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28 February 2018

RE: FRC Corporate Governance Code Consultation

Dear Ms Horton

We welcome the FRC's consultation on the Corporate Governance Code and efforts to continue to drive the high governance standards in the UK. Since the inception of the Code in 1992 the market has changed significantly, and it is a testament to structure of the code that the UK continues to lead in this area. Fundamentally we believe that the Code should remain high level, we support the current comply-or-explain approach and welcome the opportunity to feedback on the specific proposals.

Background
Royal London Asset Management (RLAM) is one of the UK's leading fund management companies, managing assets on behalf of a wide range of companies. Our investment specialists manage around £113.6 billion of assets (as at 31.12.2017) across all major asset classes.

Stewardship
RLAM is committed to being a long-term steward of our clients' assets and is fully supportive of the Stewardship Code. Our activities are led by a Responsible Investment Team and are supported by our Fund Managers and Credit Research Analysts. RLAM votes all of its UK equity holdings alongside all actively held global positions. We engaged with 251 companies during 2017 on topics such as Remuneration, Climate Change, Diversity and Succession Planning.

Please find enclosed our detailed response to the consultation questions.

Yours Sincerely,

Ashley Hamilton Claxton
Head of Responsible Investment

UK Corporate Governance Code Consultation

Q.1 Do you have any concerns in relation to the proposed Code application date.

Expectations of corporate governance and corporate behaviour are developing quickly in the UK. Practically, the application of the new Code to accounting periods as of January 2019 is reasonable.

In effect companies would be required to report against the requirements of the new Code in the latter stages of 2020, allowing those who are not currently compliant the time to change reporting practices and hire appropriate additional independent directors. We view the removal of exemptions for SmallCap companies as broadly positive. However it must be emphasised that the significant changes required will result in increased costs and administrative burden. These are largely new, growing companies and we would not want this to act as a disincentive for listing on the Main Market.

It should be made clear that the expectation is for companies to reach compliance as soon as possible, and investors should pro-actively engage with companies to encourage them to reach compliance by the application date.

Q.2 – Do you have any comments on the revised Guidance?

N/A.

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

We support the three suggested methods of employee engagement from the Government's Green Paper Consultation on Corporate Governance Reform. We believe that the greater incorporation of employee views is of enormous value to the Board in identifying any issues and making the Board more aware of company culture.

Due to the different structures and employee bases of companies, the Code warrants an individualised approach on a comply-or-explain basis. Companies should appoint a representative in the manner they deem most relevant and then explain this approach in their reporting.

Further to this we would state that the defining feature of the UK governance system is the comply-or-explain approach and a unitary board structure. We would oppose attempts to be overly prescriptive or moves that would encourage a supervisory board structure as seen in other markets.

Q.4 – 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.

We do not agree the SDGs should be included in the Code. The UN SDGs provide a consistent, cross-industry language for reporting, enabling companies to construct strategies for tackling fundamental global issues. We do not however believe it is necessary or desirable to directly include them into the Corporate Governance Code. Companies may reasonably choose to consider and include the SDGs in their strategic thinking should it fit their business model and long-term goals, which we are supportive of, but this may not be appropriate for all companies.

Rather than forming part of the Code, we would propose they are incorporated into the guidance as an option for companies to consider. This would allow the adoption of reporting practices and frameworks that are most relevant to the Company in question and retain the flexibility that is so integral to the UK approach.

Q.5 – Do you agree that 20 percent is 'significant' and that an update should be published no later than six months after the vote?

We agree that 20 percent is 'significant' and would add that abstentions should also be taken into greater consideration. RLAM uses abstentions as an initial flag of discontent, and we will write to companies in our actively managed portfolios to explain the reasons for an abstention. Therefore we think abstain votes potentially signal the prospect of future votes against management and should not be disregarded.

We also agree with the requirement for an update to be published no later than six months after the vote and would emphasise that this should be meaningful. Responses to significant votes against management are often boilerplate.

Q.6 – 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, board evaluations are an essential part of a well-functioning company. In many ways smaller companies may receive greater benefit from this process than larger established companies, supporting them in periods of rapid growth.

We emphasise that we would prefer for this to remain on a comply-or-explain basis, as the increased requirements on smaller companies will require proportionately greater costs and time commitments. They should be granted sufficient time to comply.

Q.7 – Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

We agree that nine years is a good guideline, but we do not in practice apply it as a strict criterion when voting on director elections. Long tenure in itself is not a bad thing, and we will consider overall tenure of board members, on-going succession planning and the complexity of the business when making our voting decisions. For certain industries or company structures we may apply a more flexible 9-12 year threshold when determining independence, provided the Company can offer explanation for exceeding nine years.

