MM&K Submission: Consultation on Changes to the UK Corporate Governance code

Submission by email to the Financial Reporting Council
28 February 2018

Dear Sirs

MM&K are Remuneration Advisors to a wide range of clients, including not only FTSE and AIM companies but also Private Equity firms and other large private companies, and we have had real and hands-on experience of putting in place and monitoring the provisions of the UK Corporate Code since 1992.

We are pleased to include our comments and thoughts in respect of both the specific questions raised and, where appropriate, comments on the new draft of the code (See Appendix A). Our focus is mostly upon those areas relating to our specialism of remuneration and therefore we have not responded to all the questions.

We are strong supporters of the UK Corporate Governance Code and consider that it is essential that the Code is updated on a regular basis, so as to take account of the advances made in the way that business is conducted both within the UK and globally by UK based companies, in order to maintain a strong UK business economy.

However, we would welcome this opportunity to make first some general remarks on the revision of the Code as a whole.

In the Executive Summary of the Proposed Revisions document the statement is made in the third paragraph that “In some high profile cases the quality of governance has been poor.”

It seems unclear as to what is actually meant by this, which is important as it frames much of the document.

Whilst we would have welcomed specific examples to comment upon, it is our understanding that in almost all of these obliquely referenced cases, the “process of governance” was followed and that the companies in question followed the Principles and Provisions of the Code, complying or explaining as appropriate. Indeed, it is very likely that most if not all of these high profile companies do not fall within the non-compliance statistics included in Table 2 on Page 4.

As a result of this, we are concerned that the criticism is being levelled at businesses which have made commercial decisions which have proved subsequently unpopular to a wider audience, but which passed muster at the time with shareholders and other stakeholders.

We would therefore urge the FRC to bring its best endeavours to decouple the Code from any potential perception that it is trying to fix a political matter. Politics and the “court of public opinion” are fickle masters and both can change quickly. The current and continued success of the Code relies upon it being seen to be independent of Government influence, so that the UK market remains open and transparent, irrespective of who holds office.

There is further cause for our concern in The Proposed Revisions Appendix A, Section 1 – Leadership and purpose. The new Principle A states that board function is “to promote the long-term sustainable success of the company, generate value for shareholders and *contribute to wider society* [our italics]”.

This last function goes well beyond the requirement of the Companies Act 2006 (Section 172 Para. 1 that "a director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to…

(b) the interests of the company's employees,
(c) the need to foster the company's business relationships with suppliers, customers and others,
(d) the impact of the company's operations on the community and the environment…"

"Contribute to" is a much wider responsibility than "have regard to". It would appear that the FRC is creating new responsibilities for company boards that go beyond the requirements of the Companies Act. Again there is the perception that the FRC is being asked to fix a political matter. If the Government wishes to broaden the responsibility of companies and their boards, we believe this should be incorporated in company law, not using the vehicle of the Code, which should be about the means and processes for implementing these responsibilities.

We look forward to seeing the final version in due course. Should you like to speak to us further, regarding any of our comments, please contact Damien Knight or Stuart James at this office.

Yours faithfully

MM&K Limited

Appendix A: Replies to consultation questions

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

We have no concerns on the proposed timetable from a practical reporting perspective. By starting the clock from 1 January 2019 there should be plenty of time for companies and advisors to change the way in which the Code is reported to stakeholders. In terms of the Remuneration elements of the Financial Statements, given that part of the Remuneration Report is forward looking, it would be good if the FRC could explicitly confirm that these parts must be reported with reference to the newly implemented Code.

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

We think incorporating some detail from the old Code in the Guidance is a helpful change. The Guidance avoids the broadening of the board function in Principle A referred to above, which is good. The Guidance contains useful suggestions for the effectiveness of Code implementation. We looked particularly at Section 5 Remuneration, since it is our area of expertise.

Paras 102 to 106. The board, in practice, delegates responsibility for developing and implementing wider workforce remuneration to the Chief Executive. The guidance refers to "oversight" by the board or a delegated committee and arguably acknowledges this delegation when it says "review and endorse clear principles for pay and reward…and satisfy itself that management implements these properly". But the interaction between the board and management is fundamental to the success of the wider workforce remuneration at and the same time a potential source of friction between the board and management. The Guidance might offer some more help on this issue.

Para 110. This paragraph is implicitly about downward discretion. But it does not say so. Some guidance on upward discretion would be helpful – the situation does arise and shareholders are often resistant to the exercise of such discretion.

Supplementary observation regarding the drafting of Principle A

We note that the code now indicates that a company must be led by a board which is "entrepreneurial". However, we would consider the use of this word inappropriate for a number of reasons.

