

28 February 2018

Mrs C. Horton
Financial Reporting Council
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By email to: codereview@frc.org.uk

Dear Mrs Horton

Proposed revisions to the UK Corporate Governance Code

Deloitte LLP welcomes the opportunity to comment on the proposed revisions to the UK Corporate Governance Code.

The UK Corporate Governance Code

Overall we are supportive of the broad objectives behind the proposed changes to the UK Corporate Governance Code. We believe that driving board focus on matters such as corporate culture and stakeholder engagement reflects the current demands of broader society for greater accountability from leading UK companies. However, we do have some comments about the way these and other important concepts are being introduced into the Code. Our full responses to your questions are included in the appendix later but our key messages are summarised here:

- We support the objective of regular refreshment of board composition and agree that nine years is an appropriate time period to be considered independent for non-executive directors. However, for chairmen we suggest you should consider extending this period to twelve years as we are concerned that the nine year time period could restrict the ability of companies to choose a candidate from the existing board members, i.e. 'promoting' an existing non-executive director to the post of chairman.
- We agree with the broadening of the remuneration committee remit to include setting executive director *and* senior management remuneration. We also support a move towards remuneration committees having greater access to information on workforce policies, enabling them to make executive pay decisions in the context of reward and conditions across the organisation. Our view is that more guidance is needed around the definition of 'oversight', to avoid either a boilerplate response or an over-delegation of responsibility. 'Oversight' should focus on the *supervision* and *monitoring* of workforce policies, as opposed to input in their design and implementation.
- At present Provision 7 refers to the need for the board to "identify and eliminate" conflicts of interest. In our view, it would be better, and more realistic, to call for boards to identify and manage conflicts of interest in line with the requirements of the Companies Act.
- We are supportive of the overall objective to drive greater clarity of a company's purpose. The revised Guidance includes helpful recommendations on how a board should think about corporate culture but there is, perhaps deliberately, little guidance on how boards should "establish company purpose" as

suggested by new Code Principle A. We believe some commentary in the Guidance on how a company should think about company purpose would be helpful.

Finally, we would ask that the FRC work with the FCA to review the auditors' responsibilities in respect of corporate governance. The review responsibility in the Listing Rules is long-standing but the related FRC Bulletins have not kept up-to-date as the Code provisions have changed. Some of the provisions to be reviewed are now subject to specific duties in ISAs (UK) – for example those dealing with risk, going concern and viability – where the Bulletins and ISAs (UK) are now inconsistent. Investors may expect a consistent level of auditor challenge, but the current regime does not necessarily achieve this. We suggest that the FRC and FCA agree to consult together on what the auditor's responsibilities should be in relation to the revised Code.

Further, we are looking forward to participating in the FRC's future consultation in respect of the front half generally and the "expectation gap" that exists between the assurance expectations of users and what is actually delivered under the current audit regime.

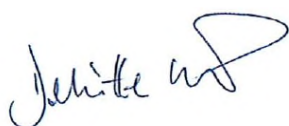
The Stewardship Code

We have chosen not to respond to each of the Stewardship Code questions individually. We would however like to stress the importance of developing the Stewardship Code to mirror the new areas of focus you are introducing to the UK Corporate Governance Code, i.e. stakeholder engagement and contribution to society. In this regard we recognise the increasing focus from long term investors on climate impacts, which is an emerging reporting area and where standards need to be codified and the information presented by companies to investors often carries no assurance. This is unusual for an area that is of such importance to the Financial Stability Board.

You are keen to see a renewed focus on application of the principles of the UK Corporate Governance Code. This will only be able to happen if the investor community is seen to support boards which provide clear and meaningful explanations of how they have applied the Code principles rather than adopting a very rigid and box-ticking approach to compliance with the provisions. It is this broader engagement on application of the principles of the Code which will drive real change in corporate governance behaviours. We know that the majority of investors recognise the importance of the licence to operate and contribution to society and will welcome the opportunity to engage with boards on how stakeholder interests are being met.

We would be happy to discuss our letter with you. If you have any questions, please contact me or Tracy Gordon on 020 7007 3812 or trgordon@deloitte.co.uk.

