The City of London Law Society

The Law Society

Law Society and City of London Law Society response to the Financial Reporting Council's consultation on the Wates Corporate Governance Principles for Large Private Companies

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Preface

The consultation has been considered by the Company Law Committee of The Law Societyof England & Wales ('the Society') and members of the City of London Law Society (CLLS). The Society is the professional body for solicitors in England and Wales, representing over 170,000 registered legal practitioners. The Society represents the profession to parliament, government and regulatory bodies and has a public interest in the reform of the law. 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 specialists committees.

Do the Principles address the key issues of the corporate governance of large private companies? If not, what is missing?

Interaction between legal duties and suggested best practice

1. Whilst we note the helpful statement at paragraph 15 that the Principles do not override, and are not intended to interpret, directors' duties, the interaction between the legal duties of directors and suggested best practice is not clear and may lead to confusion. A statement at the beginning of the document would be beneficial.

2. The primary stakeholders recognised under law are the company's shareholders, and the legal framework for directors' duties rests on the primacy of shareholder interests.

3. In most cases, the interests of shareholders will be best served if the board has a long-term vision and strategy for the company and is a good corporate citizen, cognisant of the role the company must play within the community and with its wider stakeholders.

4. However, the law does not require the board to prioritise long-term consequences or its wider stakeholders (or any particular such stakeholder) over other matters and there may be situations in which the focus of the directors must be short-term. Instead, the law sets out the duties directors owe to promote the success of the company for the benefit of its shareholders as a whole, and has codified certain stakeholder interests as amongst the factors the board must consider (where relevant) when seeking to do so.

5. As currently drafted, Principle 6 and its guidance in particular have the potential to confuse the legal obligations of directors with desirable best practice. This confusion is unhelpful when directors are considering their duties in the context of making decisions.

6. The Principle itself should be re-worded to avoid the implication that a board's primary responsibility in solvent situations is other than to its shareholder(s) and align it more closely with section 172 of the Companies Act 2006. This will also avoid further confusion when directors are considering the additional specific reporting requirements under the new "Section 172(1) statement".

7. We would also suggest that Principle 6 is re-named "*Wider Stakeholders*" and the Principle itself re-worded as follows:

8. "*A board should have regard (amongst other matters) to the interests of wider stakeholders, including employees, and should oversee meaningful engagement and foster good relationships with such stakeholders to allow them to do so. In doing so, a board should be mindful of the company's purpose*."

9. Alternatively, should the Coalition Group prefer to stay closer to the current text, we feel that the following amendments would remove the direct conflict with directors' legal duties:

10. "*A board ~~has a responsibility to~~ should oversee meaningful engagement with material stakeholders, including the workforce, and have regard to that discussion when relevant to taking decisions. The board ~~has a responsibility~~ should seek to foster good stakeholder relationships based on the company's purpose*."

11. In any case, it should be clear that these are not 'responsibilities' of the board, whose primary responsibility is to shareholders in solvent situations, but best practice and matters to be taken into account when making decisions, to the extent relevant to such decisions. We also feel referring to what a board 'should' do rather than has a 'responsibility' to do is more aligned with the purpose of the Principles, and indeed with the drafting of the other Principles. It also should be noted that the duties are owed to the company and not directly to shareholders or any other stakeholder.

12. It should also be recognised that not all stakeholder groups will wish to participate in active engagement at all, or in the same way.

Interaction between the Principles and Guidance

13. More clarity would also be beneficial as between applying the Principles and considering the guidance. It should be made clear that the guidance is just that and that a board can consider itself to have applied the Principles even if it does so in a way different from that suggested by the guidance. This could be done by making this more clear in the explanation of the application of the Principles and through avoiding the directive language currently used in the guidance, which in places is written in the same style, and as if it were an extension of, the relevant Principle. For example, use of phrases such as "*All directors should*…" is more appropriate to a Principle that must be applied than suggested guidance on how to apply that Principle.

14. The explanatory language could be amended as follows to make the interaction between the Principles and guidance more clear:

15. "*The principles are supported by non-exhaustive guidance that helps companies consider how to apply the principles in practice. However, companies should apply the principles in a way that is most appropriate to their particular circumstances.*
The guidance is not intended to be mandatory and nor is it a check-list. Rather than requiring a compliance…"

Importance of commercial sensitivity and open and honest debate in board decisions

16. We also feel that it is important to recognise the balance between (i) commercial sensitivity and creating an environment in boardrooms for open and honest debate and (ii) transparency and reporting on how companies have applied an appropriate governance model. For example, the potential for disclosure of board minutes to impact on the quality and scope of debate at meetings is acknowledged in the Guidance Note on minute taking issued by ICSA: The Governance Institute in April 2017, reflecting its consultation from the previous year, and issues in relation to disclosure of commercially sensitive performance targets have been recognised in the context of remuneration reporting.

