CMIT

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Resetting the UK's approach to corporate governance – an open letter from the Capital Markets Industry Taskforce

As the Chancellor said in his speech at the Mansion House on 10 July and in his Autumn Statement today, we are all united in the desire to improve the financial services sector to enhance further both its competitiveness and that of the corporate sector it supports in order to increase returns for pensioners, improve outcomes for investors and unlock capital for our growth businesses.

The primary role of business, served by the financial markets and the financial services sector which support it, is to drive economic growth and to create meaningful and fulfilling jobs for everyone, across the UK. And thereby to secure the financial returns that ensure dignified and financially secure retirements for all who entrust investment in our economy to deliver that outcome.

We agree with the Chancellor that, as a country, we start from a position of strength. The financial and related professional services industry employs over 2.5 million people and two-thirds of them are located outside the South East. It generates more than £100 billion in tax revenue, paying for half the cost of running the NHS. A strong City depends on a successful economy, and a strong economy depends on a successful City. And a successful City only stays successful if it stays competitive.

As part of that, we strongly believe that the UK's governance and stewardship regimes must take into account how they contribute to the country's economic growth and its international competitiveness. In that context, we welcome the policy update from the Financial Reporting Council (FRC) on 7 November and the remit letter sent to the FRC by the Secretary of State for Business & Trade today.

In its policy update the FRC recognised that it has an important public interest role to enhance the quality of audit and corporate reporting and governance to ensure confidence in our markets, while also supporting delivery of the UK's economic growth and its international competitiveness. The FRC recognised that this involves setting standards proportionate to the primary objectives of supporting market confidence and economic growth and also supporting the Government's broader ambition of making the UK the best place in the world to start, grow and invest in a business. As such, we also believe that the FRC's decision not to take forward the majority of the proposals in its recent Corporate Governance Code consultation is the correct decision. We also welcome the decision to review the Code's associated guidance and to carry out a root and branch review of the stewardship regime. We strongly agree with the Secretary of State that the FRC's role should contribute to promoting the competitiveness and growth of the UK economy, embedding that growth mandate across its work. We also agree with the Secretary of State's note that proportionality of any new requirements is essential and that it is also important to look actively at where rules and guidance no longer serve their original purpose proportionately and can be removed or streamlined. The governance and stewardship regimes in the UK have since Cadbury successfully evolved and adapted to changing times, that is one of their strengths. Now they must

adapt again to ensure their relevance to the competitiveness of the markets they apply to. Of course, this is not a new idea – the Department for Business, Energy and Industrial Strategy, as it was called then, noted in its response to its consultation on its white paper called 'Restoring trust in audit and corporate governance' that "*the Government is seeking to ensure that the reforms are consistent with the central aim of the Hill Review of UK listings: to make the UK an even more attractive place to list*".

With that in mind, we set out below some positive recommendations for that evolution and the reframing conversation that the FRC started with its policy update on 7 November and the Secretary of State has continued with today's remit letter to the FRC. As a fundamental principle, UK listed companies should not be subject to requirements companies listed on other high-quality exchanges are not subject to, without those incremental requirements being justified. In that context, we have given considerable thought to what an updated set of high-level principles could look like as part of a recalibrated governance and stewardship regime. These should form part of a reset and updated 'issuer and investor covenant'.

The covenant should emphasise collaboration and the presumption of trust between investors and the issuer boards they have appointed, through the application of the governance and stewardship regimes. We feel that too often the current regime, particularly in the stewardship space, is set up by default to be antagonistic to demonstrate challenge and such a regime cultivates mistrust.

Good stewardship is now assumed to be a measurable output that is capable of being gauged by reference to the number of letters written and number of votes cast against board resolutions; this is misleading and counter-productive to good stewardship. Good stewardship should revolve around committed long term shareholdings and consistent and balanced conversations in relation to a company's strategy, governance and culture and should recognise that shareholders can, and will, legitimately have strongly divergent views.