Yours sincerely



William Touche
Vice Chairman
Deloitte LLP

Appendix Responses to detailed questions

A. UK Corporate Governance Code and Guidance on Board Effectiveness *Introductory questions*

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

We do not have any concerns in relation to the proposed Code application date subject to the FRC achieving the planned publication of the final update Code around the middle of 2018. Anything much later than this will make it more challenging for companies to achieve satisfactory implementation by 1 January 2019.

Q2 Do you have any comments on the revised Guidance?

We are supportive of the overall objective to drive greater clarity of a company's purpose. The revised Guidance includes very helpful recommendations on how a board should think about corporate culture but there is, perhaps deliberately, very little guidance on how boards should "establish company purpose" as suggested by new Code Principle A. We believe some commentary on how a company should think about company purpose would be helpful and perhaps companies should be encouraged, via the revised Guidance, to think about the UN Sustainable Development Goals as a framework (see responses below for further detail).

It will be interesting to see how boards respond to paragraph 30 of the revised Guidance in relation to explaining their decisions and how they have taken account of the interests of different stakeholders. We imagine that detailed explanations may be resisted due to the potential for future scrutiny despite the "acting in good faith" provision in law.

Section 1 – Leadership and purpose

Comment in relation to Principle A where there was no specific question

Whilst we absolutely support the FRC's objective of driving boards to acknowledge, and not to take for granted, a company's licence to operate, we have some concerns about the way the first sentence of Principle A has been constructed. Our suggestions would be to split the sentence:

"A successful company is led by an effective and entrepreneurial board, whose function is to promote the long-term sustainable success of the company and generate value for shareholders. A board should be cognisant of the company's contribution to wider society and the resulting impact on its licence to operate."

In addition, in relation to company purpose, we think it is important to extend the board's role beyond establishing purpose:

"The board should establish the company's purpose, strategy and values, **and monitor progress** to satisfy itself that these and its culture are aligned **and provide benefit**."

To support boards in meeting this principle, the Guidance could include a clear definition of purpose and commentary on how a company can derive benefit from it. We would define purpose as "an articulation of the intended contribution a company seeks to make for wider society through its core business activities; an articulation of why it exists". We would suggest that in developing an articulation or statement of purpose, companies consider (i) their intended impact on society, (ii) the non-negotiable elements of the business model, and (iii) the intended beneficiaries of their impact. Such a statement should then directly influence the core activities of the company, across strategy and operations, culture and values and brand and stakeholder engagement. We suggest the following, corresponding amendments (shown in red) to the Guidance:

"9. An effective board develops and promotes its collective vision of the company's purpose [*insert footnote: Purpose is defined as an articulation of the intended contribution a company seeks to make for wider society through its core business activities; an articulation of why it exists.*], along with the values and the behaviours

it wishes to promote in conducting its business and sets a strategy consistent with these. It will be able to explain how events or developments affecting the long-term success of the company have been addressed

41. Boards should start by determining the company's purpose **that articulates the intended contribution the company seeks to make for wider society, perhaps with reference to an internationally recognised framework such as the UN's Sustainable Development Goals. The Board should ensure that purpose informs all key decisions including the company's strategy [insert footnote: Strategy is defined as an articulation of the key choices for delivering on a company's purpose through sustainable commercial success] and business model [insert footnote: The company's business model is its means of activating strategic choices].**

42. The Board should clearly define a set of values that are aligned to the company's purpose and strategy. Simply adopting a formal values statement is not enough. In order to have an impact on behavioural outcomes and influence the way business is done, values need to be embedded at every level of the organisation."

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

We are very supportive of the objective that the board should establish appropriate mechanisms for engaging with the company's workforce. The proposed methods set out in Provision 3 were those put forward in the Government's response to its Green Paper. We acknowledge that the current drafting of this Code provision was intended to represent a more flexible approach but concerns have been expressed to us that the words "would normally be" will be interpreted as requiring one of these three options. We suggest replacing the words "would normally be" with "could include". This would make it clear that the three options are example mechanisms which do not preclude other options (or combination of options) as long as it achieves the overriding objective from Principle C of ensuring effective engagement with stakeholders.