Q.8 – Do you agree that it is not necessary to provide for a maximum period of tenure?

By requiring that all directors be submitted for annual re-election and emphasising criteria that make a director non-independent, we agree that it is unnecessary to define a maximum period of tenure in the Code. Investors have the opportunity to annually assess whether it is appropriate to re-elect each director.

In respect of the independence of the Chair, we welcome the idea that the Chair should be considered independent or non-independent throughout their tenure; rather than excluded from independence

calculations as they are under the current code. We would however caveat that service as an independent non-executive should not preclude their appointment as an independent Chairman on the basis of excessive tenure. We agree with the Investment Association's position that it may be appropriate to extend the definition of independence in these cases to allow for the benefits of experience on the Board, consistency of leadership and the particular nature of the role of Chair of the Board.

Q.9 – 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?

As members of the 30% Club Investor Group we fully endorse the attempts to promote diversity. We are actively engaging with companies to promote diversity and encourage the adoption of initiatives to drive change at the top of the company and throughout the workforce. We believe that the greatest progress will result from a fundamental change in behaviour driven by small initiatives at the ground level.

Efforts in this area would be greatly aided by a consistent definition of what constitutes senior management and a requirement for greater reporting. Currently information in this area is inconsistent and at times undisclosed.

Q.10 – 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 agree with the proposal to extend the provisions of the Hampton-Alexander review beyond the FTSE 350, provided that target-setting remains on a comply-or-explain basis. Meeting the targets under the review is a process that will take time, and certain industries have greater challenges than others in addressing the gender balance. Setting strict rules may undermine progress at the grassroots level.

Something that has become clear from engaging with companies is that some, who appear to be laggards, are actually making constructive, practical steps and developing innovative solutions. We would encourage companies to disclose these efforts, even if they may seem small.

Q.11 – What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to practical implications, potential costs and other burdens involved, and to which companies it should apply.

We endorse the aims of the Parker review to promote ethnic diversity. As with gender diversity it should be acknowledged that this is a process. All progress and attempts should be acknowledged and publically disclosed rather than putting too great a focus on hitting specific targets.

The challenges with ethnicity are more complex than with gender and many companies do not actively assess their workforce in this regard. Work needs to be done to fully understand the best way to tackle this issue, and we would favour a staggered process to implementing formal reporting requirements and/or targets. As with gender, the requirements should start with the largest companies, to be subsequently rolled out to smaller constituents of the FTSE with the proviso that all companies are expected to address this, even if they are not subject to formal requirements.

Fundamentally we believe that companies function better when there is a diversity of background and experience on the Board and throughout the workforce.

Q.12 – 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 agree with retaining the relevant provisions in both the Code and the relevant Listing Rules etc.

Q.13 – 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 have no objections to the removal of these rules to the Guidance, this helps simplify the Code whilst retaining the object of the provision.

Q.14 – 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 are fully supportive of the increased remit for the Remuneration Committee as a way to address the disconnect between executive and workforce remuneration. Whilst this will likely result in an increased workload for the committee, there is little logic in compartmentalising the pay of the workforce from that of the senior executives.

We do not see pay ratios as a particularly useful measure other than to assess the same company year-on-year; we do however think that remuneration committees must consider the remuneration of the CEO in the context of remuneration of the workforce. We believe well-governed companies already consider this, and so formalising it in the Code is welcomed. Just as there is an accepted belief that a CEO's pay should be linked to shareholders' experience, equally the CEO's pay should be sensitive to the experience of the workforce.

In a number of companies this is already the case, with executive pay metrics applying to executive and senior leaders below the board level, but this is not true of all companies.

We do not agree with the requirement under Provision 32 for a Remuneration Committee Chair to have served on a remuneration committee for at least 12 months. The inclusion of this requirement is overly prescriptive and will limit the available talent pool. Whilst we would emphasise that all candidates should be experienced and competent; this provision may exclude those with fresh, alternative viewpoints.

Q.15 – Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

We are generally supportive of long performance conditions and holding periods of three to five years (or longer if suitable for the company), as well as strong clawback provisions or schemes that require directors to hold shares past retirement. We are open-minded about alternative models of pay such as restricted share units (RSUs), provided they are suitable for the company, its business model and strategic plans.