Engagement with shareholders has to include a balanced and constructive dialogue in relation to remuneration policy. In today's truly global market for talent, the attraction, retention and reward of talent is a key component of competitiveness. This does not mean an endless rise to global reward levels, but boards need to be able to make – and justify – decisions on reward as they do on other strategic matters. In this area agreement should be reached between investors and issuers that UK listed companies should enjoy a level playing field with regard to the remuneration frameworks accepted for listed and private market peers in Europe and the US. Such equivalence should be implemented by investors in terms of setting out their approach and expectations. At present, the divergence is marked and has become in many industries, particularly those with a global footprint, a significant recruitment and retention issue, talent drain and a growing deterrent to listing on the UK's main capital markets.

In considering remuneration policy, the question of reward quantum should be separated from structure; this is a matter for boards to justify to investors in their own particular circumstances, with benchmarking appropriate to the relevant competitive environment or phase of development being used to help determine that quantum. The aim should be to encourage simple remuneration structures that clearly align the interests of shareholders and management with simple reporting that is easy for investors to digest and less time-consuming for issuers to produce.

New investor and issuer forum

To drive and embed the reset and enhanced issuer and investor covenant, a new 'investor and issuer forum' should be established that can facilitate and promulgate more effective ongoing engagement between boards and their shareholders.

It should bring together industry leaders from the boards of listed companies and the investment community to identify key challenges and issues. It would enable them jointly to develop practical solutions and actively shape the UK capital markets in which they operate. The forum would seek to enhance effectiveness, reduce friction and increase competitiveness. It could also be the forum in which the multitude of investor groups' desire for new disclosures and metrics could be discussed, distilled and implemented.

The Investor Forum have indicated that they would be willing to take on this evolved role. This could offer a quick and efficient solution without requiring a lengthy set-up or the costly establishment of new initiatives. To deliver market-wide impact, it would be crucial for it to be fully supported by issuers and investors and to secure enhanced funding to carry out this enhanced role. This could be done for example by issuers in aggregate matching the current annual investor funding (circa £1.25m) of the Investor Forum for the next three years via a Takeover Panel-style levy.

Resetting principles

We set out below suggested revised principles, spanning both issuers and investors, as well as other critical amendments to the existing Code that we consider are required.

Issuers

The Corporate Governance Code should support the promotion of a company's success, as opposed to the prevention of its failure, to create value for all its stakeholders, including shareholders, employees, customers and society at large.

At the heart of governance is the explicit accountability of the board to the company and its stakeholders. Boards should be seen to hold themselves accountable. If a board member does not perform, their departure from the board should not be characterised as a routine retirement.

The board is accountable to the members of the company and should have the freedom to exercise its powers and judgement as it sees fit in line with the authorities delegated to it and in line with the duties of directors, including to promote the success of the company for the benefit of members as a whole.

As such, the presumption within our governance framework should be that a board will meet the highest standards of governance and transparency. But it should be able to deviate from a conventional application of these standards if it concludes that to do so is in the best long-term interests of the company – and where it decides to do so it should explain why that deviation is important for the promotion of the company's success.

The board should clearly explain how its chosen strategy discharges its duties to the company and its members. This should include appropriate metrics, as well as the role that its chosen remuneration system plays in supporting and reinforcing that strategy. The board should be free to implement its chosen strategy with appropriate explanations being given for any unconventional governance choices.

As is the case now, the chair should continue to be available to shareholders and they and the rest of the board should be annually reappointed based on their performance in delivering the chosen strategy.

Investors

The governance function and governance view within an institutional investor should reflect the stated governance policy position of the fund management function, including in relation to individual issuers. There should be consistency in the approach taken for UK listed companies and international peers. If the approach with regard to UK listed companies differs, it should be made clear why.

The governance and fund management functions within an investor should be fully integrated, with primacy given to the accountable portfolio managers.

Equity-owning investors should discharge their responsibilities according to best practice. This should include committing to interact directly with individual issuers as necessary. Equity-owning investors should engage in meaningful dialogue and should resist engaging in optical measures such as simply voting against a resolution without meaningful discussion or outsourcing decisions in relation to issuers to proxy agencies without reserving their ability to take back voting decisions on sensitive matters.

