PRI RESPONSE

REVIEW OF THE UK CORPORATE GOVERNANCE CODE

13 September 2023

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To inform this briefing, the following investor group has been consulted: PRI Global Policy Reference Group. This consultation is not an endorsement or acknowledgement of the views expressed in this briefing.
ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a range of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

ABOUT THIS CONSULTATION

The current edition of the UK Corporate Governance Code was published in 2018. The Financial Reporting Council (FRC) has specified that this is not a wide-ranging review of the Code (unlike the 2018 revision), but a response to the UK government consultation on Restoring Trust in Audit and Corporate Governance in 2022. The UK government invited the FRC to strengthen the UK Corporate Governance Code in specific areas, especially Section 4 on Audit, Risk and Internal Controls. The FRC is seeking input from interested parties on the proposed revisions.

The PRI welcomes the opportunity to share our views on this revision of the UK Corporate Governance Code, and the various opportunities provided by the FRC to share feedback during the consultation period.

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KEY RECOMMENDATIONS

The PRI welcomes this revision of the UK Corporate Governance Code. The majority of the proposed changes to the Code seek to incorporate and reflect current market practice in corporate governance, rather than set out new expectations. This is with the exception of Section 4, where the FRC is proposing more substantial changes in response to the Government's recommendation to strengthen internal controls and risk management as part of the legislative and governance reforms to restoring trust in audit and corporate governance.

While the Code applies to companies with a premium listing on the London Stock Exchange, it has a much broader reach and impact. The Code is viewed as a standard on corporate governance by many actors within and outside the UK. It plays a fundamental role in consolidating and creating a common baseline of sound corporate governance principles. A key characteristic of the Code is that it operates on a “comply or explain” basis, which reflects the fact that there is no single approach to corporate governance appropriate for all companies.

The PRI is particularly supportive of the following revisions:

■ a greater emphasis on outcomes-based reporting to complement the “comply or explain” nature of the Code;

■ increased transparency on director appointments and significant appointments which will allow investors to make more informed judgments on director’s capacities to discharge of their duties; and

■ the inclusion of narrative (sustainability) reporting within the remit of audit committees as investors view reporting on sustainability issues as decision-useful and material to their investment decisions.

We encourage the FRC to consider the following further recommendations:

■ the Code should encourage companies to disclose information on the sustainability related skills and experience of board members;

■ the Code should encourage companies to disclose information on the governance arrangements for the oversight of sustainability matters; and

■ the PRI does not support the removal of the reference to pay gaps in Provision 41 as we do not consider that this reference will lead to duplicate disclosures for reporting entities.
SECTION 1 – BOARD LEADERSHIP AND COMPANY PURPOSE

Question 1: Do you agree that the changes to Principle D in section 1 of the Code will deliver more outcomes-based reporting?

The PRI strongly agrees that more outcomes-based reporting is needed. Reporting on outcomes should become more embedded and systematic within reporting organisations. The flexibility that the Code’s “comply or explain” approach affords to companies means that investors expect companies to provide a clear and convincing rationale for departing from the Code’s provisions, explaining why such departure is reasonable and appropriate. Companies could support their rationale by providing examples of specific outcomes that they have seen as a result of not applying a specific Code provision. A greater and more explicit focus on outcomes would therefore strengthen reporting against the Code and complement its comply or explain nature.

The FRC should consider providing more formal reporting guidance, similar to the FRC’s report on improving the quality of comply or explain reporting. To do so, the FRC could build on its Annual Review of the Reporting where there are some examples of outcomes-based reporting.

Question 2: Do you think the board should report on the company’s climate ambitions and transition planning, in the context of its strategy, as well as the surrounding governance?

The PRI welcomes the explicit reference to environmental and social matters, as well as the provision that boards should report on their assessment of climate ambitions and transition planning.

Currently, there are no provisions in the Code relating to the disclosure of board skills and expertise on sustainability issues. Investors increasingly expect companies to disclose information around board members’ skills and experience, on both climate and sustainability issues. However, as highlighted in the FRC’s last annual review of Corporate Governance Reporting, reporting on board expertise on climate remains low.

Given that the proposed changes to the Code would require greater oversight from the Audit committee on sustainability matters, it is increasingly necessary for investors to understand whether boards have skills and expertise related sustainability issues.

