Brunel Pension Partnership's response to the FRC's Governance Code consultation 2023

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About Brunel Pension Partnership Limited (Brunel)

Brunel is one of eight UK Local Government Pension Scheme pools, bringing together £35 billion of investments of ten funds in the Local government Pension Scheme (**LGPS**).

Our priority is to manage our fiduciary duties to our clients. Our partnership has made strong commitments on Responsible Investment and Climate Change, in line with our shared values. In this way, we aim to help our clients provide not only for their members' retirement, but for the world they will retire into.

The strength of the underlying governance of the companies we invest in is therefore crucial to us achieving these long-term objectives for our pension fund members. We are therefore writing our response from the perspective of wanting to grow long term and sustainable value, that helps build '*a world worth living in*'.

Q1: Do you agree that the changes to Principle D in Section 1 of the Code will deliver more outcomes-based reporting?

Brunel broadly supports the changes to principle D in section 1. We recognise the desire for the FRC to align with the FCA's outcomes-based regulatory approach.[1] Nevertheless, we stress the need for further guidance from the FRC for firms to determine what would be considered an outcome of good corporate governance. We believe that demonstratable examples or metrics will be useful for stakeholders to understand how theory translates into practice; more specifically, how actions have improved a company's governance and engagement with stakeholders and how key decisions or changes made through the year have had a material impact on financial or non-financial performance of the company.

Brunel agrees that reporting needs to evolve, and greater emphasis should be placed on how companies are explaining where they are unable to meet requirements.

Q2: Do you think the board should report on the company's climate ambitions and transition planning, in the context of its strategy, as well as the surrounding governance?

Brunel is supportive of the reference to environmental and social issues as well as climate ambitions and transition planning in provision 1. We believe it provides a clear steer for companies that these considerations should form part of their strategy as an essential part of value creation. We, however, emphasise that reference to 'governance' in this provision should not be deleted.

We are not opposed to the specific callout for climate ambitions and transition planning in the provision, given the systemic relevance of the issue and its established materiality for all companies. Dynamic regulatory developments and investors' sharp focus on companies' performance in this area warrant specific mention of these issues. We don't believe that this approach will divert companies' consideration and reporting on other sustainability matters, provided that the FRC sufficiently emphasises this in its guidance.

We recommend that the FRC's guidance also details expectations around governance arrangements relating to sustainability which could include (but not limited to) oversight for sustainability matters, level of sustainability related expertise on the board and steps taken to identify and remedy skills gaps. In addition, it would be helpful to see companies providing

[1] As outlined in the FCA's 2022-2025 strategy Our Strategy 2022 to 2025 (fca.org.uk).

narratives around how significant sustainability matters (including regulatory requirements) are being addressed and progressed on, in the context of the company's business strategy.

Q3: Do you have any comments on the other changes proposed to Section 1?

Brunel supports the explicit reference to embedding culture across the organisation. As the famous quote from writer Peter Drucker states - "Culture eats strategy for breakfast", no matter how good a strategy may be, the culture is of critical importance.

In light of this position, Brunel would recommend further consideration of the following areas:

- Whistleblowing (provision 6): Brunel recommends that the FRC encourage more transparency from the board on how effective whistleblowing mechanisms have been during the year. Specifically, disclosure of board assessment including the number of incidents/ breaches of policies and the actions taken to address issues (including termination) will provide confidence to investors that instances of unethical or illegal conduct are dealt with appropriately and a speak-up culture is embedded. The effectiveness of whistleblowing mechanisms is a key indicator of organisational culture.
- Shareholder engagement (provision 3 and principle C):
    - We welcome reporting on shareholder engagement in the annual report; we caution against disclosures that are high-level or boilerplate. We would recommend that FRC specify in its guidance the level of detail that should accompany reporting on shareholder engagement, for instance, areas of progress following shareholder feedback including publication of policies/reports, enhancement of governance/internal mechanisms and examples of issues that are under board consideration for coming years.
    - We would welcome reference to board accountability for effective shareholder engagement through AGMs under provision C, particularly in the context of virtual-only AGMs. The challenges around democratic participation and shareholder voice have been well-evidenced by investors and investor groups in this regard.[2] We would point to Principle 10 of the ICGN corporate governance principles[3] for expectations around the management of shareholder meetings.
    - We recommend additional disclosure requirements for companies on how they are effectively engaging with shareholders where they have differential share ownership structures, given FCA's proposed changes to listing requirements in the UK. Brunel supports the principle of one share, one vote[4] and is of the view that companies need to transparently explain where they diverge from this principle and establish mechanisms to ensure accountability and appropriate transition arrangements.

