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UK Corporate Governance Code Consultation – Response from Baillie Gifford

Background

By way of background, Baillie Gifford & Co is an independent investment management firm based in Edinburgh. The firm is a private partnership established under the laws of Scotland and includes a group of companies which are authorised and regulated by the Financial Conduct Authority. The Baillie Gifford group provides one essential service to its clients, namely asset management. Our clients are predominately institutional in nature and located globally. We act solely as agents for our clients either via collective investment vehicles or under segregated arrangements governed by bespoke investment management agreements which set out the terms and limits under which we make investment decisions on behalf of clients.

In fulfilling our role, it is our duty to take into account material factors which affect our ability to exercise informed investment judgement on behalf of our clients. We invest using a long-term horizon, focusing on deploying clients' capital into tangible activities which we believe will generate significant future cashflows and returns. The material factors we take into account are open-ended and wide ranging, including items such as addressable market, management and financial strength, competitive position, potential for technological disruption and sustainability-related risks and opportunities.

Executive Summary

We have an overarching concern that the UK Corporate Governance Code (the Code) is developing into an onerous benchmark rather than a high-level helpful source of guidance to boards, a means to convey useful information to investors and a catalyst for engagement. The Code's influence and standing makes it a target for various stakeholders who seek to further their own goals and ambitions by having their priorities incorporated into it. Care must be taken to avoid the Code being used inappropriately, for example by introducing compliance by the backdoor, duplicating provisions that are already hard-coded in other regulations, and to ensure that its purpose is not diluted by unnecessary additions. Our approach has been to consider whether the proposed revisions to the Code would serve boards, investors and our clients well and in a proportionate manner. We have also considered the fit of the proposals with effort to attract more high-quality growth companies to list in London.

Of most concern to us are the proposals relating to internal controls. Our view is that their incorporation into the Code would be disproportionate and result in unhelpful gold plating of UK governance. If progressed as set out, we think international comparisons would be detrimental to the relative attractiveness of London as a listing venue. We are mindful that, as the outcome of the

FCA's consultation (CP23/10) is not yet known, it is not possible to assess the potential interaction of the two sets of proposals. Elsewhere, we think the remuneration-related proposals should be withdrawn. These would be unnecessary additions given our experience that market practice is already developing well. We have suggested a simplification of the Code's reference to diversity. While we have sympathy with the FRC's attention to director commitments, we have suggested an alternative approach that would strengthen transparency in a proportionate way and encourage engagement when necessary.

We have not responded to all the questions included in the consultation. However, we have included in the next section our response to those we consider most material.

Key Questions

Q1 Do you agree that the changes to Principle D in Section 1 of the Code will deliver more outcomes-based reporting?

We note the proposed introduction of a new Principle whereby companies would be expected to deliver more outcomes-based reporting of their governance activity to demonstrate the impact of their governance practices and how the Code has been applied. While we recognise the FRC's intention is to align board reporting more closely with that of investors in our stewardship reports, we think the change is unnecessary. Our experience is that boards already report extensively on governance processes, practices, activity and outcomes in the Annual Report & Accounts (ARA). These may relate, for example to board, committee, auditor and remuneration changes and/or ESG during the period. More generally, our view is that the *impact* of a board's governance activities is most likely to be evidenced over the long-term rather than in the period covered by the ARA. Even over the long-term, a positive impact will usually be difficult to attribute to specific governance activity given the interplay of governance (including E and S) factors. The impact of good governance practices may in fact be best evidenced by the quiet creation of shareholder value over a period of many years.

Q2 Do you think the board should report on the company's climate ambitions and transition planning, in the context of its strategy, as well as the surrounding governance?

We agree that, where climate is expected to be a material influence on long-term financial returns, it makes sense for boards to report on their climate ambitions and transition planning as part of overall governance and strategy in the ARA. Effort should made to minimise the duplication of disclosure given the various other climate reporting requirements. The materiality of climate-related issues will vary from one company to another. Businesses that take the view that these are not material to their operations or their prospects, should only be expected to explain clearly why they believe this to be the case.

Q3 Do you have any comments on the other changes proposed to Section 1?

We note the proposed change to Provision 3, that the chair should report in the ARA the outcomes of engagement with shareholders. As active, long-term investors, engagement is integral to our investment process and a key means by which we seek to build lasting relationships with boards that are characterised by partnership and trust. Our experience is that the most candid and meaningful engagement is best conducted in confidence. We do not think the reporting of engagement outcomes would be appropriate. To do so would risk creating the perception of micromanagement by investors rather than our provision of thoughts for consideration by the board in the context of its responsibility for leadership of the company. More generally, we are conscious that the views of shareholders can vary markedly, for example depending on their time horizon or investment strategy. It would be difficult for chairs to report on the outcomes of shareholder engagement when those shareholders are seeking very different outcomes.

In the same provision, we don't think the wording change that Committee chairs should 'engage' rather than 'seek engagement' is warranted. Committee chairs can't force shareholders to engage if they don't want to. Some may choose not to, for example those managing tracker/quant funds or overseas investors.