The FRC should consider revisions to the Code to make reporting on skills more of a focus for companies. Investors welcome disclosures on measures taken to bridge such skills and experience gaps. This includes inclusion in the research criteria for future board members, external training, briefings by management-level committees.

This will also ensure the Code reflects latest developments: for instance, the UK Transition Plan Taskforce’s draft disclosure framework which includes governance as one of five key pillars, requiring entities to describe their arrangements for board-level governance of the transition plan, including the process of board-level review and approval of the plan, and oversight of monitoring and reporting of progress against the entity’s climate objectives and priorities.
Question 3: Do you have any comments on the other changes proposed to Section 1?

Effective whistleblowing mechanisms are a key feature of good governance, as well as being reflective of a healthy corporate culture centred on trust and responsiveness. We therefore recommend that the FRC encourage companies to report on their whistleblowing mechanisms. This should be proposed through Code provisions, including reporting on the board responsibility for establishing a whistleblowing framework and monitoring its enforcement.

Company boards have a crucial role in creating "speak-up" or "listen-up" cultures, and should clearly understand the steps taken to resolve issues raised through whistleblowing mechanisms and communicate how information received is integrated into the company’s risk management strategy. The presence, or absence, of disclosure of whistleblowing mechanisms and board oversight can enable investors to assess companies’ risk management practices, as well as their overall corporate culture.

The 2021 FRC Report Creating Positive Culture found that almost all of the 134 engaged companies have a whistleblowing hotline so it is reasonable to embed a reference to whistleblowing in the Code given that most companies are already reporting on the issue.

Lastly, the PRI recently expressed concerns over the Financial Conduct Authority’s (FCA) proposed equity listing rule reforms around dual-class share structures. If these proposals are to be implemented, the Code should state that companies with such structures need to report on the implications on shareholder engagement and the measures put in place to ensure the views of shareholders are considered.

SECTION 2 – DIVISION OF RESPONSIBILITIES

Question 4: Do you agree with the proposed change to Code Principle K (in section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?

And

Question 5: Do you agree with the proposed change to Code Provision 15, which is designed to encourage greater transparency on directors’ commitments to other organisations?

The PRI strongly supports the proposed changes to Code Principle K and Provision 15. Investors are increasingly considering the number of board mandates and other commitments held by directors to assess whether directors can discharge of their responsibilities to shareholders. Increased transparency on director appointments and their capacity to undertake their role effectively is therefore beneficial for investors.

We also welcome the inclusion of significant external commitments as part of board performance reviews. Commitments to other organisations should be considered within board members individual performance review.

Enhanced outcomes-based reporting requires that companies focus their reporting on how directors and new appointments, especially directors holding key committee positions, have sufficient time to perform all of their duties. Greater disclosures will help companies pre-empt and anticipate investor queries on potentially over-committed directors.
The FRC should consider providing further guidance for companies to assess directors’ commitments to other organisations. For example, guidance could define what a significant external commitment entails, and how this affects board members performance evaluation. We do not expect the FRC to formulate a prescriptive definition of “significant commitment,” but more clarity and guiding principles for companies would be beneficial. This would create a level of consistency that will better enable investors to make assessments and comparisons between companies.

SECTION 3 – COMPOSITION, SUCCESSION AND EVALUATION

Question 6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication?

And

Question 7: Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

The PRI welcomes the reference to inclusion in Principle I in the new Code, as investors increasingly expect companies to not only reach diversity targets but also promote genuine inclusion. The amended language and emphasis on inclusion should capture the broader diversity and inclusion considerations that companies must take into account to meet the requirements of stakeholders and investors. This shifts away from focusing solely on gender or ethnic diversity, and to further consider wider aspects of diversity, such as diversity of social backgrounds and skills.

The proposed changes strengthen the Code’s provisions on diversity and inclusion, without contributing to a more fragmented reporting and regulatory landscape. This is because this provision is not introducing any new definition of diversity or any new disclosure requirements. It is not the role of the Code or the FRC to set out a definition of diversity, as this could result in duplication e.g., some characteristics are already defined by law under the Equality Act. Any clarification, if necessary, can be provided through additional guidance.

Question 8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?

