FRC Consultation UK Corporate Governance Code 2014
LAPFF Response

June 2014

Local Authority Pension Fund Forum

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The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 60 local authority pension funds based in the UK with combined assets of approximately £125 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

Section 2: DIRECTORS' REMUNERATION

Question 1: Do you agree with the proposed changes in Section D of the Code?

The Code has become out of date in several respects due to the progress of legislation to tackle various issues concerning directors' remuneration. In this context, the changes are a welcome response to shareholder expectations as a result of legislative and regulatory reform. However there is a challenge facing the Code in retaining its 'comply-or-explain' value in a capital market where intractable problems (such as exorbitant and unjustified executive remuneration excess) increasingly require legislative and regulatory determination as the only way to tackle such systemic problems.

The removal of "attract, retain and motivate" from the Code is very good news. As set out in LAPFF's Expectations for Executive Pay[1], we recognise money is a factor but it is not the sole determinant of why executives are attracted to a position, nor of why they choose to stay with a firm. The continued advocacy of to 'attract, retain and motivate' in the Code is not a position the Forum shared.

The Financial Reporting Council's (FRC) recognition that the Code's encouragement to base a significant proportion of directors' pay on performance was incongruous with EU legal standards is also welcomed.

[1] http://www.lapfforum.org/TTx2/Publications/latest-research

The rewording of supporting principle D.2 is not particularly relevant in the context of the new shareholder right to approve directors' remuneration via a binding vote. Regardless of whether the remuneration committee has successfully managed any conflicts of interest, shareholders now have the final say on the outcome of the committee's deliberations.

Question 2: Do you agree with the proposed changes relating to clawback arrangements?

The use of the same terminology used in the Regulations is helpful. We disagree with the assertion that best practice is evolving rapidly in this area. Disclosure of clawback arrangements has increased due to compliance with the Large and Medium sized companies and groups (accounts and reports) amendment regulations 2013 and not as a result of voluntary best practice.

The amended wording will not produce clarity around the principal obstacle to clawback, namely defining the circumstances under which it is **not** appropriate to recover or withhold.

Encouragement in the Code to define the circumstances in which it is not appropriate to clawback would reinforce a presumption that recovery is to be expected.

Question 3: Do you agree with the proposed change relating to AGM results? Is the intention of the proposed wording sufficiently clear?

No. The proposed wording of the new E.2 provision confuses the "proportion of shareholders" with the proportion of shares voted. It is, of course, possible for a large proportion of shareholders to vote against a proposal which passes on the basis of the proportion of shares voted. We therefore propose that the draft wording be amended to read

> "When, in the opinion of the board, a significant proportion of *votes have been cast* against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result."

The weakness of this formulation is that it does not specify the % of votes being cast against a resolution that would qualify for 'a significant proportion'. We think it should and that % should start at 20%.

The disclosure of a process is not an appropriate substitute for disclosure of action to address a concern. We recognise that in some cases a company will be unable to disclose details of remedial actions immediately following a negative vote, but the proposed change creates a risk of the process being construed as action.

Question 4: Do you agree with the proposed amendments to the Schedule?

No. The new emphasis on getting the balance right between pay now and pay later is based on a false dichotomy. The current wording in the Code suggests the choice faced by a committee is between awarding a bonus or nothing at all. The proposed alteration of this wording softens the distinction between pay that is merited as a result of providing contracted services and fulfilling legal duties (in the case of directors) and pay that rewards superior performance. This is an important distinction to retain.

The reference to non-financial metrics should be prefaced with “appropriate”. Some non-financial metrics are clearly inappropriate as a basis for rewarding executives beyond what can reasonably be expected in return for salary. For example, listed banking groups have used “relationship with the regulator” to inform bonuses. It is of course in shareholders’ interests that the bank complies with regulation, but this responsibility should be part of a salaried job description, and covered by salary. A bonus payment for fulfilling an employment contract is not justified Relationships should not alter this fact.

Question 5: Do you agree with the changes to the Code relating to principal risks and monitoring the risk management system?

Effective risk oversight requires both meaningful communications between the corporate board and other stakeholders as well as full disclosure to shareowners, at least annually, of sufficient information to enable them to assess whether the board is carrying out its oversight responsibilities effectively.

As suggested in the guidance, it would be helpful if the list of principal risks appeared in the same place as the description on controls intended to manage the risks. Neither disclosure should be provided outside the context of the financial statements and given the possibility provided for by regulation that a strategic report may be despatched in place of summary financial statements. Investors would be best served by disclosures that locate both risks and controls within the corporate governance statement. These disclosures inter alia should be sufficient for shareholders to assess the effectiveness of any actions taken by the board in monitoring for risk.

Question 6: Do you agree that companies should make two separate statements? If so, does the proposed wording make the distinction between the two statements sufficiently clear?

Question 7: Do you agree with the way proposed Provision C.2.2 addresses the issues of the basis of the assessment, the time period it covers and the degree of certainty attached?