We adopt a case-by-case approach to executive remuneration. Whilst there are certain features against which we will take a stand, we do not presume to know the internal operations of the company better than the remuneration committee. Provided that the remuneration committee gives sufficient

explanation for their decision and can demonstrate the business link and the appropriateness, we believe the directors are best placed to determine how to drive long-term sustainable performance. We therefore are willing to hold directors directly accountable for pay decisions that do not drive long-term sustainable performance through our voting.

Q.16 – Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

Whilst we are encouraged by the inclusion of a provision specifying the use of discretion, we believe that the greatest change here will come from shareholder pressure. Many companies already retain the right to use discretion in their remuneration policies, and claim to have exercised this right in their annual report. The extent to which this is in fact used however, does vary greatly.

Discretion should be used each year to assess whether incentive pay is proportionate to company performance. There have been many high-profile cases over recent years where common sense seemed to be absent from the process of determining executive pay. The granting of pay based on formulaic outcomes, resulting in vastly disproportionate awards without a link to company performance or consideration for employee or shareholder experience, has provoked enormous investor and public backlash.

These issues would have been averted through the simple application of discretion prior to the award. Equally if there is evidence of historic downward discretion, investors are much more likely to support upwards discretion (when appropriate). For example, RLAM supported the proposal at Smith & Nephew in 2016 to use upward discretion because we had extensive engagement with the company and had confidence that the remuneration committee was making the right decision for the business and had considered all the consequences of their decision.

Stewardship Code Questions

Q.17 - Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

The current form of the Stewardship Code is aimed towards 'direct investors,' i.e. asset and wealth managers. By virtue of our position we have greater exposure to companies, greater ability to engage and the chance to make voting decisions. Our approach is driven by our own in-house views and policies, which are influenced by the requirements of our underlying clients, the asset owners.

We agree there is a need for additional guidance for asset owners, which can be a key driver in improving stewardship, but hold no strong views on whether this should be via combined or separate codes. We do think there is a disconnect between what asset owners <u>say</u> they want from their asset managers with regards to Stewardship, and the <u>actions</u> they take (through awarding mandates or requiring reporting or action from asset managers). While this gap is closing and we are seeing more asset owners ask us questions about Stewardship, we think there is still a wide spectrum of expectations from asset owners on Stewardship (from disinterested to hugely supportive) which can send mixed signals to the market. Guidance to support and encourage more consistent and clear requirements from the 'demand' side would in turn encourage asset managers to invest further in their Stewardship capacity.

Q.18 - Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

We do not believe the Stewardship Code should be more explicit about expectations, as it erodes the core purpose of the Code, which is to promote transparency and investor-led Stewardship. The danger in moving to a comply-or-explain model for the Stewardship Code is that the consequence could be a move towards a more tick-box approach, with asset managers focussed on specific topics and issues, rather than on enacting their own Stewardship approach.

The scope of the current Code allows for variations in internal stewardship polices, permitting a much more comprehensive, integrated and materiality-driven approach. By encouraging transparency and disclosure this enables asset managers to focus year-by-year on what is considered to be material.

We would argue for the retention of the current model and emphasise the points above, that by better defining the requirements of the various stages in the investment chain, this will drive best practice.

Q.19 - Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

We think the tiering exercise was useful, and moving forward, it could take place on a rolling three year cycle to reduce the workload of the FRC. The FRC may want to consider publishing some case studies and examples in its guidance to continue promoting best practice reporting.

Q.20 - Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

As outlined above, we do not think it is appropriate to include specific topics of compliance within the Stewardship Code. Investors will inevitably take different views about what issues are most important at any given time, based on their investment style and client base. The more flexible approach allows investors to pursue and report against initiatives that can and do change year-to-year.

Q.21 - How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

We do not think it is appropriate to include provisions in the Code around specific topics or issues, as highlighted above. However, additional information could be included in the Guidance documents outlining examples of ESG issues that may be material and that may promote the longer-term success of companies. However, we note that active investors will each take their own view on what long-term success looks like, and use this asymmetry of viewpoints and information to generate investment returns for their clients.

Homogeneity in stewardship and investment approach is not beneficial for savers and beneficiaries; there needs to be scope for investors to take different approaches for the benefit of their clients. Other regulatory actions are increasingly promoting the requirement of asset managers and asset owners to consider their beneficiaries and the social impact of their investment decisions (such as the Pensions Regulator), and therefore this requirement does not need to be written into the Stewardship Code.

