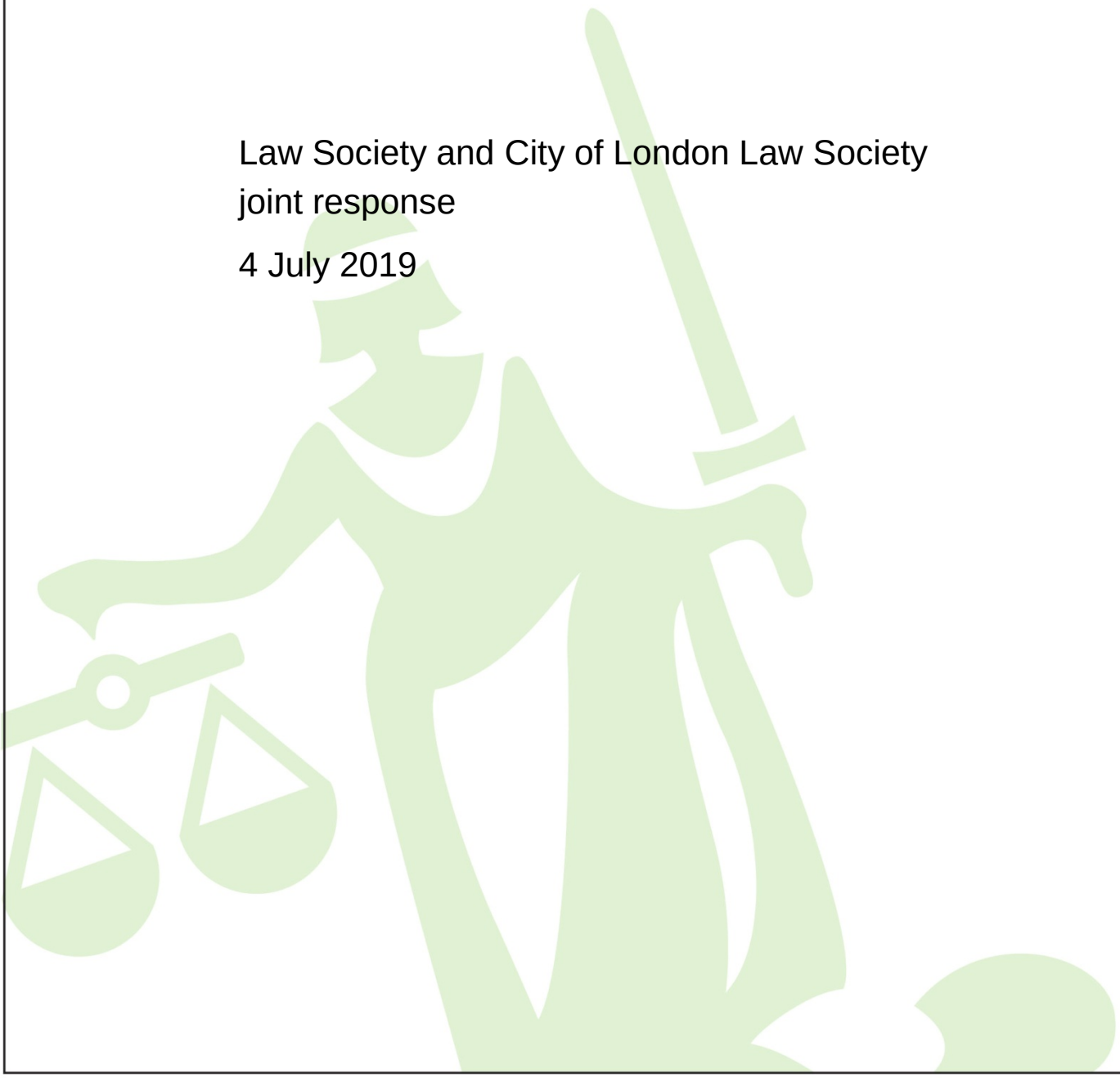
The City of London Law Society

The Law Society

ICSA review of the effectiveness of independent board evaluation in the UK listed sector

Law Society and City of London Law Society joint response

4 July 2019



Introduction

1. The views set out in this response have been prepared by a Joint Working Party of the Company Law Committees of the City of London Law Society (**CLLS**) and the Law Society of England and Wales (the **Law Society**) (together the "**Committees**").