Approach in the event of significant votes against resolutions

The express stipulation in the Code that, in the event of 20% or more votes being cast against a proposed resolution a company should explain what actions it intends to take to consult shareholders should be removed and the IA's Public Register should be discontinued.

This threshold is arbitrary and distorting. In the context of a refreshed and enhanced framework of board and shareholder engagement, it should not be necessary. If a resolution is proposed as an ordinary or special resolution, as appropriate, sufficient votes being cast to pass that resolution should be all that is required. Alongside this should operate the principle that boards will engage with shareholders as appropriate – privately and, if appropriate in the circumstances, publicly – to understand any significant votes against a particular resolution. Regular and enhanced engagement should in any event minimise the circumstances when unexpected votes against are received by an issuer.

Comply or explain

The concept of comply or explain is clear and we know that the FRC has repeatedly emphasised its support for how the principle should properly be used. Issuers should feel free not to follow a conventional application of the Code if the circumstances justify it. However, in reality it has become comply or else given the focus on reporting rather than sustainable value creation. One option would be to recast the principle as 'apply or explain' to make clear that explanation can be compliant. But it will require investors to make it clear that they are much more accepting of nuanced explanations of divergence from a conventional application of the Code, in appropriate cases, than issuers and their advisers appear to believe. This approach also needs to be reflected within the proxy agencies.

Dilution

The dilution provisions contained in the Investment Association's (IA's) Principles of Remuneration should be relaxed. They currently provide that the rules of an issuer's share scheme must provide that commitments to issue new shares or re-issue treasury shares, when aggregated with awards under all of the company's other schemes, must not exceed 10% of the issued ordinary share capital in any rolling 10-year period. And should not exceed 5% in any rolling 10-year period in relation to executive schemes.

These principles were established many years ago and are now outdated. They have a materially limiting effect on the ability of many issuers, particularly fast-growing companies that use shares as a key part of compensation, to reward their people and remain competitive in the war for talent on the global stage.

The limits should either be raised materially or be scrapped altogether, with judgement handed back to boards to decide how best to structure their compensation approach as part of the board's wider strategic approach.

Restricted share awards

Consistent with this, the current provisions in the IA's Principles of Remuneration that provide that the discount rate for moving from Long Term Incentive Plans to restricted share awards should be at least 50% of the normal grant level should be removed.

Conclusion

We believe the suggestions above will enable today's remit letter to the FRC from the Secretary of State and the policy update from the FRC on 7 November to be built on meaningfully by the market. They have widespread support, and we are confident that they will enable us to build towards a recast governance and stewardship regime in the UK that contributes to the international competitiveness of companies listed on our markets as well as our markets themselves. And in so doing these reforms will contribute to driving the UK's economic growth for the benefit of all our citizens and so ensure dignified and financially secure retirements for all.

Yours sincerely

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Julia Hoggett
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On behalf of the Capital Markets Industry Taskforce with one member recusing themselves.

Other supporters:

Main Committee, **The 100 Group**

Andy Griffiths, on behalf of **The Investor Forum**

Bidhi Bhoma, Chief Executive Officer of Liberum

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Susanne Chishti, Chief Executive Officer of FINTECH Circle

Tim Cockroft, Founder & Executive Chair of Singer Capital Markets

Simon Collins, Non-Executive Chair of Big Technologies plc, Chair of The Kubrick Group Ltd, and Chair of the Advisory Board of Quantexa

Dame Elizabeth Corley, Chair of Schroders Plc

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Sir Douglas Flint CBE, Chairman of abrdn plc and IP Group plc

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Martin Gilbert, Executive Chairman of AssetCo plc, Chairman of Revolut Ltd and Chairman of Toscafund Ltd

Lisa Gordon, Chairman of Cavendish plc

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Janine Hirt, Chief Executive Officer of Innovate Finance Ltd

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Rich Ricci, Chief Executive Officer of Panmure Gordon

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Don Robert, Chairman of London Stock Exchange Group plc and Keywords Studios plc

Nick Russell, Chief Executive Officer of Canaccord Genuity Limited

Mike Seabrook, Head of Oberon Capital

Tim Score, Non-Executive chair of The British Land Company plc

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