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By e-mail only: FRCReview@beis.gov.uk

Dear Sir/Madam

Independent Review of the Financial Reporting Council: Call for evidence

The views set out in this submission have been prepared by a working group of the Company Law Committee of the City of London Law Society (CLLS). A list of the current members of the committee can be found on the CLLS website:- http://www.citysolicitors.org.uk/index.php?option=com_content&view=category&id=115&Itemid=469

The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

Overview

This response to the Call for Evidence as part of the Independent Review of the Financial Reporting Council (FRC) gives our views and experiences on the FRC's role solely in the areas of the UK Corporate Governance Code (the Code) and corporate governance and narrative reporting, rather than as regards any of the FRC's other functions and responsibilities such as oversight of accounting and auditing.

We include only those questions where we have chosen to respond.

Impact and effectiveness

Q7. **What are the FRC's strengths and weaknesses?**

The UK has for many years had a generally accepted, global reputation for excellent corporate governance. The FRC and the Code are a key part of that. It is, nonetheless, quite right that BEIS and the FRC itself look to the future to see how that reputation can be maintained and enhanced and how the FRC can be made fit for the future.

We consider it a strength that the UK has a separate independent body that concentrates on corporate governance as a key priority and we believe that this has enabled the FRC to instigate and develop the initiatives we mention below and so help contribute to the UK's reputation for corporate governance. We do not believe that reputation would have been maintained had corporate governance been subsumed in a larger regulator with more pressing objectives that took precedence.
Equally, having a non-statutory Code provides an important degree of flexibility and allows for it to reflect and develop in light of changes in the views of a wide range of relevant stakeholders. We consider that maintaining the FRC as a separate, independent organisation specifically responsible for corporate governance through the Code, the Stewardship

Code and related guidance documents and reports aimed at enhancing standards is more likely to help maintain the focus on a balanced approach to corporate governance in the future. That said, for the reasons we give in our answer to Q 31, we feel that enforcement should remain with the Financial Conduct Authority (FCA), albeit with enhanced co-operation between the two organisations.

We consider a particular strength of the FRC to be its wide and transparent engagement with its many stakeholders. The FRC regularly updates the Code at least every two years and as part of the related consultation exercises it engages very widely with companies, investors, advisers and others at all stages until finalisation of the Code. Its Financial Reporting Lab initiative (the Lab) (see more below) is another particularly impressive example of transparent engagement with key stakeholders. This wide and transparent engagement is key in the area of corporate governance where there is a need to build a consensus view and to balance many different interests, particularly those of companies and investors, and where a one-size-fits-all approach is not desirable. We would urge the FRC to continue to act independently and to consult and engage as widely as possible and listen to all views to come to a balanced and consensus driven outcome in the discharge of its responsibilities in this regard

We also consider a strength of the FRC to be its work in trying to enhance standards and share and develop best practice. The FRC has developed a number of initiatives over the years to help raise understanding of particular areas of reporting on corporate governance related issues and so encourage standards to be raised. Examples of such initiatives range from relatively short and simple end-of-year letters to listed companies sent ahead of the next reporting season stating the FRC's perspective on aspects of annual reports that companies should aim to improve on as well as highlighting changes to UK reporting requirements, through to its highly-respected and in-depth Lab reports on, for example dividend policy and risk and viability reporting. Creating the Lab back in 2011, together with its steady stream of reports since then, shows that the FRC is serious about fostering an environment where management and shareholders in particular can work together to improve reporting. The FRC's annual report on developments in corporate governance in stewardship has served to highlight good practice, encourage other companies to adopt this and highlight areas of bad practice or where improvements are needed. Looking more broadly at corporate governance, the FRC has also initiated projects and issued reports/guidance on wider issues such as corporate culture, succession planning and board effectiveness. This sharing and developing of best practice so as to improve standards is a real strength of the FRC.

Corporate governance and stewardship codes

Q22. **In relation to the UK Corporate Governance Code, are there issues relevant to the Review's terms of reference that respondents believe the Review should consider?**

We believe it is unfortunate that the potential role(s) for which the FRC is being considered as part of the evaluation exercise in relation to the process for the adoption or endorsement of IFRS post-Brexit will not form part of this Review as a result of the mismatch in timing of these two exercises.

Q23. **How effective has the Stewardship Code been in driving more and higher quality engagement by institutional investors? If not, why? How might quality of engagement be further strengthened?**

We favour keeping the Stewardship Code as a corollary to the Code, thereby aiming to encourage best practice not just from companies but also from the institutional investor community; that said, the question of how the quality of engagement by institutional investors with companies may be further strengthened is a complex area.