A search for a dictionary definition of what constitutes an entrepreneur finds the following definitions:

"a person who sets up a business or businesses, taking on financial risks in the hope of profit"

"one who organizes, manages, and assumes the risks of a business or enterprise"

In both of these definitions, the key concept is that the entrepreneur bears the economic risk in order to make the economic gains. However, in a listed organisation, whilst there may be some amount of reputational risk for a senior executive of making a decision which is not successful, there is not the same level of economic risk.

Moreover, in the UK economy, the term entrepreneur is most closely associated with the ability to grow a successful business over the short term. It is the dynamic nature of these businesses which then attracts larger investors (be that some sort of Private Equity or larger trade competitors). Once investment has been made or the firm has been acquired, the nature of the board changes with entrepreneurship less prized over the ability to manage and execute further systemic plans for growth. In our experience, it is typical for the entrepreneurial founder to leave the enterprise and begin the process again on a new venture.

This short term dynamism is therefore at explicit odds with the promotion of a culture that wants to promote the "long-term sustainable success" of a business.

We would further argue that the perceived need for large listed companies to be entrepreneurial has had a direct impact on the way in which the long term awards for executives, be they LTIPs or some other equity based instrument, have been used over the last five years.

It is has perhaps not been unreasonable for some executives recently to ask for high levels of entrepreneurial reward/remuneration in return for meeting shareholders demands for entrepreneurial level returns in the short term. The executives, through their leadership and execution of the strategy, have created real value in the business and should therefore share some of the value that has been created. However, these levels of remuneration have led other executives, who are in organisations with different business models, to request similar levels of remuneration for success.

It is therefore this lack of distinction between the nature of the underlying business and its connection to an executive's remuneration which has caused many of the perception issues outside of the business. It is unfortunate that the need to consider what "value" has been created by the executives over the long term and how much of that value is appropriate for them to receive is not formally considered within the Principles or Provisions of Section 5 in the new Code.

As a result of all of the above reasons, we would suggest that the word "entrepreneurial" is removed or, alternatively, some other word is used to express the need for a company to take some, calculated but proportionate risks in order to be successful over the longer term.

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

Whilst we would agree that the proposed methods are sufficient to potentially improve the amount of information the board receives from the workforce, it only creates a one way flow of information.

Importantly, it does not mandate that the director/advisory board/non-executive director must then report back to its workforce constituency. Whilst we would not advocate the right for the workforce to have power of appointment over the individual/body in question, we do consider that there should be an amendment to Provision 3 such that it might begin:

"The board should establish a method for gathering the views of the workforce and for the decisions of the board to be directly communicated back to the workforce". We consider that having to share this information back with the workforce will create much better engagement.

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 do not consider that further specific reference is required

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?

We are not sure as to why Provision 6 is included within the Code. As a matter of law, a resolution is successful if it receives 50.1% of the vote. If it does not receive this it is unsuccessful, we are not sure as to why the number of votes required to pass a resolution has effectively been increased to 80% for listed companies.

In particular, in respect of votes regarding Remuneration, it is important to note that different shareholders will have different standards and strategies for remuneration within their investments and it should not be for the company to create a policy which bends excessively to the views of its major shareholders. Taking this approach, which looks at outside influences rather than inwardly on company performance, is seemingly in contradiction to Principles O and P of the code.

We would therefore suggest Provision 6 is removed from the Code. Given that the IA, as referenced in footnote 2, are putting in place such a register, it may be worthwhile to put in place something on this matter within the Guidance instead, as it is for each company to decide how to deal with the concerns of a minority of shareholders.

Ultimately, it should be remembered that most shareholders have the ultimate right of veto by selling the shares and buying into a company which has resolutions and policies that better fit their outlook.

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 agree that FTSE boards should have an independent board evaluation every three years. The external board evaluation is an important tool in checking that "group think" and similar maladies have not befallen an organisation.

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 would agree that nine years is a reasonable time period to be considered independent. We believe that a successful long term business has within it a certain amount of continuity and, explicitly, people who are part of the "corporate memory". However, this needs to be balanced against the need to protect against "stale thinking" and therefore nine years appears reasonable (it could even be ten years).

We would suggest a bigger danger to "stale thinking" is when the group of non-executive directors remains the same for an extended period. We would suggest that the chair and non-executives (taken as a group) should not be the same cohort of people for a period of longer than, say, four financial years without a resolution being passed by the shareholders that they are comfortable with the board to proceed for another year.

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

It should be for the shareholders to decide whether they wish for a non-executive to continue – albeit as a "non-independent" person. Subject to our replies to Q6 (above) we do not consider that a maximum period of tenure is required.

