THE INVESTOR FORUM

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Dear Sir or Madam,

Green Paper on Corporate Governance Reform

The Investor Forum's purpose is to promote a long-term approach to investing in UK companies and to provide a platform for collective engagement on strategic matters between investors and company boards. The Forum was set up in late 2014 as a result of the Kay review and now has 34 members with approximately £715bn invested in UK equities representing 35% of the FTSE All Share Index; in itself indicative of how seriously investors take their stewardship responsibilities. Since its inception, the Forum has completed seven comprehensive engagements with companies which are described in *The Investor Forum's Review 2015/2016*[1].

The Forum is aware that many bodies, including the Investment Association, are providing comprehensive responses to the Green Paper and addressing each specific question. Instead, as the Forum's insight derives from its broad experience of engagement with companies, we would like to make the following general points on governance issues from a practitioner's perspective:

- **The Framework**: The UK's corporate governance framework is not fundamentally broken. The UK is an international leader in corporate governance. The unitary system and general duties of directors - which require boards to promote the success of the company for the benefit of all shareholders and to have due regard to the interests of employees, consumers and other stakeholders - are broadly fit for purpose. That said and as explained below, more effective use of existing tools and certain refinements would further improve the framework.

- **Existing Tools and Developments**: More effective use of the full range of tools available to investors under the existing framework could be made. For example, more targeted use of the power to appoint, or not to re-appoint, existing directors could be made (such as to replace the Chairs of Remuneration Committees where significant issues have not been resolved). All investors, and not just institutional investors, should be encouraged to vote, and systems should be put in place for retail investors to make them aware of the process or voting policies. If this authority has been delegated to a third party, they should hold that intermediary to account for the way that vote has been cast. Also, shareholders can requisition resolutions to address

[1] Available on the Forum's website at: https://media.wix.com/ugd/1cf1e4_661b01aaeab94b47b72d10b14e8de45d.pdf

specific issues, although they seldom do, not least due to the legal issues, administrative requirements and costs that this raises, especially outside of the AGM cycle.

There have been significant developments to the framework in recent years including the triennial binding remuneration policy vote, viability statements and extended auditor and audit committee reports in annual reports and accounts and the launch of the Forum, to name a few. It is important that sufficient time is given to assess the impact of these changes before further amendments to the corporate governance framework are adopted.

- **Targeted Escalation & Collaboration**: There should be a targeted approach to identify, and focus on, those companies that have evident governance problems, are potentially impending "governance failures" and require extensive investor involvement to resolve. Conversely, the introduction of additional measures, or the application of extensive collaborative engagement, is not necessary for the mainstream of companies with at least good or average governance effectiveness.

  Engagement through investor collaboration is an effective route to address serious corporate governance issues in companies. Organisations, such as the Forum, can facilitate such quality targeted engagement. The Forum has established a framework to support and assist investors in their engagement on strategic matters, as an efficient escalation mechanism to amplify their individual actions. Collective engagement does not just happen; it requires skill, trust, discreet facilitation, persistence and significant resource. The Forum advocates selectively pursuing collaborative engagement where it is likely to enhance shareholder value in a way that effectively manages the legal and regulatory risk for UK and international investors. A summary of the *Collective Engagement Framework* is available on the Forum's website[2]. Key aspects of the approach include clear procedures and the "hub and spoke" model which, together, address potential issues which may arise in relation to inside information, concert parties and groups.

- **Pro-Active Interaction**: Pro-active forward-looking interaction with companies is also essential to prevent acute governance issues arising in the first place, and to further improve governance standards. In particular, the mainstream of companies can benefit from this approach, through initiatives such as the Forum's *Stewardship & Strategy Framework*[3], the adoption of which should be seen as a sign of the voluntary promotion of best practice standards. If approaches such as this are widely adopted, the Forum hopes that there would be a significant cumulative effect on promoting corporate governance standards and maintaining the reputation of the UK's system as an international leader that is also flexible and proportionate. Over time, this should result in a reduction in instances of governance failure.