We note that since December 2010, FCA authorised investment firms (other than venture capital firms) that manage investments for professional clients have been obliged under COBS 2.2.3 to disclose on their websites the nature of their commitment to the Stewardship Code or, where they do not commit to the Code, their alternative investment strategy.

The FRC is itself currently conducting an initial consultation on the future direction of the Stewardship Code and we consider that we should await the outcome of this initial consultation and indeed the fuller consultation that will follow later this year.

We would reiterate a comment that we made in our response to the FRC consultation on the Code, namely to suggest that proxy advisory firms acting on behalf of institutional investors should be encouraged to engage early enough with companies on which they are about to issue voting recommendations, so that their concerns can be made known to, and discussed with, the company as soon as possible. The company can then offer an explanation or justification and/or address the concerns before (as opposed to after) final voting recommendations are settled and issued by the proxy advisory firm.

Speed and effectiveness of investigations; enforcement and compliance

Q24. **Do respondents view the FRC as reluctant to undertake investigations or enforcement, or able to do so at speed?**

The regulatory basis for the Code derives from the FCA Listing Rules (LRs) and Disclosure Guidance and Transparency Rules (DTRs), in particular from (i) LRs 9.8.6R(5) and (6) (the requirement for a statement of how a listed company has applied the main principles of the Code along with the comply or explain statement regarding application of its provisions) and (ii) DTR 7.2 (corporate governance statements).

Accordingly, it is the FCA that has the power to enforce the LRs and DTRs, and not the FRC.

Therefore, in this regard (i.e. the Code and corporate governance reporting), the FRC has no status to undertake investigations or enforcement. We query whether it is perhaps wrongly thought by some that the FRC has the same powers as the FCA in relation to corporate governance reporting and companies/directors and as a consequence, has been wrongly criticised for not using powers that it does not actually have. We are not aware that the FCA has ever chosen to seek to enforce the relevant corporate governance provisions of the LRs or DTRs in this respect.

See our answer to Q31 for more on enforcement, for example in respect of the FRC engaging more with the FCA.

Q25. **How could the FRC better ensure it is able to take swift, effective and appropriate enforcement action? What practical or legal changes would be needed to achieve this?**

For the reasons given in this response, we do not believe it is necessary or appropriate to confer enforcement powers on the FRC.

FRC and corporate failure

In relation to questions 27–30, we are very concerned at the suggestions for a more interventionist approach (whether from the FRC or the FCA) with the aim of reducing the risk of corporate failure.

Shareholders delegate management of a company to its board of directors. There are many existing routes for shareholders to gain the information they need in order to decide whether they want to take action or not, such as analysing annual reports and ad-hoc announcements, and having meetings with companies (in particular with non-executive directors including the senior independent director) to

explain their concerns and seek change which may include requiring the appointment or removal of directors. This may be achieved by discussions with the chairman or the senior independent non-executive director or failing this by requisitioning meetings/resolutions or by voting against a reappointment at the annual general meeting. We consider that shareholders are best placed to monitor their investee companies and then decide whether or not to take action if the directors are not exercising those powers as they would wish. There are already statutory bodies (such as the Insolvency Service and the Pensions Regulator) with powers to take action against directors who appear to be in breach of their statutory and fiduciary duties and other obligations following a corporate failure, and this, together with the reputational implications of involvement in any such failure, is generally an effective way of ensuring directors maintain appropriate standards of behaviour and engagement.
We do not consider that the FRC (or any other body) will have the detailed knowledge needed in relation to any individual company, let alone potentially all of the companies that it regulates/oversees, to be in a better position than the directors or the shareholders to decide what would be the best approach to avoid corporate failure and ensure success. It is also not clear to us whether, how, when, or on what basis the FRC (or any such other body) would seek to intervene prior to any such failure actually occurring.

We are also concerned that a more interventionist role or more regulatory focused activity could get in the way of engagement between boards and shareholders and perhaps even be seen as an alternative.

Q27. **Is there more the FRC could or should do to help reduce the risk of major corporate failure?**

We consider that the current approach of the FRC - publishing the Code; regularly reviewing it; engaging with companies, investors and others; issuing publications and reports to enhance standards by sharing and encouraging best practice in reporting as well as giving examples of poor reporting should be continued and is the right approach.