The PRI is supportive of the Code’s greater emphasis on reporting from nomination committees on how diversity and inclusion considerations were factored into decision-making processes. We expect that such reporting should lead to nomination committees giving greater priority to the consideration of diversity aspects in succession planning.

Therefore, PRI considers the changes in Provision 24 to be reasonable and appropriate to encourage companies to disclose information on how they are building a pipeline of diverse pool of potential future appointments, internally and externally, to address the shortage of talent.

The PRI also supports the introduction of senior management and their direct reports in Provision 24 in the new Code, as diversity both at within leadership positions at senior executive and at board level are necessary to ensure that the benefits of greater diversity are fully realised. The 2022 edition of the Female FTSE Board Report found that while women now account for almost 40% of directors on FTSE 100 boards, two-fifths of FTSE 100 firms don’t have at least one woman among one of their the top four executive roles, and there are only nine female CEOs in the FTSE 100.
The Code states that the board and its committees should have a combination of skills, experience, and knowledge. However, a recent study showed that two thirds of board members in the UK do not feel they have sufficient skills and understanding in relation to ESG. Investors are interested in understanding whether and how nomination committees are working to remediate these knowledge gaps through their search and nomination procedures.

Question 9: Do you support the proposed adoption of the Chartered Governance Institute recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?

We welcome the requirement for a commissioned board performance review. The requirement for FTSE 350 companies to commission, rather than consider an external reviewer at least every three years, is also a positive change. Investors increasingly expect companies to use external providers to conduct board evaluation reviews because of the additional benefits of an external evaluation. An externally facilitated review allows for an independent and objective assessment of board performance. Boards can also benefit from bringing in a fresh perspective on their performance as external reviewers have experience in assessing other boards’ performance. In a similar way, external reviewers may be more confident pointing out weaknesses and areas for improvement compared to internal reviewers.

SECTION 4 – AUDIT, RISK AND INTERNAL CONTROL

Question 10: Do you agree that all Code companies should prepare an Audit and Assurance Policy, on a ‘comply or explain’ basis?

The PRI previously welcomed the requirement for companies to publish an Audit and Assurance Policy in our response to the BEIS consultation on Restoring Trust in Audit and Corporate Governance. We consider that all Code companies, not just Public Interest Entity (PIE) companies, should prepare an Audit and Assurance Policy on a comply or explain basis. This ensures the Code creates a single set of requirements for all Code companies, and enables investors to make assessments and comparisons between companies. An Audit and Assurance Policy would serve as a useful starting point for investors to assess a company’s approach to internal control frameworks, audit, and independent assurance, as well as how stakeholders’ views have been considered.

The PRI welcomes the revised responsibilities of the Audit Committee to engage with shareholders. We consider that Audit and Assurance policies will, over time, drive greater and more informed investor engagement with the audit process as a whole.

Question 12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

We agree that the remit of audit committees should be expanded to include narrative reporting, as well as sustainability reporting, and where appropriate, ESG metrics. Investors view reporting on sustainability issues as decision-useful and material to their investment decisions, alongside
financial information. As set out in the PRI's Investor Data Needs framework, for data to be decision-useful, it must be of sufficient quality.

Greater oversight by the Audit committee, who have experience overseeing financial reporting, is necessary to ensure that sustainability information benefits from a level of reliability and oversight that is proportionate to its growing importance to investors.

Regarding the concerns of companies and other stakeholders on the increasing workload and expanding remit of Audit committees, this Provision clarifies that the Audit committee is not the only committee overseeing sustainability reporting. A standalone committee or other directors should still work with, and support, the work of the Audit committee. While sustainability matters should be a focus area for the entire board, audit committees’ experience in financial reporting should be leveraged and built upon for narrative and sustainability reporting.

Further, investors increasingly seek to understand where the ownership and responsibility for the oversight of sustainability matters sit within the board. This includes matters related to reporting, strategy, review, management of sustainability-related risks. The PRI agrees with the FRC’s approach to not be prescriptive on the appropriate arrangements for the governance of sustainability, such as whether companies should have a standalone committee for sustainability issues. However, investors need information on the structure companies have established, along with an explanation on the effectiveness of the structure and why it is adapted to the company’s own circumstances. It is currently unclear whether the Code requires companies to disclose such information. The addition of an explicit provision in the Code, or standalone guidance, is necessary to prompt companies to report on their governance of sustainability issues.