Whether these will "achieve meaningful engagement", as per your question, will be wholly dependent on the manner of implementation by companies but we do support these three mechanisms being presented as options. We suggest that the first sentence of Provision 3 does not do enough to drive meaningful engagement as it is focused on "gathering the views" of the workforce, which suggests a one-way dialogue. Perhaps the FRC might consider the following suggestion: "The board should establish a method for gathering the views of and engaging with the workforce" to drive meaningful engagement through appropriate feedback and follow-up.

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?

Societal licence to operate will change over time. We have suggested mentioning the UN SDGs in the Guidance above. However, we believe that companies should be able to make their own assessment of how they articulate their company purpose and understand their contribution to society, rather than having to report against a set of other principles. Allowing companies more flexibility in this area, should encourage a considered and tailored response. We would strongly recommend that the FRC should give consideration to requiring large companies to report against the recommended framework of the Task Force on Climate-related Financial Disclosures, perhaps including this in the Revised Guidance on the Strategic Report.

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?

In our view it would be more appropriate to revert back to the previous wording of the Code which allowed for some judgement in the decision about what was "significant". Whilst 20% will represent a significant vote for some companies, for others it will not. Matters such as the size of the free float for a company will also be relevant in determining what is significant. We understand that using 20% creates alignment with the Investment Association register but we have concerns that this will drive a disproportionate focus on the size of votes with the potential for an adverse impact on behaviours and there is the potential for board agendas to be hijacked by minorities for inappropriate reasons.

We are comfortable with a recommendation to publish an update no later than six months after the vote. However, we once again express our concerns about the significant increasing regulatory burdens on companies to report on various matters coming from numerous sources, in various formats and to differing timetables. We strongly encourage use of the annual reporting cycle wherever possible as the primary vehicle for this reporting due to the quality of process and scrutiny to which information is subjected.

Comment in relation to Provision 7 where there was no specific question

At present Provision 7 refers to the need for the board to “identify and eliminate” conflicts of interest. In our view, it would be better, and more realistic, to call for boards to identify and manage conflicts of interest in line with the requirements of the Companies Act.

Section 2 – Division of responsibilities

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.

Yes, we are comfortable that the “comply or explain” approach to the Code means that companies of all sizes can develop their governance arrangements in a way which suits them best whilst achieving the overall aims of the Code principles without the need for exemptions. Assessing the effectiveness of the board’s performance is an important discipline and the added element of external facilitation once every three years should serve to increase the rigour of such assessments. In our view the benefits of these exercises outweigh the relatively minor costs involved.

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 support the objective of regular refreshment of board composition and agree that nine years is an appropriate time period to be considered independent for non-executive directors. However, for chairmen we suggest you should consider extending this period to twelve years as we are concerned that the nine year time period could restrict the ability of companies to choose a candidate from within the existing board members, i.e. ‘promoting’ from an existing non-executive position on the board to chairman. This is on the basis that an internal candidate would probably have been on the board for three, four or five years before being considered and would, therefore, only have a relatively short period as chairman before they were no longer considered independent.

As reflected in the Guidance on Board Effectiveness, the role of chairman is very different to the role of non-executive directors and the responsibilities and relationships required to be formed are such that one set of independence indicators for both are not appropriate. In our view, the overriding Code principle for chairmen to “demonstrate independent and objective judgement”, together with a twelve year maximum tenure, should be sufficient to achieve the desired behaviours and the objective of regular refreshment of board composition.

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

Yes, we agree that it is not necessary to provide for a maximum period of tenure. Imposing a maximum period of tenure goes against the Code’s principles-based approach and will restrict the options available to companies for their governance arrangements.

Section 3 – Composition, succession and evaluation

Q9 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?

Yes, we do.

Board succession planning is an important part of ensuring that companies remain sustainable in the long-term and are sufficiently flexible to face their future challenges. How succession planning is managed is a key measure of the effectiveness of a board; an effective board will have a clear and documented policy on succession for all key roles on the board and senior management team.

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.

Yes – we agree with extending the Hampton-Alexander recommendation beyond the FTSE 350, so that companies of all sizes disclose the gender balance on the Executive Committee and Direct Reports to the Executive Committee. This should not place significant cost or other burdens on these companies.

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 believe that there is already sufficient emphasis on the importance of diversity (in all senses) within the proposed Code principles and provisions. We believe that the focus should be on skills and experience and indeed, this is shown to be more important for investors. Nevertheless, we certainly support *encouragement* to report on levels of ethnicity in executive pipelines.

