of prudent and effective controls, which enable risk to be assessed and managed. The role of the board is normally to “oversee” the establishment of such a framework by management, not to establish it themselves.

Principal C

We suggest that wording should be changed from “shareholders and stakeholders” to “shareholders and other stakeholders”. The former wording suggests that shareholders are not stakeholders – which is not accurate.

Provision 1

“The board should assess the basis on which the company generates and preserves value over the long-term”.

We would suggest that better wording would be: “The board should define the basis on which the company generates and preserves value over the long-term.”

“how its governance contributes to the delivery of its strategy.”

We are not entirely clear on what is meant here. What sort of discussion would you envisage?

Provision 2

“Directors should embody and promote the desired culture of the company.”

We suggest the following wording: “Directors should embody and promote the desired values of the company”.

Provision 3

“This would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director”.

In the context of a ‘comply or explain’ provision, isn’t the word “normally” redundant here? It would be clearer if either the company adopts one of the three explicit options for workforce engagement, or explains its reasons for choice of another option.

Provision 5

“the chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against the strategy”.

In our view, engagement with shareholders to discuss performance against strategy is primarily a task for the CEO rather than the Chair. Hence we would suggest the following wording:

“the chair should seek regular engagement with major shareholders in order to understand their views on governance and strategy”.

Provision 7

We are uncertain as to why this Provision on conflicts of interest has been included in the Code given that directors’ treatment of this topic is already determined by company law. Furthermore, the assertion that “The board should take action to identify and eliminate conflicts of interest” is unrealistically stringent. Conflicts of interest of various kinds are a fact of business life. The key governance point for boards is not that they should be identified and eliminated, but that they should be identified, disclosed and managed.

Section 2 – Division of responsibilities

Principal F

“The board should include an appropriate combination of executive and nonexecutive (and, in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates the board’s decision making.”

We feel that this statement should be split into two sentences, as we don’t necessarily see the second point about the need to avoid domination by individuals or cliques as following from the composition of the board in terms of executives and non-executives. We see them as two separate points.

Should become:

“The board should include an appropriate combination of executive and nonexecutive (and, in particular, independent non-executive) directors. No one individual or small group of individuals should dominate the board’s decision making.”

Principal H

“The board, supported by the company secretary, should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.”

Although there is nothing technically wrong with this statement, we think that it would be more useful to make it a statement about the chair’s responsibility rather than a board responsibility.

“The chair, supported by the company secretary, should ensure that the board has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.”

Provision 10

“The chief executive is responsible for proposing strategy to the board, delivering it as agreed, and ensuring timely and balanced information is presented in order for the board to make decisions effectively.”

We feel that this statement is too prescriptive. Boards take differing approaches to the development of strategy. In some instances, the board itself will play a significant role – it will be much more involved in the process than simply challenging or approving/rejecting a strategy that has been proposed by the CEO. We would prefer the Code to reflect this range of possibilities. Our suggested wording is as follows:

“The chief executive should play a key role in proposing strategy to the board, delivering it as agreed, and ensuring timely and balanced information is presented in order for the board to make decisions effectively.”

Provision 14

“External appointments should not be undertaken without prior approval of the board, with the reasons explained in the annual report.”

It is not clear to us as to whether this statement is referring only to executive directors or the entirety of the board. We would agree with the statement in respect of executive directors, but the wording should be adjusted to make it clear that it is not referring to non-executive directors.

Provision 15

Whereas the rest of the Code has switched to using the term “workforce” rather than “employee” (in order to capture those who work for the company but who are not legally-defined employees), the director independence criteria are still using “employee”. For the sake of consistency, we suggest that the same terminology should be used throughout the Code.

Section 3 – Composition, succession and evaluation

Principal I

“The board and its committees should have a balance of skills, experience, independence and knowledge. Board membership should be regularly refreshed.”