2. 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.

3. The Law Society is the professional body for solicitors in England and Wales, representing over 160,000 registered legal practitioners. It represents the profession to Parliament, Government and regulatory bodies in both the domestic and European arena and has a public interest in the reform of the law.

4. The Joint Working Party is made up of senior and specialist corporate lawyers from both the CLLS and the Law Society who have a particular focus on issues relating to company law and corporate governance.

Responses to Consultation Questions

Question 1. Do you agree that the purpose of independent board evaluation is to help boards improve their performance and to demonstrate that they are committed to doing so? If not, what do you consider the purpose should be?

5. The Committees welcome the opportunity to respond to ICSA's consultation and are supportive of measures that have the effect of bringing greater rigor to the independent board evaluation process. In this regard, the Committees consider that the commitment and willingness of boards to assess and understand issues that impact on their ability to perform to high standards and, most importantly, to take relevant follow-up action where actual or potential weaknesses or areas for further development are identified are the critical elements of an effective board evaluation. With this in mind, we would suggest redrafting the proposed definition of "independent board evaluation" (as set out on page 8 of the consultation paper) as shown below:

    - first, to provide a robust and objective review of the board's effectiveness to help the board continuously improve its own performance and the performance of the company; and

    - secondly, to demonstrate to shareholders and other stakeholders that the board is committed to performing to a high standard, and that it is committed to understanding and addressing any areas where remedial action or further development is required in order to enhance its effectiveness.

6. This proposed change to the definition would also need to be reflected in the scope of future independent board evaluation processes in order to assess the extent to which the board has, in practice, sought to address any such previously identified areas requiring remedial action or further development.

Question 2. Will the changes made to the UK Corporate Governance Code in 2018 be sufficient on their own to improve the standard of board evaluation and reporting by listed companies, or would additional actions be helpful?

7. Given that companies can chose to comply or explain with the UK Corporate Governance Code (2018 version) (**Code**) and that there appears to be no real consensus as to what constitutes an effective board evaluation, there is an argument that the Code changes, on their own, may not be sufficient to drive real change in this area. In our view, real change will require both boards to commission independent and robust evaluations and demonstrate a commitment to address any remedial action or further development necessary in order to enhance their effectiveness and shareholders to hold boards to account if they fail to do so.

8. It should be noted that the changes introduced in the Code apply only to financial years starting on or after 1 January 2019 and, as such, companies have not yet published their 2019 annual reports which will detail their compliance (or explain any non-compliance) with the updated requirements of the Code. Our experience is that very few companies have been early adopters of the 2018 version of the Code. Accordingly, it is too early to say whether the changes will have the intended effect of improving the standard of board evaluation and reporting and therefore, whether additional actions will be helpful. On balance we think it would be sensible to allow time for a full cycle of compliance in order to see what changes result from the updated Code before seeking to impose any significant additional requirements for companies.

9. This consultation puts the issue of board evaluation into the spotlight and may, in itself, drive improvements for the first reporting cycle under the new Code as boards will have in the forefront of their minds that if standards do not improve, further action is likely to follow.

Question 3. If further action is desirable, do you support the proposed package of a code for board reviewers and principles and disclosure guidance for listed companies? If so, should they be mandatory or voluntary? Are there any parts of the package you consider to be unnecessary or inappropriate?

10. The Committees support the development of a code of practice for board reviewers.

11. Whilst, in principle, the Committees also support the concept of establishing principles of good practice for listed companies and disclosure guidance for listed companies, we would question whether the introduction of such principles and guidance is warranted at this time. As stated in our answer to Question 2 above, it is too early to assess the impact of the updated Code and whether this in itself will serve to achieve appropriate improvements the standard of board evaluation and reporting.

12. In our view, both the adoption of a code by board reviewers and adherence to the principles and adoption of disclosure guidance by listed companies should be voluntary rather than mandatory. We can see merit in this operating by way of a comply or explain

approach, similar to other provisions of the Code, but do not see this as a necessary feature.