Section 4 – Audit, risk and internal control

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 comfortable with this retention on the basis that they drive a good level of board focus on these matters, which is beneficial.

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.

Committee terms of reference are an important element of board governance arrangements and so we do believe that these should be publicly available. However, the proposed Code provision 9 calls for the responsibilities of board committees to be set out in writing, agreed by the board and made publicly available so we are comfortable that there does not need to be additional reference specifically for the audit committee.

Section 5 – Remuneration

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?

Summary: We agree with the broadening of the remuneration committee remit to include setting executive director *and* senior management (e.g. Executive Committee) remuneration. We also support a move towards remuneration committees having greater access to information on workforce policies, enabling them to make executive pay decisions in the context of reward and conditions across the organisation.

In terms of the 'oversight' or monitoring of workforce pay and policies, we agree that this responsibility should be with the board, with flexibility to delegate to either the remuneration committee or another committee (e.g. sustainability committee), as appropriate.

Our view is that more guidance is needed around the definition of 'oversight', to avoid either a boilerplate response or an over-delegation of responsibility. We do not believe that a delegated

committee should become the primary reporting body for HR (where this is currently the executive board). 'Oversight' could focus on the *supervision* and *monitoring* of workforce policies, as opposed to input in their design and implementation. Any authority or powers of approval should be clearly defined.

Setting remuneration for board and senior management

We agree with Provision 33 giving the remuneration committee responsibility for 'determining the policy for director remuneration and setting remuneration for the board and senior management'.

We support the definition of senior management as the 'executive committee or the first layer of management below board level'. This is current practice for many companies, and enables committee members to monitor the development and progression of executive talent within the organisation, supporting the board's succession planning in line with Section 3 of the draft Code.

We would note that the drafting of Provision 33 could be clarified to specify that, at board level, the committee's responsibility is for the *executive* directors and chair (as set out in paragraph 107 of the Guidance).

Considering executive remuneration in the context of workforce pay and conditions

We support a move to ensure that remuneration committees are better informed of workforce policies and conditions, and take these into account when making decisions on executive remuneration.

Over the last ten years, remuneration committees have responded to pressure to align executive salary increases with those of employees, and greater access to information on workforce pay and policies would further enable committees to make executive pay decisions in the context of conditions across the organisation. Particular areas of focus may include pension allowances, bonus distribution and other forms of success sharing across the workforce.

The Guidance¹ suggests that to provide a more *integrated* approach in setting executive and workforce pay, a **set of clear principles**, aligned to the values set by the board, could be reviewed and endorsed by the board or a delegated committee, to apply to pay and reward across the organisation. The Guidance recommends that the board or a delegated committee would then '**satisfy itself that management implements these [principles] properly**'.

We would encourage greater clarity around how the board or delegated committee should monitor the application of these principles, and what level of oversight is expected (see below).

'Oversight' of wider pay and policies - delegation by the board

We agree with Principles A and O that the **board** should be **responsible** for:

- establishing 'the company's purpose, strategy and values, and satisfy itself that these and its culture are aligned' (Principle A); and
- satisfying itself that 'company remuneration and workforce policies and practices promote its long-term success and are aligned with its strategy and values' (Principle O).

Where a board chooses to delegate responsibility for workforce pay and policies to a committee (e.g. remuneration, sustainability committee), the level of 'oversight' expected should be clearly outlined, to avoid either a 'boilerplate' response or an over-delegation of responsibility.

We do not believe that the committee should become the principal reporting body for HR, where this was previously an executive function (e.g. CEO). This would create practical challenges in decision making

¹ Guidance 104 – 105

processes, significant additional time commitments, and may result in the over-delegation of a unitary board's responsibilities.

In our view 'oversight' should involve the *supervision* and *monitoring* of workforce policies, as opposed to input in their design and implementation. From a process perspective, this might involve annual reporting from HR on key policies and decisions made during the year. Where a board or delegated committee has any approval power in respect of new policies, for example, this should be clearly defined.

