Response to the FRC consultation on the revised UK Corporate Governance Code from A Blueprint for Better Business

Submitted – 8th February 2018

Introduction to Blueprint

A Blueprint for Better Business (www.blueprintforbusiness.org) is an independent charity which challenges businesses to define and pursue a purpose that serves society, through which sustainable returns to investors are made. This requires a change in prevailing business thinking about both what motivates people and what business success really means.

The Blueprint approach sees organisational purpose - that is the clear reason why the business exists - as fundamental both in guiding the direction of the business and inspiring people to commit to a shared worthwhile endeavour. It sees profit and returns to investors as a necessary condition and outcome, but not the purpose. It recognises that when people are respected and united in the pursuit of a shared worthwhile goal, it releases unrealised potential in people and businesses. There is also growing evidence that businesses which act in this way deliver better long-term performance.2

Blueprint has developed Five Principles of a Purpose Driven Business, which offer a picture of how a business might look if it thinks in this way about purpose and people (they are included in the appendix for information and we reference them throughout our response). The Principles were rigorously developed through a year-long collaboration with a wide range of businesses, NGOs, investors, academics, different faiths and others in 2013.

Since its formation as a charity in 2014 Blueprint has been engaging with the leaders of major UK-based businesses to build a community of senior leaders committed to the purpose agenda and seeking to embed the approach in their businesses.

Overview of Blueprint’s response

Overall, we are very positive about the new Code and Guidance. We welcome the emphasis on the wider responsibilities businesses have to society, and in particular the importance of organisational purpose. We believe that part of the problem in recent decades has been the prevalent misconception that in UK law directors owe their duty directly to shareholders, and that this duty is to maximise shareholder value. Neither is true.3 It is extremely important that the new code makes clear that in UK law the duty of directors is to the company itself. It is in discharging this duty to

1 We are not funded by business but by charitable foundations and individuals.

the company that they have to take due account of the benefit to the members and have regard to those others affected by the company’s actions.

We note that s172 of the 2006 Companies Act does not define the “success of the company”. It therefore leaves room for the directors to define and articulate a purpose for the company which should guide and direct its strategy to create value. The revised code offers an important opportunity to clarify and reinforce the true obligations of directors and thereby promote a more effective corporate-centred (rather than shareholder-centred) form of governance.\(^4\) Alongside this we are pleased that the Government plans to introduce secondary legislation to require all companies of a significant size to explain how their directors comply with the requirements of s172, with regard to the interests of employees, suppliers, customers and other stakeholders (Consultation, p8, para 30).

In pursuing its mission to “promote transparency and integrity in business”, we urge the FRC to keep in mind that **transparency is not an end in itself**.\(^5\) Transparency requirements can be met merely by a business placing information in the public domain – this does not mean that information is accessible and intelligible to those outside the business. **The reporting requirements throughout the Code must be in lock-step with requirements for information to be communicated in a way that is accessible and enables public scrutiny.**

We have not sought to answer every question in the consultation but focused on seven areas where we have relevant experience and expertise. Our response covers:

1. Leadership and purpose and the Code’s recognition that businesses exist to serve society and all their stakeholders not just their shareholders;
2. the importance of lasting relationships and constructive dialogue with stakeholders;
3. Sustainable Development Goals;
4. workforce voice;
5. remuneration;
6. diversity;
7. Stewardship Code

\(^4\) Ibid
1. Leadership and purpose

PRINCIPLE A (Revised Code, p3): A successful company is led by an effective and entrepreneurial board, whose function is to promote the long-term sustainable success of the company, generate value for shareholders and contribute to wider society. The board should establish the company’s purpose, strategy and values, and satisfy itself that these and its culture are aligned.

PRINCIPLE D (Revised Code, p3): All directors must act with integrity and lead by example in the best interests of the company. The workforce should be able to raise concerns in relation to management and colleagues where they consider that conduct is not consistent with the company’s values and responsibilities.

The recognition in these principles and the consultation document that “the primary duty of directors is to promote the long-term success of the company” (Consultation, para 4) is extremely important. In requiring the board to establish the company’s purpose this Principle rightly gives more weight to the significance of s172 and the scope it gives the board to set and uphold an intrinsic purpose. Indeed by placing long-term success, generating value for shareholders and contributing to wider society on an equal footing it helpfully signals that the overriding duty of the board of directors is not to maximise shareholder value.