13. We do not consider it necessary or appropriate for either the code or principles to contain a requirement that the reviewer approve any disclosure in a company's annual report relating to the board evaluation. Refer to our response to Question 20 for further details on this point.

Question 4. Are there other actions that should be taken to improve independent board evaluation in the listed sector as well as or instead of these suggested measures? If so, please specify.

14. Please refer to our response to Question 3. We believe that it would be helpful to allow time for a full cycle of compliance reporting against the new Code before seeking to introduce any significant new measures.

Question 5. Should shareholders have more direct influence on the appointment of the independent board evaluator? If so, what form should this take?

15. We support the provisions in the draft principles of good practice for listed companies that no single board member or employee should have sole responsibility for the appointment of an external reviewer and that the decision to appoint any such reviewer should be ratified by either the full board or the nomination committee (draft principle 1). This will ensure that no one individual can unduly influence the choice of reviewer. We would note however that, in the FRC's Guide on Board Effectiveness (**Guidance**) (paragraphs 114-116), the chair has certain responsibilities in relation to the board evaluation, including responsibility for selecting the reviewer. There appears therefore to be a tension between the provisions of the draft principles and the Guidance which, unless clarified, should be addressed.

16. The Committees do not consider that it is appropriate for shareholders to have direct influence over the appointment of the board reviewer. We believe that the appointment of the reviewer is a matter for the board and that, as such, where shareholders have concerns about the appointment of any particular reviewer then these concerns should be raised directly with the board in the first instance. Shareholders have the ultimate sanction of voting against the election or re-election of directors at the AGM if they are unhappy with the way in which the board selects a reviewer, sets the scope for the review or addresses issues identified as a result of the evaluation.

Question 6. Should the code and principles be applied to other sectors as well?

17. The Committees express no view on this.

Question 7. Do you agree with the proposed definition of 'independent board evaluation'?

18. We note ICSA's statement in paragraph 49 of the consultation paper that the determining factor of whether an evaluation is truly independent is whether the analysis of the board's effectiveness has been independently conducted and reported, rather than whether a specific methodology has been followed. The Committees agree with this statement. However, with regards to disclosure, we are of the view that the nature and level of public disclosure should be a matter for the company, consistent with its general obligations regarding the standard of disclosure expected in the annual report and accounts and other market announcements.

19. The definition of "independent board evaluation" on page 34 of the consultation paper refers to an analysis and report prepared by a third party "independent of the company". As noted on page 10 of the consultation paper, there is a high level of concentration in the board reviewer market, with four organisations accounting for 63% of the evaluations. Given that many directors sit on more than one FTSE 350 board, it is inevitable that reviewers may be involved in the review of a director's performance for more than one company. As such, in order to avoid the risk of one director seeking to influence unduly the choice of reviewer where he or she has built up a relationship with a reviewer through their role on another board, we are supportive of draft principle 1 (referred to in Question 5 above) which removes the ability for a single individual to decide which reviewer to use.

20. In selecting a reviewer, boards should also be mindful of possible conflicts or lack of independence (and/or the risk of "group think") if the reviewer also reviews other boards on which directors (and in particular, the chair) sit. We do not think this should necessarily prevent a reviewer being appointed but boards should be alert to the potential issue.

Question 8. Do you agree that a disclosure approach to understanding a signatory's competence and capacity is appropriate? Should the code identify specific processes that must form part of evaluations carried out by signatories?

21. We believe it is appropriate for reviewers to be required to disclose on their website information about their experience, expertise and resources.

22. The Committee believes that as a matter of good practice, there are some minimum standards that should generally be observed as part of an external board evaluation, for example, the reviewer should (i) meet with all directors and company secretary individually; (ii) review board and committee board papers and board/committee minutes; (iii) observe a board meeting and each of the committees meetings; (iv) to have access to the immediately preceding internal and external board evaluation reports. However, we recognise that each company is different and that it may therefore be more appropriate to set out some minimum standards to be observed and ask companies to either report their compliance with such standards or explain any non-compliance, without providing an overly prescriptive approach.