[2] https://www.ft.com/content/c6c69607-5e18-4bb8-8140-78457d1823fc; https://www.icgn.org/icgn-insights-article-shareholder-meetings-new-virtual-normal

[3] ICGN Global Governance Principles 2021.pdf

[4] https://www.brunelpensionpartnership.org/wp-content/uploads/2023/03/Brunel-Voting-Guidelines-2023.pdf

- Workforce engagement (provision 5): Brunel is supportive of the provision's encouragement of companies to incorporate the worker perspective in strategic decision making and corporate governance processes. Although we acknowledge that there is no single method that would work for all companies, we note that only a small proportion have workforce directors[5] (on their own or in combination with other engagement mechanisms) in place. Given the potential benefits for companies (see guidance from a group of asset owners [here](#)), we would like to see a genuine consideration of the effectiveness of the engagement methods and reporting of this board assessment via a high-level summary.

Q4 and 5: Do you agree with the proposed change to principle K and provision 15, which seek to make outside board commitments an explicit part performance reviews and improve transparency for shareholders on outside commitments?

Brunel are in favour of the proposed changes. Over-boarding has been linked negatively to company performance, as per a Harvard Law School study.[6] We believe that making outside positions an explicit part of board performance reviews will be in the best interests of the shareholders and the resilience of the company itself.

We are however, understanding of the FRC's current position to not be explicit in determining the number of external positions that can be allowed. In practice, most investors undertake case-by case assessments of over-boarding, considering a number of factors such as (but not limited to) overall board composition, level of independence, size and complexity of operations and structure and diversity.

Regarding provision 15, it is essential that boards provide information on external commitments in the context of actions taken and broader considerations around board effectiveness and not just as a high-level statement intended to justify current practice. In addition, it would be helpful to have sight of underlying internal process that determines whether directors are over-boarded and any internal limits on external commitments that have been instituted.

An improvement in transparency and consistent reporting in one section of the annual report on director profiles, directorships (executive and non-executive), attendance of meetings and committee memberships (including non-profits) will enable investors to take an informed view.

We would also recommend that the FRC provide additional guidance on 'significant' external commitments to ensure a level of common understanding of the term in the context of the above discussed factors/metrics. We offer below Brunel's framework for voting on matters concerning external positions of board members:

We will consider recommending voting against a director who appears overcommitted to other duties, with the guideline of having no more than five directorships. When considering this issue, we take into account a number of factors, including the size and complexity of roles. Certain industries, such as banking (given its business model and regulatory complexity) and multi-site operating companies such as international mining (due to the need for site visits) require more time commitment.

[5] https://www.frc.org.uk/getattachment/56bdd5ed-3b2d-4a6f-a62b-979910a90a10/FRC-Workforce-Engagement-Report_May-2021.pdf
[6] https://corpgov.law.harvard.edu/2019/08/05/director-overboarding-global-trends-definitions-and-impact/

As a broad guideline, we consider a chair role equivalent to two directorships and an executive role equivalent to four directorships. A chair should not hold another executive role and an executive should hold no more than one non-executive role, except for cases where serving as a shareholder representative on boards is an explicit part of an executive's responsibilities. A significant post at a civil society organisation or in public life would normally also count as equivalent to a directorship, whether executive, non-executive or a chair role.

Q6: Do you consider that the proposals outlined effectively strengthen and support existing regulations in this area, without introducing duplication?

Brunel is of the view that the proposals ensure a good balance between providing direction for companies on diversity and inclusion and ensuring that additional or inconsistent requirements are not placed on them. The reference to inclusion along with diversity is an important and welcome change, given inclusion is not often a natural consequence of diversity. It requires individuals to experience empowerment and a sense of belonging independent of their unique characteristics.