Core to our Five Principles of a Purpose Driven Business (‘Blueprint Principles’) is that such a business operates true to a purpose that serves society, respects the dignity of people and thereby generates a fair return for responsible investors. Such a business would also enable and welcome public scrutiny of the alignment between its stated purpose and its actual performance. Some businesses fall into the trap of creating a purpose ‘brand’, which is designed by the senior leaders but not reflected in the experience of those working in or with the organisation, or indeed manifested in the corporate strategy.

We agree that it is the board’s responsibility to ensure the business has a clear purpose to deliver long-term sustainable performance, that this clearly drives the corporate strategy and is aligned with the culture. Removing a slight ambiguity in the last sentence of Principle A by adding the word “all” would help make clear the board’s duty to ensure alignment is comprehensive:

The board should establish the company’s purpose, strategy and values, and satisfy itself that these and its culture are all aligned.

It is important that a company’s purpose is authentic and feels real within the organisation (to its employees) and outside (to customers and supplies). This is the implied expectation in the new Code but it would be stronger and clearer if the last sentence of Principle D included a reference to purpose as follows:

The workforce should be able to raise concerns in relation to management and colleagues where they consider that conduct is not consistent with the company’s purpose, values and responsibilities.
2. Lasting relationships and constructive dialogue

INTRODUCTION (Revised Code, p1): to succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders. These relationships will be successful and enduring if they are based on respect, trust and mutual benefit.

PRINCIPLE C (Revised Code, p3): In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.

Quality and trusting relationships are at the heart of our Five Principles. A purpose-driven business should be a good citizen, which considers each person affected by its decisions as if he or she were a member of each decision-maker’s own community.

An effective dialogue with stakeholders will require a high degree of respectful listening. The emphasis behind many of the proposals is on giving stakeholders a voice – which we support - but this is only meaningful if the voice is heard, considered and consciously acted on. Speaking truth to power (whether to boards or senior leaders) is also one of the oldest and most difficult ethical challenges, because it can often entail a real or perceived personal risk.

For such a dialogue to bring the benefits that the new Code envisages, it will require the development of a new and different mind-set and an understanding that making ‘good’ decisions can be difficult and frustrating. Many boards have become used to ‘managing the message’ and being fully in control of the timing of decisions. By contrast, dialogue with stakeholders will need to be given additional time and space.

It is important that board members and senior managers get out of the boardroom and experience the front line. For example, spending time with those who are in debt as a result of the way the company does business (whether individuals or suppliers) would help to ensure the leaders stay close to their stated purpose of contributing to society.

We suggest changing the language in the introduction to make some of these points more clearly:

These relationships will be successful and enduring if they are given sufficient time and space and views from stakeholders are heard, considered and acted on in the boardroom.

The Guidance should also be clearer that (for the reasons set out above) if boards and directors are to achieve the quality of relationships required for long-term success they will need to do much more than simply create new stakeholder inputs for existing meetings. It should provide examples of what best practice engagement looks like and be clear that this requires a significant additional investment of time.
3. **Reporting on the Sustainable Development Goals**

Consultation, para 29, p7 - The independent Advisory Group to the Department of Culture Media and Sport and the Treasury recently published Growing a Culture of Social Impact Investing in the UK. The report recommends that social impact aspects in the context of the UN Sustainability Development Goals (SDG) should be included in the consultations on the Code and the UK Stewardship Code. For the former we have incorporated in Principles A and C the need for companies to consider their responsibilities to shareholders and stakeholders and the contribution made to wider society. In Provision 4 we ask companies to report on these issues and how this has affected board decision-making.

Q4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

A purpose-driven business should be a guardian for future generations, honouring its duty to protect the natural world and conserve natural resources. We support the conclusions from the 2017 Better Business Better World report\(^6\) that the Sustainable Development Goals provide a way for businesses of all sizes to consider the opportunities to grow, whilst having a positive impact on society and the environment.

Many purpose-led businesses and investors we work with already use the SDGs in this way, however others remain unaware of their existence and value. **Mentioning them explicitly in the Code and Guidance as a tool for business to use when developing their purpose and long-term sustainable strategy would be very valuable.**

4. **Workforce Voice**

PROVISIONS (p3, para 3) - The board should establish a method for gathering the views of the workforce. This would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously.