Question 9. Should the code set out minimum standards in relation to the independence and integrity of the reviewer? If so, are the suggested standards the right ones?

23. The standards suggested on page 37 say "*Signatories should not provide any other services to a client during the course of an engagement, or subsequently accept any work from them which might create a perception of a conflict of interest*." However, in the second paragraph below this statement, the draft code recognises that a signatory may undertake up to three consecutive evaluations and follow up for the same client. In our view, the words "*subsequently accept any work which might create a perception of a conflict of interest*" are too wide and we would suggest an alternative form of wording:

24. "…*or subsequently accept any material work from them the nature of which and the timeframe within which it is commenced might create a perception of a conflict of interest*".

Question 10. Do the code of practice and the principles for listed companies deal adequately with potential conflicts of interest?

25. Please refer to the answers to Questions 7 and 9.

26. As referred to in Question 9 above, the requirement in the draft code (under the heading "Independence and integrity") that signatories should not provide any other services to a client during the course of an engagement, or subsequently accept any work from them which might create a perception of a conflict of interest risks being overly restrictive. The focus should be on managing and disclosing potential conflicts of interest.

27. In a similar vein, draft principle 2 of the principles for listed companies (which states that the company will not appoint external reviewers with which it has other current commercial relationships) appears to be unduly restrictive. As stated above, we believe the focus should be on ensuring that any commercial relationship which exists is properly disclosed and arrangements put in place to ensure that a conflict of interest does not arise. Where this cannot be achieved, then the reviewer should not act.

Question 11. Are there any other issues that should be addressed in the code?

28. The Committees do not believe that it is appropriate or necessary for reviewers to have any form of approval in relation to the public disclosure about the board evaluation process and outcomes made by the company in the annual report. Please refer to our answer to Question 20 for a further discussion of this issue. As such, we would suggest the deletion of the heading "Client disclosure" and the paragraph underneath it.

29. Set out below are some additional drafting comments:

30. Under the heading "Competence and capacity":

31. In the third line of the first paragraph replaced the word "qualified" with "competent". There are no formal qualifications required to perform a board evaluation.

32. In the third line of the second paragraph, delete the words "and their shareholders". It is for the board to assess the reviewer's competence.

33. Delete the recommendation that the reviewer should have the ability to "*analyse the effectiveness of specific decisions made over time which were critical to the success of the busines*s". This is clearly a responsibility within the remit of the board and it seems unlikely that any third party would realistically have the necessary competence, access to the relevant information or historic context for the relevant decision to be able to provide any such meaningful analysis in the context of a board evaluation.

34. 6th bullet. At the end of the sentence, the reference to "or" should be "and" (top of pg 36).

Question 12. Is there a need for oversight and/or accreditation, or should service providers be able to self-certify that they are meeting the standards set out in the code of practice?

35. The Committees do not believe there is a need for an oversight or accreditation body. Accreditation brings with it a risk of providing false comfort to boards who use an accredited reviewer. As already stated above, the Committees consider that the commitment and willingness of boards to assess and understand issues that impact on their ability to perform to high standards and, most importantly, to take relevant follow-up action where actual or potential weaknesses or areas for further development are identified are the most critical elements of an effective board evaluation.

36. Separately, there is a risk that imposing specific requirements that need to be met in order to be accepted as a signatory (for example, a requirement that a remuneration consultant has worked with at least one FTSE 350 company in order to become eligible to become a signatory to the code – as per paragraph 64 of the consultation paper) could ironically risk the creation of a closed shop, prohibiting new entrant firms from becoming signatories and therefore, reducing the pool of reviewers, rather than encouraging other reviewers to enter the market.

37. The draft code requires that signatories to the code of practice publish a statement on their website on how they apply the principles of the code and publish on their website information about their experience, expertise and resources. Boards should use that information to determine how well suited a particular reviewer may be to conduct a company's board evaluation. Boards should also publish in the annual reports and accounts details of the criteria they have used in selecting the relevant reviewer and the scope of review that was agreed. This information should then enable other stakeholders to assess the appropriateness of the decisions made by the board and to assess the likely effectiveness of the review.

