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Proposed revisions to the UK Corporate Governance Code: a step forward in recognising a company's responsibilities towards wider stakeholders?

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I. Introduction

In December 2017, the Financial Reporting Council launched its consultation on proposed changes to the UK Corporate Governance Code.⁴ Among other things, the revised Code suggests changes regarding stakeholder representation in corporate decision-making⁵ and this note comments on these issues.⁶ It argues that the revised Code should involve all stakeholders in corporate decision-making, rather than concentrate on the interests of one group, i.e. the workforce. Further, it is suggested that the Code is not an appropriate tool for reporting on compliance with s 172 CA 2006 and that it should instead be located within the strategic report. These issues are analysed in turn below (section II and III respectively) and are followed by short conclusions.

II. Gathering the views of the stakeholders

The FRC correctly points out that companies can do more to recognise that other stakeholders play a significant part in promoting the long-term success of the company.⁷ However, the primary focus of the revised Code is on the workforce and not wider stakeholders (in passing, the change from 'employee' interests to 'workforce' considerations is a welcome development and should also be reflected in s 172). The revised Code acknowledges the importance of a wider stakeholder focus, but in practice it concentrates only on the workforce, by discussing the adoption of one of three employee engagement mechanisms – a director appointed from the workforce, a formal workforce advisory council, or a designated non-executive director.⁸

During the consultation period of the revised Code the question is posed whether or not the proposed methods in Provision 3, referred to above, are sufficient to achieve meaningful engagement. Provision 3 states that the board should establish a method for gathering the views of the workforce. In particular, the Revised Guidance on Board Effectiveness ('Guidance') contains very useful advice

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⁴ See <www.frc.org.uk/consultation-list/2017/consulting-on-a-revised-uk-corporate-governance-code>.

⁵ See Section 1, Provisions 3, 4 of the revised Code & questions 3 and 4 of the Consultation. FRC, 'Proposed Revisions to the UK Corporate Governance Code' (2017) paras. 26-33 and Appendix A.

⁶ It reflects the views of the authors expressed in the response to the Consultation Paper.

⁷ FRC, Proposed Revisions, para. 4.

⁸ Section 1, Provision 3 of the revised Code.

on gathering the views of the workforce.⁹ However, the engagement methods suggested in Provision 3 and listed above should apply to all stakeholders rather than only to one group. The Revised Guidance clearly refers to stakeholders more widely (paras. 26 – 30) and the new Code should be in line with the Guidance.

We suggest the following changes to this Provision of the revised Code. First, all references to ‘workforce’ in Provision 3 should be replaced with ‘stakeholders.’ Secondly, we suggest combining an advisory stakeholder panel (including the representation of the workforce) and a designated non-executive director representing all stakeholders. The stakeholder panel could meet outside the board and report to the board through a designated NED. This could be a route to get the views of all stakeholders heard at board level, whilst still achieving the aim to protect the workforce. Nevertheless, if required, companies could suggest alternative ways of stakeholder engagement. The biggest challenge with regard to the suggested stakeholder panel concerns setting out an effective mechanism to determine the composition of the panel and the representation of the interests of all stakeholders. To achieve this goal companies could advertise recruitment to the panel on their websites or publish surveys annually. Alternatively, stakeholders could be obliged to create a central organisation (divided into sub groups) representing their interests, which could be a point of reference for the companies. Other challenges include the role and working pattern of the advisory panel, cooperation between the panel and board and reporting of the NED to the board.

In this context reference to the South African Social and Ethics Committee (‘SEC’) is relevant. It creates a statutory solution and could be applied with adjustments in the UK. In brief, based on s 72 of the Companies Act 2008 (read with Companies Regulation 43) every state owned company, every listed public company and any other company that has, in any two of the previous five years, had a public interest score of at least 500 points (the number of employees and the turnover are some of the factors that will determine if a company is obliged to have such a committee) must appoint an SEC. The aim of this Committee is to draw certain matters to the attention of the board and to then report to the shareholders. These matters include: social and economic development, good corporate citizenship, the environment, health and public safety, consumer relationships, labour and employment. This committee is dealt with in legislation in South Africa, but a similar committee could be provided for in the Code and subsequently formed by companies, on a ‘comply or explain’ basis. In other words, if a company opts not to have such a committee an explanation must be provided. This might fit better with the soft law culture of the UK.