PROVISIONS (p4, para 4) - 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 section 172 of the Companies Act 2006 influenced the board’s decision-making.

Q3. Do you agree that the proposed 3 methods are sufficient to achieve meaningful engagement?

None of the methods suggested will by themselves achieve meaningful engagement with employees but any of them can be useful signals of intent. To be genuine, a consultative mindset is required. In the Blueprint Principles, a responsible and responsive employer is one which enables and welcomes constructive dialogue, including with the workforce, about its performance against its

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stated purpose. This will only be meaningful if the workforce voice is heard, considered and consciously acted on.

To really uncover whether the board is thinking and acting in this way the emphasis should be on providing evidence of how engagement with the workforce has informed and impacted board decisions, rather than the process by which that voice was heard.

Without prejudice to the point above, if specific engagement methods are recommended in the final Code there are some risks that should be flagged more clearly in the Guidance:

- A focus on being a responsible and responsive employer should be front and centre for every member of the board. There is a significant risk with all three options that they pass the responsibility for employee engagement to one person and take the responsibility off the board as a whole.
- Although they may be from the workforce, once appointed to the board as a director our understanding is that he or she has fiduciary duty obligations over and above their representation of a specific group (e.g. employees).
- Board engagement with employees is no substitute for regular engagement between management and the workforce.

5. Remuneration

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<tr>
<th>PRINCIPLE O (revised Code, p12) – The board should satisfy itself that company remuneration and workforce policies and practices promote its long-term success and are aligned with its strategy and values.</th>
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<tr>
<td>Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?</td>
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Consistent with what we noted above in relation to the centrality of purpose, we believe that Principle O would be strengthened by including a specific reference to purpose which should drive performance and determine what success looks like:

The board should satisfy itself that company remuneration and workforce policies and practices promote its long-term success and are aligned with its purpose, strategy and values.

As per the Blueprint Principles, a responsible and responsive employer is one which treats everyone with dignity and provides fair pay for all.

Whatever people are being paid – at whatever level - it should be able to be justified in line with how much value they add to the organisation. There is a distinct difference between people being rewarded for extraordinary excellence – in terms of sporting prowess or innovation or entrepreneurial talent - rather than just accepting an appointment which comes with a large salary
Increased openness and greater internal and external scrutiny of whether pay and policies are aligned to the company’s purpose – as suggested by the Code – are a powerful place to start.

**GUIDANCE (para 103, p20)** - This means overseeing not only pay, conditions and incentives but also other policies that have an impact on the experience of the workforce and drive behaviours. This includes policies around recruitment and retention, promotion and progression, performance management, training and development, reskilling and flexible working.

We welcome the new Code’s focus on empowering Remuneration Committees and stating clearly that their role is to oversee all workforce policies that drive behaviours. *In our experience with large companies, all too often these policies (in recruitment, performance management, flexible working) provide incentives at odds with the business’s stated purpose and values.* The structure of pay and rewards is a powerful indicator of the underlying assumptions about people and motivation. Over time this structure can greatly increase or diminish latent intrinsic motivation, and so affect both culture and performance. The board has a crucial role in understanding and making explicit the assumptions on which decisions are made.

**GUIDANCE (para 113, p21)** - The remuneration committee should engage with the workforce to explain how executive remuneration aligns with wider company pay policy and promotes long-term value generation.

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

The 2018 Edelman trust survey finds that that the most commonly cited barriers to trusting businesses are overpaid executives (58%). The same survey also noted that given the levels of distrust of social media the most powerful way for businesses to communicate is through their own employees, who are trusted mediators.⁷

For both reasons we see particular value in executive remuneration proposals being explained and justified to the workforce and think this should be given greater prominence in the new Code. If the board has a constructive dialogue with its workforce – as discussed above – then this simple act will be a real test of whether the proposals are transparent and fair in the context of the long-term interests of the business. Being required to do this will give remuneration committees further cause to ensure executive pay is justifiable. *Again it would be useful if the guidance note included a reference to alignment to purpose as something the Rem Co should be willing to engage with.*

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⁷ [https://www.edelman.com/trust-barometer](https://www.edelman.com/trust-barometer)
6. Diversity

Q9. Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

The latest research from McKinsey reiterates that diversity is an important factor in delivering long-term sustainable performance. The report finds that companies in the top quartile for racial and ethnic diversity are 35% more likely to have financial returns above their respective national industry medians. Similarly, companies in the top quartile for gender diversity are 15% more likely to have financial returns above their respective national industry medians. The value of diversity has been a consistent feature of our own experience of working with big companies and we welcome the changes proposed in the new Code.