Question 13. If there is a need for a formal oversight body, which of these functions should be included in its remit – accreditation, monitoring of compliance, dealing with complaints, reviewing and revising the code?

38. The Committees do not believe there is any need for a formal oversight body.

Question 14. Do you have any suggestions for how oversight arrangements might operate in practice (including who might undertake them and how they might be funded)?

39. Given the response to Question 13, the Committees express no view on this.

Question 15. Is there a need for some good practice principles aimed at listed companies conducting externally facilitated board valuations? If there is a need for such principles, do you agree that adoption by companies should be voluntary?

40. We believe that the principles are helpful and build upon the provisions and principles of the Code and the Guidance. We believe their adoption by companies should be voluntary as the way in which any such evaluations are conducted should be tailored to the particular circumstances of the company in question but we do believe there would be merit in companies being asked to explain the rationale for not adopting particular principles.

Question 16. Do the draft principles cover all the relevant aspects of the relationship between the company and external reviewer? Are they reasonable and appropriate? Do they go far enough?

41. Please refer to the answer to Question 10.

42. Draft principle 2 refers to the company not appointing an external reviewer that has carried out more than two previous consecutive full board evaluations. Should this be limited to the two most recent external board evaluations? Alternatively, it could be worded to prevent the engagement of a reviewer that has conducted two evaluations in either the last four or five years?

43. The last sentence of draft principle 3 is in our view unnecessary. As a matter of contract, it will not be possible for a company to seek to amend the terms of engagement without the agreement of the reviewer.

44. Draft principle 4 requires the company to provide the reviewer with access to external stakeholders, where necessary to meet the agreed objectives of the evaluation. In our view, it is for the board, working with the reviewer, to agree the scope of the evaluation and we would resist any change to this draft principle which would require a company to provide access to external stakeholders as part of the review against the wishes of the board. Given the lack of precision as to what is meant by "stakeholders" in this context, we think any such requirement would be overly broad and uncertain in scope. There

may also be potential issues as regards confidentiality and/or privilege in engaging with other stakeholders in this regard.

45. In order to enhance the effectiveness of the review, the Committee believes it may be beneficial to include in the principles of good practice for listed companies a requirement that, if requested by the reviewer, the company provide all relevant information about the previous year's board evaluation and follow up actions taken by the company to address areas of concern that were identified. The reviewer may wish to see this information in order to assess whether certain trends are emerging and/or whether the board is taking/has taken effective action to address weaknesses if the reviewer thought this would be helpful in conducting an effective evaluation of the current board.

Question 17. Should the principles include a requirement that companies should only engage board reviewers that have signed up to the code of practice for reviewers?

46. The Committees do not believe that the principles should include a requirement that companies only engage reviewers that have signed up to the code of practice. Boards should be free to engage the reviewer that they believe is best suited to undertake the board evaluation, regardless of whether such reviewer has signed up to the code. However, we believe that, where a board has chosen a reviewer that is not a signatory to the code, it should explain the rationale for its selection.

Question 18. Is there a need for guidance on how companies should report on board evaluations in order to comply with the provisions of the UK Corporate Governance Code?

47. The Committees believe guidance which builds upon the requirements of the Code and the Guidance would be helpful.

Question 19. Does the draft guidance cover all the relevant issues of interest to investors and other users of annual reports? Are the expectations it places on companies appropriate?

48. We do not believe it is possible or desirable to try to cater for the interests of an undefined group of users of annual reports. People use such reports for a wide range of purposes.

49. Section 172(1) of the Companies Act 2006 requires the directors to act in good faith in a manner most likely to promote the success of the company for the benefit of its members as a whole. In addition, Provision 27 of the Code requires the directors to state that they consider that the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's position, performance, business model and strategy. As such, the primary purpose of the draft guidance should be to assist the board in determining what information will be of most interest to shareholders and to help manage other stakeholders' expectations.

50. Paragraphs 4 and 10 of the draft guidance refer to disclosures around the identity of those persons whose views were sought as part of the evaluation. The list of persons whose views should be sought is different in paragraphs 4, 8 and 10 and should be aligned (note also that paragraph 108 of the Guidance refers to obtaining feedback from the workforce). Both paragraphs 4 and 10 refer to the fact that the views of external stakeholders may be sought. In this regard, we would refer you to our response to Question 16 and our belief that whilst boards may choose to provide access to external stakeholders as part of the review, this should not be a requirement of any board evaluation.