Question 15: Where controls are referenced in the Code, should 'financial' be changed to 'reporting' to capture controls on narrative as well as financial reporting, or should reporting be limited to controls over financial reporting?

As set out in our response to question 12, sustainability information is material for investment decisions. The reliability and robustness of controls around narrative reporting should increase over time, to reach levels of integrity and oversight equal or closer to that of financial reporting. Therefore, reporting by companies should capture controls on both financial and narrative reporting.

Such changes are appropriate given that the Code asks companies to report on their controls over narrative reporting and companies remain free to explain why controls over narrative reporting differ from controls on financial reporting.

SECTION 5 – REMUNERATION

Question 22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

The PRI welcomes the explicit reference to the alignment of remuneration outcomes and ESG objectives. Executive remuneration should be aligned with corporate strategy and performance to drive value creation, and linking ESG performance to pay can help hold executive management to account for delivering on sustainability goals.
However, existing remuneration packages do not always promote sustainable value creation and can risk creating incentives contrary to this objective. There is also a risk of pay padding where ESG objectives are consistently achieved. ESG factors should form a meaningful component of the overall remuneration framework. For this reason, Provision Q should explicitly mention that ESG objectives should be linked to companies’ material ESG issues.

Remuneration committees should exercise independent judgement and appropriate discretion to ensure sustainability-linked pay is adjusted where targets have been met as a result of external factors outside the control of executives such as changes in regulations or market conditions e.g., greenhouse gas reductions targets met as a result of an economic downturn. For these reasons, we also welcome the emphasis of Principle Q on “remuneration outcomes”.

Further, we agree with the inclusion of workforce pay and conditions in Principle Q in the new Code. Nomination committees should ensure that remuneration outcomes, regardless of the design of the remuneration plan, remain consistent with the circumstances of the wider workforce. The committees should also be adjusted where necessary to maintain cohesion within the organisation. Disclosures on these aspects will help companies anticipate shareholder queries by disclosing why such readjustments were not necessary.

**Question 23: Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?**

Bonus-malus pay structures can incentivise executives to take precautions that mitigate risks to the company, discourage negligent management, and increase focus on sustainability issues by aligning pay with performance and long-term strategy to protect and create value.

Therefore, the requirement of additional reporting on clawbacks and malus in Provision 40 is welcomed. More information on minimum circumstances and application period to trigger malus and clawback allows investors to better assess how companies’ policies are effective in holding executives accountable and incentivising long-term performance. We agree that companies should be encouraged to include information beyond the areas set out in Provision 40 to reflect company specific circumstances.

In addition, remuneration arrangement plans that include bonus-malus and clawbacks to adjust remuneration when ESG-related targets are not met, or when there is a material ESG related failure, can further incentivise the alignment of remuneration outcomes with performance on sustainability. The FRC should consider encouraging companies to explain whether and how clawbacks and malus are used to promote performance on sustainability issues. Malus and clawbacks related to sustainability should not be used in lieu of, but in addition to the inclusion of sustainability criteria in remuneration plans.

**Question 25: Should the reference to pay gaps and pay ratios be removed, or strengthened?**

We do not support removing reference to pay gaps. Avoiding duplication with existing disclosure requirements in annual reports on gender pay gaps and pay ratios is important, but requiring the board to explain the “reasons why the remuneration is appropriate using internal and external measures, including pay ratios and pay gaps;” would not necessarily lead to duplicate disclosures. This does not require the board or the company to produce additional disclosures on the pay gaps themselves, but to explain how the board considers that the remuneration policy and outcomes are coherent with the company’s pay gaps (companies can cross-reference their existing disclosures to avoid duplicate reporting). Retaining the reference to pay gaps and ratios would also be consistent with Principle Q and Provision 35 (in the new Code).
In addition, the PRI supports the FRC’s suggestion to ask “companies to report on what measures have been implemented to reduce and eliminate pay gaps within their organisation.” Widening compensation gaps between senior executives and the wider workforce may have implications for employee motivation, retention, and employee productivity. As such, explanations from companies on whether they have taken measures to address potential pay gaps within their organisation to mitigate such risks would be welcomed.