Q7: Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

Brunel is supportive of the expanding focus from gender and ethnic diversity to consideration of a broader range of characteristics. We are of the view that companies' workforce should reflect diversity within societies and include aspects such as but not limited to gender, race, disability, age, sexual orientation, gender identity, religion or belief, care-giving responsibilities, socio-economic background and linguistic groups. We would recommend that the wording in provision I is amended to this effect, avoiding reference to 'protected and non-protected characteristics' which may ringfence what companies could consider compliant with UK law.

Q8: Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior appointments?

Brunel is supportive of the reference to diversity in the context of nomination processes and succession planning. We are also supportive of the amendment that includes reporting on the effectiveness of diversity and inclusion policy, and transparency around progress against set targets and initiatives. We think guidance here should also encourage companies to report on challenges in meeting targets and qualify any regression in performance. We also welcome the focus on gender balance beyond the board level and across senior management and their direct reports. Brunel has prioritised gender diversity across the four biggest executive roles, namely Chair, Senior Independent Director, CEO and Finance Director.[7]

[7] https://www.brunelpensionpartnership.org/wp-content/uploads/2023/05/2023-Responsible-Investing-and-Stewardship-Report.pdf

Q9: Do you support the proposed adoption of the CGI recommendations as set out above, and are there particular areas you would like to see covered in guidance in addition to those set out by CGI?

Brunel is in support of the requirement of board chairs to commission externally facilitated board performance reviews. The level of scrutiny and independence that this can bring can be beneficial and provide insights (including on weaknesses) that may not have been captured before.

Q10: Do you agree that all Code companies should prepare an Audit and Assurance Policy (**AAP**), on a 'comply or explain' basis?

Brunel agrees that all code companies (as opposed to just public interest entities (PEI)) should be required under the code to prepare an Audit and Assurance policy statement.

Historically, the lack of scrutiny on audit processes and shareholder sanctions has contributed to poor audit quality and related adverse outcomes.[8] We believe this provision and subsequent disclosures will enable investors to start a dialogue about these processes, even where companies are at early stages of disclosure or are unable to comply with the provision. We would, however, strongly recommend that the FRC sets minimum standards for acceptable reporting and provides guidance detailing how companies can report on a scale proportionate to the level of maturity of the firm in these areas.

We also support the FRC's proposal to allocate responsibility to the audit committee for the development, implementation and maintenance of the policy given the expected level of expertise of the members of this committee. We believe that regular dialogue between audit committees and investors will enable evolution of the AAP statements, making them more informative and well-considered, while closing expectation gaps over time.

Q12: Do you agree that the remit of audit committees should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

Brunel is supportive of the expansion of responsibilities allocated to the audit committee is relation to narrative reporting, including sustainability reporting and related external assurance. As indicated in the consultation document, this is in line with other areas of focus for the audit committee such as the AAP and the resilience statement.[9] The proposed amendment also provides opportunity for companies to integrate their thinking on sustainability and financial issues and provides clarity on the interlinkages and impacts in disclosure. It is essential that sustainability information and metrics are accurate and reliable. Sufficiently senior and effective oversight, accountability and assurance over sustainability reporting is therefore critical.

We do, however, envisage that there may be some challenges in relation to capacity and skill sets as a result of these changes. Accordingly, we recommend that:

- The FRC's guidance should outline how audit committees should be supported on sustainability matters i.e., they must be provided with access to internal and external expertise and where skills gaps are noted via performance reviews, additional

[8] https://www.ft.com/content/b220719a-edca-4ebf-b6bc-5f7a67078745

[9] Particularly where companies will fall under the requirements to produce a resilience statement under proposed legislation.

training should be provided to ensure that committee members stay abreast of developments, including regulatory requirements.