51. Paragraph 8 of the draft guidance requires the company to disclose whether the reviewer has previously facilitated board reviews for the company or for the chair. We suggest that this disclosure requirement be made subject to a time limit, such that it only applies to board reviews conducted in the last five years.

52. With regard to the wording in the last line of paragraph 8 which reads "(or the person who appointed them if not the chair)" we believe it should be clarified that, if the appointment of the reviewer is undertaken by the full board or the nomination committee (as per draft principle 1 of the draft principles of good practice), then it is not necessary to make a disclosure in respect of each member of the board or nomination committee.

53. Separately, and whilst not a matter that we believe should form part of the board evaluation disclosure in the annual report, we are of the view that the guidance should contain a recommendation that those directors who are responsible for selecting which reviewer should act and, accordingly, be put forward for the board's approval, should disclose to the board (and any relevant committee) the nature of any existing relationship with the reviewer in order that the board can satisfy itself that the reviewer has been objectively chosen. Consideration should be given to this including the director disclosing circumstances where the reviewer in question has conducted an evaluation of that director in their role as a director of another company within the last two years. Whilst having recent experience of the way in which a reviewer approaches and conducts an evaluation in practice is likely to be helpful as part of the selection process, the board (or relevant committee) in making the appointment should also be cognisant that a director's own experience of that reviewer (whether positive or negative) may unconsciously influence whether they would wish that reviewer to act. Whilst the fact that a reviewer has evaluated a director in his/her role at another company should not act as a bar to a company selecting that same reviewer, it is important that the board is apprised of all relevant facts and able to assess for itself whether the selection is as objective and unbiased as possible.

54. With regard to the requirement in paragraph 11 of the draft guidance that the company should state whether sections of the report that describe the evaluation process and findings have been agreed with the external reviewer, we do not believe this is appropriate or necessary. Refer to our response to Question 20 below for further discussion on this point.

55. Paragraph 12 of the draft guidance itself recognises that there may be legitimate commercial concerns or other sensitivities which mean that it is not appropriate for some of the findings of the board evaluation and follow up actions to be publicly disclosed. Accordingly, in paragraph 17 of the draft guidance, we would recommend that the words "what specific" in the second line be replaced with the words "the general nature of the". For reasons that we expand on in our response to Question 20, we question whether it is helpful or appropriate to require disclosure of "specific" detail relating to matters which might give rise to developmental needs or remedial action.

Question 20. Should the independent reviewer be expected to certify that the disclosures made by the company are accurate? If so, what form should this take?

56. There are a number of requirements which provide a framework for the board evaluation disclosures in the annual report. In particular, provision 23 of the Code requires the annual report to describe how the board evaluation is carried out, along with the outcomes and actions taken. This is supported by further requirements in the draft disclosure guidance regarding the disclosure of outcomes and actions taken. In particular, paragraph 14 requires the annual report to identity for each of the aspects of the board's performance which have been evaluated, where there is a need for improvement and, where possible, specific actions and a timetable for completing them. In addition, paragraph 15 requires that where companies have identified in previous annual reports specific items that they intend to take, they should report on whether those actions have been implemented and, if not, explain why not.

57. Under section 463 of the Companies Act 2006, the directors have liability for any untrue or misleading statements contained in the strategic report, directors' report, remuneration report or corporate governance statement. Accordingly, as there is already an obligation for directors to ensure that they do not make any statement in the annual report which is untrue or misleading, the Committees do not believe it is necessary for the reviewer to certify that the disclosures made by the company in respect of the evaluation meet this standard (i.e. are accurate).

58. The Committees believe that the focus should be on ensuring that the disclosures made by the company fairly reflect the processes undertaken by the reviewer as part of its evaluation of the board, the nature of any issues/concerns identified and, crucially, the steps to be taken to address any such issues. In addition, progress in addressing issues of concern identified in previous years' evaluations should be reported on in subsequent annual reports.