An alternative approach seen in the financial services sector (where the remuneration committee has oversight responsibility for the Material Risk Taker population), may be to appoint a sub-committee of relevant individuals from HR, finance and risk/compliance, who agree and implement policies for the wider workforce under the agreed principles, regularly reporting on their work to the relevant committee.

Delegation to Remuneration Committee versus Sustainability Committee?

We believe that there are pros and cons to the oversight role being undertaken by the remuneration committee versus a sustainability committee.

There is an argument that policies linked to workforce employment standards (i.e. equal pay, predictability of income, reskilling, training) would best fit under the agenda of a sustainability committee, alongside matters such as workforce engagement, investment in innovation and productivity (gender pay is often allocated to this committee).

On the other hand, there is clear overlap in some areas with a remuneration committee's existing remit e.g. consideration of how workforce incentives are aligned with a company's values and culture.

It should be noted that only around 30% of the FTSE 350 operate a sustainability (or equivalent) committee, therefore flexibility should exist for an organisation to take a 'best fit' approach.

Reporting on delegated responsibilities

While the Guidance is clear that the board may choose to delegate oversight of workforce pay and policies to a committee, there is some ambiguity in the proposed draft Code that this automatically falls to the remuneration committee.

Provision 41 states that 'the company's approach to investing in, developing and rewarding the workforce' should be reported on as the '**work of the remuneration committee**' in the annual report. While we fully support the disclosure of an organisation's approach in this area, we would encourage greater clarity in the Code and Guidance to (i) ensure there is sufficient flexibility for companies to delegate responsibilities, or retain them with the board, as appropriate; and (ii) enable reporting of this information elsewhere in the annual report (i.e. in the strategic report, HR leader report), with cross-referencing provided.

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

We support the inclusion of Provision 36 which requires shares granted under long-term incentive plans to, in normal circumstances, be subject to vesting and holding periods of at least five years. While this is 'normal' market practice in the largest organisations, we support a requirement for all premium listed companies to follow this trend and increase the time horizons under incentive plans to five years or beyond.

We believe that the 'right' incentive design varies by business and we have been disappointed to see limited progression in the diversity of plan design following the publication of the Executive Remuneration Working Group's final report. We feel that a broader selection of performance measures, including metrics linked to how a company delivers performance to a wider range of stakeholders – e.g. customer metrics, ESG, investment and development would incentivise executives to deliver long-term success in a more balanced and sustainable

way, and is aligned with the broader themes of the revised draft Code. These measures continue to be challenged by many shareholders.

However, we do not believe that the Code is the correct forum in which incentive design should be prescribed, and this may be better considered under the forthcoming review of the Stewardship Code.

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

We are supportive of the proposed changes to the Code which require remuneration committees to exercise independent judgement and discretion when approving remuneration outcomes, ensuring that they are appropriate in the context of company and individual performance, and wider circumstances.

We believe that remuneration committees should be undertaking this process as a matter of routine rather than in exceptional circumstances, and that outcomes should be 'actively' rather than passively approved in the context of wider factors. We are supportive of the proposed wording being included as a Principle (Principle Q), noting that this will apply to companies on a comply-only basis. We believe that this, together with the accompanying Provision 41 requiring companies to report on 'to what extent remuneration outcomes have been affected by board discretion', should bring about meaningful change in the way that decisions on remuneration outcomes are discussed, approved and documented.

From a practical perspective, we agree with the wording in Provision 37, which recognises that remuneration policies and schemes will need to provide boards with the *ability* to exercise discretion to override formulaic outcomes. We expect the proposed changes will give committees the impetus to re-visit existing incentive plans and policies, with a view to ensuring that the use of potentially wider discretionary powers is permitted and make any amendments as necessary. Where committees identify a disparity between formulaic remuneration outcomes and wider performance/context, we believe in principle that they should be empowered to use discretion to make both a negative or positive adjustment as appropriate.

The findings of the Executive Remuneration Working Group's final report state that 'remuneration committees increasingly feel that they cannot use discretion, as it will not be supported by shareholders. Companies often feel that they are unable to use upward discretion, and that investors will only approve the use of downward discretion.' We would ultimately support a move that enables companies and investors to restore trust, allowing for the effective use of both upward and downward adjustments, while recognising that trust in this area is likely to be built by committees demonstrating a responsible track record, and transparency around, how discretion has been applied.