We highlight the BCG-INSEAD Board ESG Pulse Check, which outlines how, of surveyed directors, many see a lack of board ESG competency as a material challenge. Furthermore, 69% of respondents to another study by INSEAD and Heidrick and Struggles said ESG was not integrated into their board competency matrix.[10]

While it isn't reasonable to expect that all committee members will be experts on sustainability issues, they should have a good level of understanding of the sustainability strategy, material ESG impacts on the business and of the business and be able to delegate and challenge management where appropriate. They should also be aware of any knowledge gaps and seek additional support/increase capacity through training. Companies are also expected to be transparent to shareholders where they bolster their capacity through external experts.

- The FRC's guidance should clarify how the requirements for audit committees would work in practice where board-level sustainability committees already have an explicit mandate to consider sustainability matters. The guidance should set out how companies should think about their governance for environmental and social matters and how different board committees could work together to provide oversight of these matters and ensure integrity of reporting. Effective collaboration between committees could also help address the issue of capacity.

Q13: Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal controls systems in a proportionate way?

Brunel is broadly supportive of the FRC's amendments to enhance the effectiveness and disclosures around risk management and internal control systems. Given the code provides a reasonable level of flexibility for companies to implement these changes, we recommend that the FRC provide granular guidance to ensure that:

- the bar is raised in terms of market practice and;
- declarations from company boards boost investor confidence.

In our view, these intended objectives can only be fulfilled if the FRC sets out what boards making a declaration around effectiveness of risk management and internal controls will need to do at the very minimum, covering both processes and desired outcomes. Otherwise, there is a danger that reporting will vary significantly, creating an illusion that appropriate procedures have been undertaken. It will also mean that individual companies will have to determine minimum expectations for themselves, consequently creating difficulties for investors to assess the robustness of the declarations.

[10] Directors Can Up Their Game on Environmental, Social, and Governance Issues: The BCG-INSEAD Board ESG Pulse Check.

Q14: Should the board's declaration be based on continuous monitoring throughout the reporting period up to the date of the annual report, or should it be based on the date of the balance sheet?

While we agree that risk management and internal controls monitoring should be carried out on a regular basis, there could be practical difficulties for the board to declare the effectiveness of these systems at every point during the year on the basis of 'continuous monitoring'. Therefore, we recommend that the FRC articulate clearly in the provision how often these checks should be undertaken by the board to be considered adequate for the purpose of a declaration. That said, we would expect that risk frameworks are built to provide the board with the ability to view risks and incidents at any given time. Furthermore, we expect boards to ensure that the *underlying* risk processes are designed to operate on a continuous basis.[11]

Q15: Where controls are referenced in the Code, should 'financial' be changed to 'reporting' to capture controls on narrative as well as financial reporting, or should reporting be limited to controls over financial reporting?

Brunel supports the expansion of the scope of controls from financial to all reporting. However, we reiterate that the expanded provisions will likely result in variance in the overall quality of reporting. Even within the same firm, we would expect to see different levels of comfort in disclosing against different aspects of risk management and internal controls. Arguably, processes and controls for non-financial reporting will likely be less mature and take time to develop. This raises the question of whether board declarations should be disaggregated, and reporting should address each of the components of the declaration separately.

Q19: Do you agree that current Provision 30, which requires companies to state whether they are adopting a going concern basis of accounting, should be retained to keep this reporting together with reporting on prospects in the next Provision, and to achieve consistency across the Code for all companies (not just PIEs)?

Brunel agrees with the FRC's approach to retain reference to going concern in provision 30. We also support the FRC's position on provision 32, providing flexibility for non-PIE companies in reporting on future prospects.

Q22: Do the proposed revisions strengthen the links between remuneration policy and corporate performance?

Brunel is supportive of the strengthened wording around links between remuneration outcomes, corporate performance, and strategy. We also welcome the explicit reference to ESG objectives in the context of long-term strategy.