That said, it is important to remember that ensuring diversity of thought is not simply a matter of bringing in new directors. Existing board members also need to develop a mindset that challenges rather than seeks to justify the status quo. Making membership more diverse has an important part to play but this needs to be alongside a mindset change from those who are already there.

7. Stewardship Code

We see the Governance Code and the Stewardship Code as two sides of the same coin – one cannot succeed without the other. There is a lot that companies can do themselves to become more purposeful, but the fundamental shift needed will not happen without an equivalent transition throughout the whole investment system. The investor community is increasingly recognising its stewardship responsibilities – Larry Fink’s 2018 letter to CEOs is the latest high profile example and the door is open for the FRC and others to be ambitious and world-leading, setting the tone of this international debate through the new Stewardship Code.

The new Stewardship Code needs to apply to all those involved in the investment chain - asset owners, consultants, asset managers, analysts – and it must challenge head on the existing incentives and behaviours that disable businesses who focus on long-term sustainable performance.

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We therefore welcome the suggestion of having an s172 equivalent for asset managers (Consultation, p22, para 23), which would give them explicit responsibility for promoting the long-term interests of the company, not simply their own financial returns. We also see significant benefit in requiring all organisations in the chain to have to identify and report on their own purpose, mirroring the approach on “Leadership and Purpose” proposed in the Governance Code.\(^\text{10}\)

As part of our work at Blueprint, we are engaging with a number of stewardship investors on the question of assessing how far company managers are genuinely pursuing a purpose-led approach to running their business. We intend to bring the fruit of those discussions to the forthcoming consultation on the Stewardship Code. We would be very happy to discuss this work, or anything else included in our response, further with you.

\(^{10}\) As proposed in the 2018 Better Stewardship consultation by Tomorrow’s Company, [https://tomorrowscompany.com/publication/better-stewardship-an-agenda-for-concerted-action/](https://tomorrowscompany.com/publication/better-stewardship-an-agenda-for-concerted-action/)
Appendix – Blueprint’s Five Principles of a Purpose Driven Business

**FIVE PRINCIPLES OF A PURPOSE DRIVEN BUSINESS**

**HONEST AND FAIR WITH CUSTOMERS AND SUPPLIERS**
- Seeks to build lasting relationships with customers and suppliers
- Deals honestly with customers, providing good and safe products and services
- Treats suppliers fairly, pays promptly what it owes and expects its suppliers to do the same
- Openly shares its knowledge to enable customers and suppliers to make better informed choices

**A GOOD CITIZEN**
- Considers each person affected by its decisions as if he or she were a member of each decision-maker’s own community
- Seeks and provides access to opportunities for less privileged people
- Makes a full and fair contribution to society by structuring its business and operations to pay promptly all taxes that are properly due

**HAS A PURPOSE WHICH DELIVERS LONG-TERM SUSTAINABLE PERFORMANCE**
- Operates true to a purpose that serves society, respects the dignity of people and so generates a fair return for responsible investors
- Enables and welcomes public scrutiny of the alignment between stated purpose and actual performance

**A RESPONSIBLE AND RESPONSIVE EMPLOYER**
- Treats everyone with dignity and provides fair pay for all
- Enables and welcomes constructive dialogue about its behaviour in keeping true to its purpose
- Fosters innovation, leadership and personal accountability
- Protects and nurtures all who work for it to ensure people also learn, contribute and thrive

**A GUARDIAN FOR FUTURE GENERATIONS**
- Honours its duty to protect the natural world and conserve finite resources
- Contributes knowledge and experience to promote better regulation for the benefit of society as a whole rather than protecting self interest
- Invests in developing skills, knowledge and understanding in wider society to encourage informed citizenship