17. These issues are particularly relevant when there is a suggestion that details of decision making should be reported. In practice, it would for example be important for all directors to be comfortable with the decisions being reported as examples of how wider stakeholder interests have been taken into account, and also with the manner in which they are reported. As also noted in the ICSA Guidance Note, there are differing pressures on recording and reporting decisions of directors across different industries and types of companies.

AIM traded companies

18. We feel that it would be helpful to refer to the corporate governance requirements for AIM traded companies as well as premium-listed companies to give better context to readers. AIM traded companies are being required, under the recently amended AIM Rule 26, to maintain certain information on a website, including:

19. "*details of a recognised corporate governance code that the board of directors of the AIM company has decided to apply, how the AIM company complies with that code, and where it departs from its chosen corporate governance code an explanation of the reasons for doing so. This information should be reviewed annually and the website should include the date on which this information was last reviewed*;"

20. This could be the FRC's UK Corporate Governance Code, but is typically more likely to be the Quoted Companies Alliance's Corporate Governance Code.

ARE THERE ANY AREAS IN WHICH THE PRINCIPLES NEED TO BE MORE SPECIFIC?

Principle 2

21. We believe that the statement "*All directors should collectively demonstrate…*" should be clarified. Directors have individual duties, including to exercise independent judgement, and (as highlighted in the final paragraph of the guidance on Principle 2) diversity of background, outlook and skills is important to a well-functioning board. However, there is a well-established principle of a board as a whole having the necessary competence. It could be clarified by re-wording it as follows:

22. "*The board as a whole* ~~*all directors*~~ *should* ~~*collectively*~~ *demonstrate a high level of competence relevant to the company's business needs and stakeholders*…"

Principle 3

23. We feel that the use of the term 'constitutional documents' should be reconsidered. It is important to differentiate between the company's 'constitution' within the meaning of section 17 of Companies Act 2006 and, say, private shareholder agreements and board and committee terms of reference etc.

24. If such documents were to be considered part of a company's 'constitution' they should be filed publicly at Companies House and would fall to be treated differently under the Companies Act 2006; for example if directors failed to act in accordance with them. That would likely lead to such documents being 'sanitised' for public consumption and less useful for shareholders, which would we feel be counterproductive and an unnecessary burden to place upon companies.

25. We also feel that use of 'terms of reference' should be clarified. The scope of powers of board committees will always need to be defined vis à vis the board as a whole. However, whilst specific matters may be reserved to the board, it would not be unusual for the board itself to retain the broad powers granted to it under the Companies Act and not to have specific terms of reference; though it may well be that the shareholder(s) reserve certain powers or give certain directions, either generally or in particular circumstances.

Principle 5

26. We note that, as with the UK Corporate Governance Code, the term 'workforce' is used rather than 'employee'. As that is not a term defined in law or regulation, and for example the FRC's Guidance states that in the context of the UK Corporate Governance Code it is not meant to align with legal definitions of workforce, employee, worker or similar, we feel it would be beneficial to include guidance on how companies should interpret this term if its use is retained. They will at the same time have to consider reporting in respect of their employees, and complying with the various other legal obligations, and so guidance will be valuable to avoid confusion or unnecessary time spent seeking further guidance.

Principle 6

27. As noted above, we feel that this Principle should be re-named to refer to 'wider stakeholders'.

28. As also explained above, we feel as drafted this Principle conflicts with directors' statutory duties and so should be amended accordingly.

29. We feel that it would be helpful to explain the proposed interaction between the guidance stating that the board "*should present a fair, balanced and understandable assessment of the company's position and prospects, and make this available to its material stakeholders on an annual basis*" and companies' existing statutory obligations to prepare an annual report and accounts (including a strategic report). In particular, if companies comply with their statutory reporting obligations, what more is expected in order to comply with this Principle.

30. The annual report and accounts will be publicly available at Companies House, and so available to all stakeholders. If the intention is for example that in addition to this companies should be making the annual report and accounts available on their websites (we note that will now be a requirement for the new "Section 172(1) statement") then it would be helpful for that to be stated. Similarly, if it is felt that companies making their annual report and accounts available to stakeholders would not be sufficient, then more guidance should be given as to what more is desirable or expected.

31. As explained in our comments under Principle 5, we feel that guidance would be beneficial in respect of the use of the term 'workforce'.

DO THE PRINCIPLES AND GUIDANCE TAKE SUFFICIENT ACCOUNT OF THE VARIOUS OWNERSHIP STRUCTURES OF PRIVATE COMPANIES, AND THE ROLE OF THE BOARD, SHAREHOLDERS AND SENIOR MANAGEMENT IN THESE STRUCTURES? IF NOT, HOW WOULD YOU REVISE THEM?