Q28. **Is the FRC quick and effective enough to act on warning signs arising from its work on accounts and financial reporting, or on evidence of concerns over poor corporate governance?**

As mentioned in our answer to Q 24, the FRC does not have any powers to act on evidence of concerns over poor corporate governance or corporate governance reporting. However, as we state in our response on Q 31, we would encourage the FRC to take the initiative in passing on any such concerns to the FCA in a timely and proactive way.

Q29. **Is there a case for a more “prudential approach”? If so, how could this operate in practice, and to which category of company might such an approach apply?**

We are not entirely sure what is meant by a more "prudential approach". If it means a more interventionist approach, then as stated above we are not in favour for the reasons given above.

If it means more supervision and regulation, perhaps along the lines of regulated financial services firms, then in terms of choosing which categories of companies should be included, common thresholds that are chosen for enhanced regulation/reporting obligations relate to numbers of employees or turnover and balance sheet totals. However, we see these as very blunt ways of measuring which companies may have the most impact if they were to fail and so merit a "prudential approach". Whilst it was seen fit following the financial crisis to launch the detailed and long-running Walker Inquiry into the corporate governance of banks and other financial institutions which, following its Final Report, led to an increase in regulation/supervision of financial services entities, we would urge caution and in-depth research before any other entities are similarly categorised as meriting a "prudential approach".

We note that, as part of the response to the collapse of Carillion Plc, there have been calls from MPs for a review of the how the Cabinet Office carried out its risk assessments regarding the public contracts Carillion was engaged in. It seems to us that in cases of strategic suppliers with many Government or local government contracts, a Government body such as the Cabinet Office, with experience of monitoring such contracts and organisations, is better placed to look after that aspect than a regulator without the necessary specialist knowledge.

We appreciate that Parliamentary/Select Committee enquiries now often take a role in examining and reporting where there have been perceived business failings and we also acknowledge that the old-style DTI inspectors' reports were not without their critics, however, we query whether there is actually a gap currently in terms of an enquiry and public report that looks, in a fact-based, objective and holistic way at significant business failures (corporate governance; the board; the role of shareholders; accounting; audit). For example, section 431 of the Companies Act 1985 which set out the framework for these DTI investigations is still in existence. It allows the Secretary of State to appoint "one or more competent inspectors to investigate the affairs of a company and to report the result of their investigations to him." Such an appointment may be made on the application of not less than 200 shareholders or of shareholders with not less than 10% of the issued shares. The Secretary of State may require the applicants to give security "not exceeding £5,000, or such other sum as he may by order specify" for the costs of the investigation (although of course this sum could be increased as the figure is somewhat out of date). Although as mentioned above, these reports were criticised on occasion, we are not aware of any substantive failings in this investigation and reporting regime or of any particular reason why the investigative powers given to the Secretary of State are no longer used. Indeed, the fact that they are still in existence when the majority of the Companies Act 1985 has been repealed or subsumed into the Companies Act 2006 implies that the various bodies involved in the new legislation thought that these powers were useful and should be retained. In addition, section 447 of the Companies Act 1985 allows the Secretary of State to authorise an investigator to require a company to provide such documents or information as the investigator may specify.

Q30. **Introduction of the viability statement was an important development, but could it be made more effective?**

We consider that as this is a relatively recently introduced disclosure requirement and the issue by the Financial Reporting Lab of its November 2017 report on risk and viability reporting has only recently taken place, this area of reporting should be allowed to continue to develop without further change at this stage. One failure (the well-rehearsed example of Carillion) does not mean that the current requirement for a viability statement is either ineffectual or in need of reform.

Powers and sanctions

Q31. **Are there gaps in the FRC's powers? Would its effectiveness be improved with further (or different) powers?**

For the reasons given below, we do not believe that it would be appropriate for the FRC's powers to be expanded.

We note that the Government, in its response to the consultation on the Green Paper on Corporate Governance Reform, chose not to alter the FRC's powers but instead asked that new or revised letters of understanding be agreed between the FRC and other regulators. The Government response talked of this approach being "in line with the UK's approach of strengthening corporate governance through non-legislative, code-based provisions and voluntary industry action to keep pace with higher expectations of business, and only legislating where necessary". We strongly support that approach.

In response to this Government request, the FRC entered into a number of Memoranda of Understanding (MoU) with the likes of the FCA, the

Serious Fraud Office, the Department for Business, Energy and industrial Strategy and a temporary arrangement with the Insolvency Service; for example, in December 2017, the FRC entered into an MoU with the FCA as regards arrangements for co-operation and co-ordination between the two. The MoU deals with, among other things, information sharing and mentions the areas of corporate reporting and corporate governance and notes that if one regulator considers that information it has gathered will be materially relevant to the other, it will notify it so that the other may make a formal request for disclosure (para 14).