Also, we recommend the following changes regarding the Guidance in the context of Provision 3. The advice on gathering the views of the workforce (paras. 31-36) should be applicable to all stakeholders. Finally, at para. 29, the Guidance refers directors briefly to the Guidance prepared by

⁹ FRC, ‘Proposed Revisions’ Appendix B paras. 31-36.

the ICSA/IA.¹⁰ There should be a clearer link between these documents. At least, the 10 Core Principles from the ICSA/IA Guidance should be repeated in the Guidance. Ideally, both documents should be merged to make the guidance more accessible as currently there is some repetition between them (i.e. Core Principle 1 of the ICSA/IA Guidance is repeated at para. 27 of the Guidance).

III. Reporting on engagement with the workforce and other stakeholders

Provision 4, in Section 1 of the revised Code provides that the board should explain, in the annual report, how it has engaged with the workforce and other stakeholders and how their interests and the matters set out in s 172 influenced the board's decision-making. This provision does not specify how these goals should be achieved though. However, the main critique regarding stakeholder considerations in the draft Code concerns the lack of clear and coherent treatment of these issues. There is an overlap between Provision 4 and the statutory strategic report requirements¹¹ as the aim of the former and latter is to provide details on how s 172 has been applied.¹² Also, Provision 4 stipulates only that this information should be included in the annual report, but it does not specify whether it refers to the governance or strategic report section of the report.

Reporting on compliance with s 172 should take place only within the strategic report. It is not clear why it has to be dealt with in the Code, especially, if the Government is planning to introduce secondary legislation where the aim will be to specifically report on s 172 and where the application will be wider (not just quoted companies, but all companies of significant size).¹³ Overall, Provision 4 should be deleted as it would be an additional layer of disclosure which seems to be excessive in view of the current legislation. If, however, the Government decides to keep Provision 4, the reporting requirements proposed in the revised Code should be linked to these strategic reporting requirements.

Although not specifically relevant, in the context of the revised Code, the introduction of the secondary legislation on the reporting of s 172 is questionable. The law is already quite complex and any additional legislation should aim only at clarifying reporting requirements, especially the current strategic reporting provisions. The strategic report could be used to demonstrate compliance with s 172, ideally by putting a stronger emphasis on consideration of stakeholders' interests (this could be

¹⁰ ICSA and IA, 'The Stakeholder Voice in Board Decision Making: Strengthening the Business, Promoting Long-term Success' (2017).

<www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=press/2017/2017-09TheStakeholderVoiceinBoardDecisionMaking.pdf>.

¹¹ s 414ff CA 2006.

¹² However, the application of the Code and the strategic report is slightly different. The Code applies to all companies with a premium listing of equity shares and the strategic report requirements apply to quoted companies.

¹³ Para iv, page 4 and Action 6, p 32 of the Government's Response to the Green Paper on Corporate Governance Reform.

done by incorporating all factors listed in s 172 into s 414C) rather than only concentrating on shareholders' interests.¹⁴

Another, relevant question posed during the consultation process of the revised Code asked whether specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance is necessary. Our view is that specific reference is not needed. Sustainability should be achieved by compliance with s 172 and the strategic reporting provisions, rather than by the reference to the UN SDGs or other NGO principles in the Code. These principles might be unknown to many companies and crucially could make reporting more cumbersome.

IV. Conclusions

To summarise, the revised Code represents a step forward in recognising the role of wider stakeholders in the company. However, the reform should take another direction. To avoid confusion and overlap, reporting on compliance with s 172 should take place within the strategic report. The revised Code could be used solely for explaining how the company has engaged with all stakeholders (e.g. through the advisory stakeholder panel or designated board committee). Finally, the Guidance should be amended to reflect the interests of all stakeholders and should be better linked with the ICSA/IA Guidance.

¹⁴ See our recent paper <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049203>, especially p 48.