32. Yes, we feel that the high-level nature of the Principles allows their application across a broad range of structures, and this will be important to their adoption and use by companies. Were they to be more prescriptive then they would be less likely to be adopted.

33. However, as noted in our answer to question 1, we do feel that it is important to clarify the non-mandatory nature of the guidance to ensure that companies feel that they can adopt the Principles in a way that is most appropriate for their particular circumstances; and in particular that they do not have to 'apply' the guidance.

DO THE PRINCIPLES GIVE KEY SHAREHOLDERS SUFFICIENT VISIBILITY OF REMUNERATION STRUCTURES IN ORDER TO ASSESS HOW WORKFORCE PAY AND CONDITIONS HAVE BEEN TAKEN ACCOUNT IN SETTING DIRECTORS' REMUNERATION?

34. Yes, to the extent that this should be provided through the Principles. We do not feel that any additional detail or prescription would be necessary or appropriate, especially as this is an area already subject to specific legislation and regulations. As noted in our answer to question 3, were the Principles to be more prescriptive then they would be less likely to be adopted.

SHOULD THE DRAFT PRINCIPLES BE MORE EXPLICIT IN ASKING COMPANIES TO DETAIL HOW THEIR STAKEHOLDER ENGAGEMENT HAS INFLUENCED DECISION-MAKING AT BOARD LEVEL?

35. No. Please see our comments under question 1 in respect of the importance of commercial sensitivity and open and honest debate in board decisions and under questions 3 and 4 in respect of the importance of the Principles not being overly prescriptive.

DO THE PRINCIPLES ENABLE SUFFICIENT VISIBILITY OF A BOARD'S APPROACH TO STAKEHOLDER ENGAGEMENT?

36. Yes, to the extent that this should be provided through the Principles. As noted in our answer to question 3, we do not feel that any additional detail or prescription would be necessary or appropriate.

DO YOU AGREE WITH AN 'APPLY AND EXPLAIN' APPROACH TO REPORTING AGAINST THE PRINCIPLES? IF NOT, WHAT IS A MORE SUITABLE METHOD OF REPORTING?

37. Yes, provided the interaction between the Principles and guidance is clarified as suggested in our answer to question 1. It should be clear that not following the guidance does not equate to a failure to 'apply' (or fully apply) the Principles and that a set of procedures, standards and behaviours which achieve the same objective as any particular Principle through another route does not represent a failure to apply the Principles.

THE PRINCIPLES AND THE GUIDANCE ARE DESIGNED TO IMPROVE CORPORATE GOVERNANCE PRACTICE IN LARGE PRIVATE COMPANIES. WHAT APPROACH TO THE MONITORING OF THE APPLICATION OF THE PRINCIPLES AND GUIDANCE WOULD ENCOURAGE GOOD PRACTICE?

38. The Principles are part of a wider context of law, regulation and best practice and should not be considered in isolation, and nor should the requirement to comply with law and regulation be confused with the desirability to follow best practice.

39. To the extent companies are required to publish a "Section 172(1) statement" and choose to adopt the Principles as a "corporate governance code", this should be monitored together with companies' various other reporting obligations in the same way as any other reporting obligation and we do not see that any new powers or processes are necessary to do so.

40. In respect of adoption of the Principles as a measure for best practice, it will be open to interested parties to consider what, if any, code has been adopted and review companies' statements about their compliance and application of that code. For example, to the extent wider stakeholders such as employees and suppliers have particular concerns they can take those concerns into account when considering whether to accept or continue employment or trading with a particular company.

41. Once the new codes and requirements, particularly the requirement to publish a "Section 172(1) statement", the revised UK Corporate Governance Code and the revised AIM Rule 26 (as discussed in our answer to question 1) have all had time for companies to develop their understanding and application, and for interested parties to review the information reported, their impact could then be reviewed and considered further. For the moment, it is important to allow such time for assessment before imposing further changes.

DO YOU THINK THAT THE CORRECT BALANCE HAS BEEN STRUCK BY THE PRINCIPLES BETWEEN REPORTING ON CORPORATE GOVERNANCE ARRANGEMENTS FOR UNLISTED VERSUS PUBLICLY LISTED COMPANIES?

42. As noted in our previous answers, it is important that the Principles are not overly prescriptive and (subject to our previous comments) we feel that this balance has been struck appropriately in the draft Principles.

43. As noted in our answer to question 1, we feel that it would be helpful to consider AIM traded companies in addition to premium listed companies to more clearly explain the wider context for the Principles.

WE WELCOME ANY COMMENTARY ON RELEVANT ISSUES NOT RAISED IN THE QUESTIONS ABOVE.

44. We have included commentary on relevant issues within our answers to the earlier questions, in particular questions 1 and 2.