- **Refinements**: All requirements of the existing legal framework must be discharged and consideration should be given to refining some of them to further underpin effective engagement:

  - Directors' Responsibilities: Although directors' responsibilities are clearly outlined in Section 172 of the Companies Act, it is important that non-executive directors genuinely fulfil their duties. These encompass ensuring that the company develops, executes and

[2] At: https://www.investorforum.org.uk/collective-engagement-framework

[3] A meeting which brings together key board members, executives, investment decision makers and governance practitioners and enables shareholders to evaluate the contribution of the board and the executive in controlling and executing strategy.

communicates a clear business model and strategy that is sustainable over the long term; and creates a culture considerate of all stakeholders that maintains sustainable long-term relationships with them.

There should also be a clear acknowledgement as to the division of responsibilities between investors and boards. Although investors can vote, scrutinize and hold boards to account, they are not in the same position as directors and cannot be responsible for their duties, especially strategic and management decisions. Boards should be wholly accountable for their duties and effective stewardship should ensure this. In particular, strategic decisions need to be made by boards within this framework, fully independent of advisers and consultants. Non-executives need to be provided with the ongoing training and resources they need to fulfil these duties.

- Stakeholders: Directors should be encouraged to take their stakeholder responsibilities (including employees' interests) seriously so that listening to diverse stakeholders becomes ingrained in the company's culture. In the ordinary course this should be voluntary, perhaps supported by a general provision in the FRC's Corporate Governance Code (**Code**) requiring companies to have appropriate stakeholder consultation mechanisms. There should be flexibility to adopt practices that are best suited to each business context.

- Increased Transparency & Accountability: Boards should be able to demonstrate how their decisions have been made and evidence their link to the long-term strategic direction of the company in a clear and informative manner. The Forum's *Stewardship & Strategy Forum* is a good way for boards to showcase their workings and how they support the company's long-term strategic direction. Transparency could also be further promoted through changes to the Code requiring reporting on how directors' duties have been discharged, including as to the mechanisms for taking into account long-term considerations and other stakeholders. We are aware that the Investment Association and ICSA: The Governance Institute are undertaking a joint project to draw up practical guidance on this topic which may inform the market outcome. Shareholders should assiduously hold boards to account on these matters.

As general principles: i) any new measure should be proportionate and the costs and benefits of any proposed change should be assessed before adoption; and ii) it is usually those closest to the issues, the board of directors, that are best placed to resolve them, as opposed to more distant investors and governments, a principle referred to in legal terminology as "subsidiarity".

- **Overseeing the System**: The regulatory environment for stewardship and corporate governance is complicated and fragmented. There are many bodies involved in the supervision and regulation of companies, investment managers, pension funds, auditors, brokers and others in the investment chain. In the UK alone, these include the FCA, PRA, UKLA, Takeover Panel, FRC, and the Pensions Regulator. Although in the majority of cases, the UK's principles based "comply or explain" approach is desirable as it positively encourages good behaviour (rather than negatively prohibiting bad behaviour), in cases where things have gone awry, it can be unclear which body ought to, or might, have responsibility for further action.

One model that could potentially be adopted is an approach akin to the Bank of England's Financial Policy Committee. The FPC's role is to identify, monitor, and take action to remove or reduce risks that threaten the resilience of the UK financial system. The FPC has power to issue directions to the FCA, PRA and make recommendations to other bodies. A similar committee could be established with the remit of monitoring the corporate governance practices of listed companies, identifying where companies are failing to discharge their duties and taking action, including through other regulators where appropriate. At this stage, the Forum would suggest that a review be undertaken to better understand the role of each authority, how enhanced oversight could be brought to the system and whether an approach similar to the FPC could work and within which regulatory body it would sit.

- **Global Capital**: UK corporate governance reform must be considered in the context of a global economy in which the UK competes for international capital flows. Given Brexit and other political developments, this is particularly topical. Additional statutory or regulatory measures should have clear regard to enhancing the global attractiveness of investing in the UK.

To conclude, the Forum would recommend a *targeted* approach to build on the existing practices, and the framework, of corporate governance and stewardship in the UK. In considering new measures, the clear objective should be to develop, and restore, trust between companies, their shareholders and broader society. This approach seeks to prioritise long-term value creation for UK companies and to maintain the UK as an attractive and internationally competitive jurisdiction in which to do business. To use the language of the Green Paper, a system of "high standards and low burdens".

Yours faithfully,

Simon Fraser
Chairman