Remuneration linkages to sustainability strategy and performance can be value enhancing and create greater management accountability, if structured appropriately and implemented effectively[12]. However, there are several examples of companies that have resorted to ESG-linked pay in ways that exacerbate existing concerns around misalignment

[11] This includes the ability to monitor and identify emerging and changing risks, identifying incidents and effectively implementing remedial action and lessons learned.
[12] https://www.unpri.org/executive-pay/esg-linked-pay-what-does-the-research-say/7863.article

of incentives and performance – e.g. by using vague ESG metrics or by setting ESG targets that are easily achievable and contribute to pay padding[13]. Therefore, we would recommend that the FRC provide guidance for companies around setting of ESG-linked pay in ways that are substantive and meaningful in the context of their operating conditions. For example, companies should be encouraged to avoid relying on qualitative measures or those that do not reflect the ESG priorities of the business. Relevant ESG factors should be selected based on a nuanced understanding of what impacts the financial or the operating performance of a company and how an entity's operations and products impact stakeholders and the environment, in the context of broader societal goals and planetary boundaries.[14] Targets set should be clearly defined and stretching. In addition, companies should provide sufficient transparency on the impact on realised pay, so investors are able to assess the efficacy of the mechanisms in place. Remuneration committees have an important role here in ensuring that ESG-linked pay just as other components of pay are fit for purpose. Where there are adjustments required in line with changes in the broader market or company performance, committee members must use their discretion to adjust pay accordingly.

We support the reference to workforce pay and conditions as one of the factors remuneration committees must pay attention to. Executive remuneration has long been viewed through the lens of corporate performance, however there is a need to look beyond and consider how companies distribute value. In this context, a holistic approach on executive remuneration would reflect on shareholder payouts, workforce pay and value to society in determining what is appropriate. We would like to reference the work of a group of asset owners here that are involved in developing a fair reward framework which is a dashboard that compiles different indicators of fair reward, robust pay setting processes and consultative engagement with shareholders, and enables the ranking of individual companies against each of these 'fairness' indicators.[15]

Q23: Do you agree that the proposed reporting changes around malus and clawback will result in an improvement in transparency?

Brunel is in agreement that the inclusion of malus and clawback in the code will result in improved transparency. We argue this could be furthered through directional guidance to encourage companies to utilise these mechanisms in an effective manner. There is a need for remuneration committees to use malus and clawback more readily, especially in areas where an executive has behaved inappropriately. Accordingly, we are supportive of the provisions in the code that call for transparency on the minimum conditions in which malus and clawbacks would apply. Companies should also establish a broader set of specific circumstances in which these mechanisms could be used. It is critical that remuneration policies, LTIP plans, bonus rules and employee contracts consistently reflect these conditions so there is a greater chance that remuneration committees can exercise discretion and that malus and clawbacks are in fact enforceable.[16] In addition, remuneration committees should be encouraged to develop processes and transparently report on how executives may be assessed against malus and clawback criteria. It is not sufficient that companies set out conditions for when malus and clawbacks will be triggered, there needs to be evidence

[13] https://www.ft.com/content/25aed60d-1deb-4a41-8f39-00c92702b663
[14] https://www.unpri.org/executive-pay/esg-linked-pay-recommendations-for-investors/7864.article
[15] https://www.esginvestor.net/uk-executive-fair-pay-tool-to-fix-broken-system/
[16] https://www.theia.org/sites/default/files/2021-11/Principles%20of%20Remuneration%202022%20-%20Final.pdf

that remuneration committees can and are implementing them in a timely and effective manner.

Q25: Should the reference to pay gaps and pay ratios be removed, or strengthened?

Brunel strongly recommends that the reference to pay gaps and ratios is retained in the code with an emphasis on actions taken to rectify existing gaps and how these measures have been incorporated into decision making of remuneration committees. This will address the FRC's concerns about duplication of reporting. Our view is that pay ratios provide helpful insights to investors on pay conditions across the organisation and more broadly, companies' contribution to systemic societal inequalities.

Q26: Are there any areas of the Code which you consider require amendment or additional guidance, in support of the Government's White Paper on artificial intelligence?

Artificial intelligence (**AI**) is a rapidly evolving area and Brunel would expect that boards are clear that they have considered the issue and impacts to the business and taken appropriate measures (for example on appropriate use of AI). Brunel is exploring our own approach to stewardship on the matter - please refer to a research project undertaken by Bath University students here. This report investigates the opportunities, risks, and public policies associated with the application of AI in various sectors within Brunel's portfolio, including IT, healthcare, energy, and finance.