We would prefer to use the wording: “Board membership should be regularly reviewed and periodically refreshed”. Although it is important for boards to regularly consider how they can improve themselves in terms of new contributors, it would be going too far to suggest that boards should be constantly turning themselves over in terms of composition. A measure of stability can in some circumstance be the right option.

Principal K

“Regular evaluation of the board should consider the balance of skills, experience, independence and knowledge, its diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.”

We feel that the last three words of the first sentence (“to achieve objectives”) are redundant and can be deleted. In the second sentence, we would recommend replacing “demonstrate” with “determine”.

Provision 23

This states that the annual report should provide “an explanation of how diversity supports the company in meeting its strategic objectives”.

Whilst we are fully supportive of the other revisions to the Code which seek to promote diversity across various dimensions (e.g. gender, ethnic diversity, cognitive diversity, etc), we are not clear about the intention behind this specific provision. We suspect that it may generate boilerplate-type statements which will not be particularly helpful to shareholders or other stakeholders.

Section 4 – Audit, risk and internal control

Principal N

“The board should establish the risk and internal control framework...”

In our view, it is important to distinguish between the board’s role in overseeing risk management and internal control (and satisfying itself that it is fit for purpose), and executive management’s role in actually implementing these activities. For that reason, it is not accurate to state that board should “establish” this framework. A better wording would be as follows:

“The board should oversee the establishment of the risk and internal control framework by management...”

Section 5 – Remuneration

Principal O

“The board should satisfy itself that company remuneration and workforce policies and practices promote its long-term success and are aligned with its strategy and values.”

Is this statement referring to workplace remuneration policies and practices, or workplace policies and practices more generally? It is not entirely clear from a reading of the Code alone. We would recommend a clarification in the drafting – both in this Principal and in the other provisions where this wording is utilised.

Provision 32

“Before appointment as chair of the remuneration committee, the appointee should have served on a remuneration committee for at least 12 months.”

We do not agree with this new addition to the Code. It is too prescriptive and we are not convinced that it will do much to improve remuneration outcomes. Furthermore, if such a recommendation were to apply to the chair of remuneration committees, why should a similar recommendation not also apply to the chairs of other board committees, e.g. the audit committee? We note that a similar experience requirement is not being applied to the chairs of these other committees, and believe that the remuneration committee chair should not be singled out for a different approach.

Provision 34

“Levels of remuneration for the chair and all non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for all non-executive directors should not include share options or other performance-related elements. “

We agree with the wording of this Provision. However, we wish to add that remuneration for non-executive directors could also reasonably include payments in the form of company shares in addition to, or instead of, cash payments. We see nothing wrong with NEDs becoming stockholders of the company as long as these awards are not performance related at the time of the award. It would be useful for the Code to be clear that such stock awards should be seen as distinct from the award of share options or other forms of performance-related incentivisation.

Provision 37

“Remuneration schemes and policies should provide boards with discretion to override formulaic outcomes. They should also include provisions that would enable the company to recover and/or withhold sums or share awards, and specify the circumstances in which it would be appropriate to do so.”

We agree with the intention behind this Provision. However, we are concerned by reports arising from our discussions with major institutional shareholders who claim that the individual employment contracts of senior executives are often found to be inconsistent with the company’s declared remuneration policies. Consequently, in cases where companies may wish to correct egregious remuneration outcomes or prevent rewards for failure, it may not legally be possible for them to do so. We would suggest that the company should also be required to declare that there are no contractual barriers to the implementation of its stated remuneration policy.

Given public concerns surrounding rewards for failure, we also believe that the Code should be more explicit about the circumstances in which the company should recover and/or withhold sums or share awards. It should not restrict itself to simply reporting those circumstances. We would recommend that, as a minimum, a company should commit itself to recovering and/or withholding sums or share awards in circumstances of material accounting restatements, gross misconduct and the entry of the company into any kind of insolvency procedure.

I hope you have found our comments helpful. If you require further information about our views, please do not hesitate to contact me.

Kind regards,

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