Q.22 - Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

Any efforts to encourage the integration of ESG and social factors into behaviour and investments should be encouraged, however the current nature of the stewardship code is (as stated above) to encourage transparency and disclosure, rather than impose any overly prescriptive requirements or topics on investors. We are not in favour of modifying the Stewardship Code to set out prescribed topics for investors to report on.

By focusing in this way, the consequence often is that the goals specified in the Code will receive disproportionate attention, rather than what is in the best interests of our clients and the investee company.

Q.23 - How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

We don't believe it is necessary for the Stewardship Code to set out rules or expectations regarding the effectiveness of engagement or how engagement with companies should be reported. Monitoring this would be an impossible task. We believe that being effective at engagement may provide a commercial advantage as an asset manager, and this is why we do it. We believe the market is best-placed to judge which asset managers are being effective in their engagements and those that are not.

Engagement gives us insights into company behaviour, which at times we may consider proprietary, limiting our ability to report publically in detail on the companies, issues, and whether our engagements have been 'effective'. Measuring effectiveness in itself is problematic, as engagement is often undertaken over many years. An effective engagement may result in a change in company behaviour, or it could mean we have obtained additional insight and understanding on which we can make our investment decisions. Effectiveness is highly subjective and any actions to set out expectations around this could lead to a tick-box approach. We are satisfied that our clients hold us accountable for the effectiveness of our company engagements.

Q.24 - How could the Stewardship Code take account of some investors' wider view of responsible investment?

Responsible Investment in relation to asset classes other than equities is an emerging area and further guidance on other asset classes would be useful. However we would caution against being overly prescriptive. We apply the principles of Stewardship to all of our assets and have increased our disclosure and reporting about our Stewardship activities within fixed income specifically.

Q.25 - Are there elements of international stewardship codes that should be included in the Stewardship Code?

We have no strong view.

Q.26 - What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

Independent assurance is important in signalling to our clients that we have the internal processes in place to implement and comply with our public statements. However, the very nature of Stewardship and governance is that it is subjective and requires judgement.

Assurance processes can be damaging to customer outcomes if they reinforce strict rules and processes internally that drive linear decision-making around things like proxy voting. In some cases, deviation from proxy voting rules is in the best interest of companies and clients, but overly strict assurance processes could create a disincentive for asset managers to use judgement when making voting decisions.

We are therefore cautious about introducing additional requirements around assurance because it can have unintended consequences and create worse outcomes around Stewardship.

Q.27 - Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

We do not provide the ability for clients in pooled funds to vote separately. The reason for this is we take a strong 'house view' on governance issues, and communicating this view in a consistent and coherent way is vital if we are to have influence on company behaviour. Allowing separate client voting in pooled funds would dilute this message.

We are very clear with clients before they invest with us about our view on governance issues so they can make an informed decision before choosing us as their fund manager. We would however have no concerns about including a comply-or-explain section to the Stewardship Code asking whether we allow separate voting in pooled funds.

Q.28 - Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

As previously stated under Q.9, we regard diversity of the Board and Executive pipeline as essential to the future success of business. We support its inclusion into the Corporate Governance Code and we regularly engage with companies on this issue as we believe it is a material risk for some. However, its inclusion into the Stewardship Code could again restrict the ability of investors to prioritise engagement that is material to clients and the company in question.

Q.29 - Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

We believe climate change is a material risk for some companies and sectors and therefore we regularly engage with companies on this issue. But, as above, we do not support the inclusion of overly prescriptive topics into the Stewardship Code and think investors are best placed to judge what is material at any given time.

Q.30 - Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

As an opening for our Stewardship Statement we define the purpose of stewardship and why it is important for our organisation and investment decisions, as such we would support the formal inclusion of this into the Code.

Q.31 - Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

We do not support this proposal. Whilst we can and do produce voting and engagement reports for clients tailored to specific funds, reporting against the Stewardship Code at a fund by fund level would, in our opinion, result in a cumbersome and unintelligible report.

Splitting reporting by fund would create higher costs with no additional value for clients. It would duplicate existing client reporting, and would further confuse our corporate message that we take a strong 'house view' on governance issues. We vote and engage with companies on behalf of our entire business, not just specific funds within the business.

The current structure of the report allows an overview of a firm-wide approach to stewardship, giving insight into our efforts in various different areas providing a comprehensive, overarching guide to our stewardship activities. Much of this is driven by the level of the shareholding across the firm, as this is how we may exert the most influence, rather than at a fund level. The funds which require higher level ESG reporting due to their purpose have their own publically available reporting.

We believe the current firm-wide approach to Stewardship Statements should be maintained.