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?

Whilst the changes in section 3 should increase awareness and highlight better the responsibilities of the board we do not consider that there will be further action until the Nomination Committee is put on the same footing as the Audit and Remuneration Committee. Whilst all three Committees have to produce reports, the Nomination Committee is the only one not governed by a minimum legislative standard. As a result, it is our view that the Committee and its importance to good governance is not appreciated or taken as seriously by businesses – who, naturally, focus on those reports which have legal requirements and therefore have to be "right".

We would suggest that to improve diversity, the Nomination Committee should be subject to the same standards and reporting requirements as the other Committees.

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 do not see why, if there is to be reporting as per the Hampton-Alexander recommendation, this should not also apply outside the FTSE 350. We do note, however, that the requirement to state the number of men and women at this level within provision 23 does not come within any specific action points or requirements. It is unclear therefore to see how this requirement within the Code practicably assists with improving corporate governance. We would suggest that, if it is retained, it is given meaningful context to make it of use to companies.

Supplementary observation regarding Principle J

We note that there is a requirement to consider cognitive diversity within this Principle. We strongly support this and consider that it is cognitive diversity which is the factor that is likely to be most prevalent when comparing successful businesses. However, neither the Provisions nor the Guidance provide any explicit reference regarding the development of cognitive diversity. We consider this to be an oversight which should be addressed in any reworking of the Code before finalisation. We consider that this could be done through the inclusion of an additional bullet point in Provision 23. The wording for this could be along the following lines:

"a description of how the board is cognitively diverse, including the basis for measurement, and where applicable, any actions that may be required to develop a more cognitively diverse board;"

There are a number of reputable tools and tests in the market which would mean that this could be objectively measured. By not being prescriptive as to which to use, this will allow for each company to decide which approach as to cognitive diversity would best suit then

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 are of the general view that any requirement for pay reporting is only meaningful within the context of a company and therefore any reporting would have to be at a more granular level than is currently done for gender pay reporting (as an example) in the UK.

We are of the general opinion that high level public reporting of diversity is more harmful than no reporting at all as it provides poorly explained data which can be taken out of context and sensationalised – which undermines public confidences in UK businesses, the exact opposite purpose of the UK Code.

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 are not in a position to comment upon this section and therefor offer no comment.

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 are not in a position to comment upon this section and therefor offer no comment.

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 agree that it is important that the wider organisations' remuneration is considered at the board level. However, it is difficult to see where this requirement is actually contained within the Code. Provision 33 relates principally to the remuneration of the board and senior management. A requirement to oversee remuneration and workforce policies and practices, taking these into account when setting the policy for director remuneration, is a weak provision – it is not really clear what the yardstick is against which the success of workforce policies and practices is judged. At the same time the requirement to "take them into account when setting the policy for directors' remuneration" invites the bland statements we have seen in many company Remuneration Reports, that "in setting directors' pay we have taken into account the remuneration of the wider workforce". The Code should set a requirement to state the principles by which the board operates on both counts and the extent to which and how these principles have been followed in practice. We do note that the very last Guideline (Guideline 113) advises the remuneration committee to engage with the wider workforce. If this is important to corporate governance going forward then it should reside in the Code itself.

In addition, we would also suggest that the remit to look at this wider audience should actually sit with the Nomination Committee. By way of example, the points made in Guideline 103 are a natural extension of the requirements set out in Provision 23. By being involved in the wider remuneration of the business, the Nomination Committee would be closer to the business and, therefore, be able to better identify potential candidates for succession planning.

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

Following on from our previous answer to Q15 (above), we would observe that Guideline 113 which deals with wider workforce engagement does little to prevent "passive engagement" through the issuing of a report or other written communication to the workforce. We consider that any engagement with the wider workforce should be more active and we would refer you to our comments and suggested wording above in our reply to Q3.

In addition, as referenced in our comment (above) on Principle A, we consider that the Code should ask companies to identify their underlying businesses risk model and make sure that their remuneration policy matches that, with high returns on long term incentive plans only available where executives create real and meaningful increases in value of the business over the short term. We would suggest that any reference to this is explicit with regard to the creation of "value" and how that is defined for that company.

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

In our experience, the ability to use discretion over incentive plans has been included in almost every set of plan documentation that we have seen. We do not think the impetus for using these provisions will come from a re-drafting of the Code. Any exercise of discretion currently comes with the risk of potential litigation regarding its "reasonable use" and therefore has to be taken after much consideration. Again, we do not see this changing, even with the stronger revised wording provided by the Code.

Q17 to 31: We are not providing any comments on the UK Stewardship Code at this time.