LAPFF was party to a joint response from a coalition of investors with regard to the FRCs consultation on going concern. The submission argued strongly against removal of the continued viability statement (i.e. a “stewardship going concern” statement). We, therefore, welcome the proposal to retain a form of C.1.3 in place of the previous proposal to remove the requirement for such a statement.

In the investor coalition submission it was made clear that a list of likely risks to solvency and liquidity such as that proposed under C.2.1 would not have impacted behaviour in the way advocated by Sharman (The Sharman Inquiry: Going Concern and Liquidity Risks: Lessons for Companies and Auditors: Final Report and Recommendations of the Panel inquiry (June 2012). The retention of C.1.3 together with C.2.1 and C.2.2 is preferred to the abandonment of C.1.3 in favour of C.2.1.

However, the proposed new wording for C.1.3 means that it no longer constitutes a positive assertion that the company "is" a going concern. As such, the new wording provides implicit rather than explicit reassurance. The implied reassurance that a company has the ability to continue to operate, and meet reasonably expected liabilities as they fall due is only a reassurance if those reading the statement consider that the basis for accounting which underpins the reassurance is robust.

The Companies Act 2006 places "true and fair view" as the standard for accounts to comply with the requirements of company law. That is a standard to discharge the duties of the directors so that they, *inter alia*, demonstrate that they are trading solvently as a going concern (or not as the case may be) and that distributions would be lawful by reference to the accounts.

There are several cross connections that make the legal position the logical one. If a company is not a going concern, then the distributable profits may well be less due to closure provisions and asset write-downs. Further, whether a company is a going concern depends on shareholders and creditors funding it. For shareholders and creditors to have the incentive to fund a company, this depends on there being net assets as collateral and a proper view of the profit trend. Clearly, with the legal model there is a risk to auditors of wrongly signing off on accounts, with contractual recourse to them, where profits stated do not exist, and/or the company is not capable of being a going concern due to the omission of losses or the overstatement of assets.

It follows that where the basis for accounting fails to meet the legal "true and fair view" standard, no assurance can be taken from a statement such as that proposed under the revised C.1.3.

LAPFF requests that the original positive assertion requirement is kept (ie, the company "is" a going concern).

Question 8: Do you have any comments on the draft guidance in Appendix B on the going concern basis of accounting and / or the viability statement?

The investor coalition submission to which LAPPF was a signatory also raised concerns over the use of "at least 12 months" on the grounds that setting explicit timeframes does not sit well with the economic reality of varying business cycles. In this context, the repetition in the guidance of 12 months as the reference period over which material uncertainties in the financial statement should be identified is not supported.

The guidance concerning the list of principal risks is welcome and proper non-boiler plate disclosure of these risks will give shareholders valuable information. However, the list is 'nice-to-have' and will not generate the desired level of accountability considered vital for the protection of capital and to ensure effective stewardship. See also our comments to Question 5 above.

Question 9: Should the FRC provide further guidance on the location of the viability statement?

The current Listing Rule requirement should continue to be satisfied by C.1.3 albeit a revised version providing that the statement continues to be a positive assertion as set out in our answers to Question 6 and 7 above. The FRC should avoid creating a situation in which the viability statement qualifies as compliant with Listing Rule 9.8.6R (3). Such a change, if enacted, would in LAPFF's view weaken the robust financial governance standards which attract investors to London Listed companies.

Question 10: Should the recommendation that companies report on actions being taken to address significant failings or weaknesses be retained? If so, would further guidance be helpful?

LAPPF supports the retention of this recommendation.

Question 11: Should the option of giving companies the possibility of putting the full corporate governance statement on their website be considered further? If so, are there any elements of the corporate governance statement that should always be included in the annual report?

No. The LAPFF position is rooted in the financial governance framework provided by law which by default gives shareholders voting rights. The schedule for exercising voting rights is by design complementary to the schedule provided by law for annual statutory reporting obligations and the ongoing related obligation to maintain accounting records that demonstrate solvency at any time.

Separating important governance disclosures from the annual report, which has a fixed chronological relationship to voting at the AGM, risks damaging the deliberate temporal relationship between information rights and voting rights.

Question 12: Are there any disclosure requirements in the Code that could be dropped entirely?

As stated in LAPFF's submission to the FRC's Directors Remuneration Consultation in November 2013 there are various provisions which have been overtaken by legally required disclosures that we now consider redundant.

D.1.3 requires companies to seek shareholder approval for grant of options to non-executive directors. Under the regulations, such grants will in future not be possible unless approved future policy tolerates this practice. As such, this provision appears to be redundant.

D.2.1 requires a statement about the relationship of remuneration consultants to the company. This is now redundant. The law as set out under Para 22 b-c of the regulations is much more stringent.

D.2.3 allows for the power to determine non-executive pay to be delegated to a board committee subject to an adjustment to articles which give shareholders this power. The disclosure provisions relating to non-executive fees in paragraphs 25 and 28 of the new regulations are consistent with the idea that shareholders need full disclosure of non-executive pay to exercise their powers under the Articles. The suggestion in the Code that a board committee is able to determine fees risks divorcing disclosure from the power to act on information that is disclosed. This provision should be removed.