Whilst we are very supportive of the FRC, we do not think it would be appropriate for the FCA's powers to move to the FRC. In our view, there is insufficient evidence to support any such move. As the LRs and DTRs address the disclosure requirements in respect of compliance with the Code and other narrative reporting requirements outside of the Companies Act 2006, it is entirely consistent and appropriate for the FCA to have the related enforcement powers. Moreover, the FCA is very experienced in its enforcement role and, given its enforcement role over the whole of the LRs and DTRs, is able to take a holistic, balanced view and decide where the key issues and breaches have occurred.

Instead, at this stage, we suggest that now that these more formalised MoU are in place (although we assume that co-operation took place before the MoUs), they should be given time to work and then be judged before changes in powers and sanctions for the FRC are considered. We would in particular urge the FRC to take the initiative and liaise with the FCA in a timely way once it becomes aware of relevant corporate governance issues. This would leave the FRC to continue with its engagement and enhancing standards role and then to liaise with, and make recommendations, where it feels it appropriate to do so, to the FCA, which would retain its enforcement powers.

We also consider that whilst the FRC regulates accountants, auditors and actuaries and has the role of setting and enforcing the agreed professional standards that apply to them, the position is not the same for directors. Here it is necessary to consider the existing statutory duties of directors. Directors' duties, as set out, in terms of their general duties, in the Companies Act 2006, are owed by directors to their companies and it is for companies to decide whether or not they wish to take action in respect of them. Shareholders may also make their feelings known and try and effect change. Ultimately, companies can take action against any directors, through the courts, for breach of duty (whether for breach of section 172 (the duty of directors to promote the success of the company for the benefit of shareholders) or section 174 (breach of the duty to exercise reasonable care, skill and diligence) or some other duty). Failing that, shareholders may decide to pursue a derivative action under the Companies Act 2006. Although it may be difficult for a shareholder to bring a derivative action on behalf of the company for breach of directors' duties and will, at least initially, involve considerable expense, this is the accepted and long-standing way that directors’ duties are challenged in a case where the company has not taken action itself.

We see no reason why a failure as regards corporate governance or corporate governance reporting (or indeed any other aspect of reporting or corporate governance) by a director should not be treated in the same way as any other potential breach of duty, as described above and be dealt with ultimately by the courts if that is what companies or shareholders opt for.

Moreover, the draft Companies (Miscellaneous Reporting) Regulations 2018 (the Regulations), which require reporting in annual reports as to how directors have had regard to the matters set out in section 172(1) of the Companies Act 2006, are designed to bring more information into the public domain, in particular into the hands of shareholders. We expect such reporting to develop over time, giving shareholders more of the information they need to monitor their investee companies and decide whether they need to take action. We consider that until the effect of the Regulations can be assessed, other changes in terms of supervision/enforcement and corporate governance should not be made.

If the FRC were to be given power to sanction breaches of the Code, it is not clear what this power would relate to and when and how the FRC would decide to exercise that power. For example, as regards a power to sanction for inadequate disclosure of how the Code's principles have been applied or a power to sanction for inadequate explanations of non-compliance, as such breaches may be very subjective, how would the FRC decide whether a statement/explanation would be inadequate enough to merit sanction? Common complaints are that disclosures are boilerplate or bland or do not give enough company-specific insight, but it is hard to see how the FRC would decide when one company's disclosure is sufficiently bland compared to another's that it merits sanction. Also, if shareholders have not chosen to hold a company to account for a corporate governance disclosure or a meaningless explanation of non-compliance, is it right that the FRC should intervene when shareholders may be content with the explanation or may have decided that, although the statement/explanation is meaningless, it is not sufficiently important to warrant taking action?

To summarise, we feel strongly that the existing routes for enforcement, namely by (i) companies and/or shareholders enforcing breaches of directors' duties (soon to be armed with the additional reporting required by not only the Regulations but also by the additional reporting required, on a comply or explain basis, by the July 2018 Code) and/or by (ii) the FCA enforcing breaches of the LRs and/or DTRs, supported by enhanced co-operation from the FRC, are adequate. Accordingly, in our view, new powers for the FRC should not be considered at this time.

If you have any queries please do not hesitate to contact me.

Yours faithfully

David Pudge
Chair, Company Law Committee

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