Q4 Do you agree with the proposed change to Code Principle K (Section 3 of the Code), which makes the issue of significant external commitments an explicit part of board performance reviews?

Our sense is that boards are increasingly aware of investor sensitivity regarding the time commitment and headroom of directors, particularly given the challenges of recent years. We would be surprised if it was not already considered as part of a board's performance review, particularly given reference elsewhere in the Code to the need for non-executive directors to 'have sufficient time to meet their board responsibilities' (Section 2 Principle H/G). We think the proposal is therefore repetitive and unnecessary. Baking it into the board's annual performance review may even risk causing delay to an otherwise direct conversation during the year.

Q5 Do you agree with the proposed change to Code Provision 15, which is designed to encourage greater transparency on directors' commitments to other organisations?

The potential overcommitment of directors has from time to time been of concern to our UK investors. On these occasions we have engaged directly with the companies and the response has been a managed reduction in the number of positions held by the individuals. On the one hand, we understand the prima facie appeal to the FRC of its proposal for enhanced ARA disclosure of director appointments including committee memberships and how these are managed. On the other, we are resistant to the lengthy additional narrative that would result from the prescriptive nature of the amendment to Provision 15. We have noticed, however, that disclosure of private company directorships, charity and similar external roles varies – these can add up. A lighter-touch alternative to the proposal would be to retain the current summary information on all significant director appointments of each board member but encourage reference also to private/other roles held and remove reference to describing how each director has sufficient time to undertake their role effectively in light of commitments to other organisations. This approach would strengthen transparency in a proportionate way and encourage engagement when necessary.

Q7 Do you support the changes to Principle I moving away from a list of diversity characteristics to the proposed approach which aims to capture wider characteristics of diversity?

As a firm and as an investor, Baillie Gifford is supportive of diversity in its widest sense. We think boards have come a long way in their approach to it and not just at board level. Rather than the proposed terminology regarding characteristics, we suggest consideration be given to simplifying the underlying message on diversity. One option, for example, might be for boards to refer to the 'concept of fairness' being adhered to when making new appointments at all levels throughout the business.

Q8 Do you support the changes to Provision 24 and do they offer a transparent approach to reporting on succession planning and senior management appointments?

We don't think these changes are necessary. Our experience is that boards understand the importance of succession planning both for board and senior management positions and the importance of diversity considerations. We think they can largely be left to get on with it and engage when requested to do so. We expect the bullet points in Provision 24 to already be covered when describing the diversity policy as part of the corporate governance requirements within the Disclosure Guidance and Transparency Rules ('DTR) sourcebook.

Q10 Do you agree that all Code companies should produce an Audit Assurance Policy on a comply or explain basis?

No, we strongly disagree. We are concerned that implementation would be disproportionate, potentially damaging to the competitiveness of the UK market and risks being perceived as the imposition of legislation by the back door. While we note the FRC's desire for consistency, we have material concern that the proposed extension would be a significant burden on companies brought into scope. As investors in many smaller growth companies, for example, we are acutely sensitive to the potential regulatory, resource and cost burden that would be associated with compliance. We do not want the Code to strangle their growth. While the 'comply or explain' wrapper would in theory offer some flexibility, in practice the concept is not always given the thoughtful consideration that it should be by all stakeholders including proxy agencies. As a result, there's risk that companies would either be funnelled into burdensome compliance or expected to provide increasingly demanding explanations.

Regarding the FCA's consultation, if the proposal for a single market structure is pursued, companies with a standard listing will be required to step-up to reporting against the Code. The FRC's proposal would raise this hurdle higher. As a result, even for sizeable standard companies, flexibility would be required as the runway towards Code compliance would likely be longer. Some of these companies may decide it's a step too far. Separately, there is risk that implementation would put AIM listed companies off progressing to adoption of the revised Code from the QCA Code. As investors in certain AIM-listed companies we would be disappointed if this were to happen. We view such voluntary progression as evidence that early-stage businesses are committed to evolving their governance framework to support long-term growth. The potential impact on high growth companies considering a London listing is unclear but we expect it would be unhelpful.

We note that the draft legislation is expected to require companies to set out how the AAP has taken account of shareholder and other stakeholder views, and the FRC proposes that audit committees lead this engagement. We have never had any problem scheduling engagement with audit chairs when we have considered it necessary to do so. However, our experience of the triennial remuneration policy and annual remuneration implementation report process is that engagement of this nature is a time-consuming process for both investors and companies. It is not clear what investor appetite there might be for AAP-related engagement. This links to our response to Q3 regarding the change of wording; audit committee chairs can only seek engagement – shareholders for whatever reason, may choose not to engage. From our perspective, shareholders appoint directors, some of whom join audit committee, and it would reasonably be the responsibility of those directors, using their knowledge of material factors relevant to the business, to develop the proposed AAP with board support. As investors, we would expect to largely let them get on with it.

Q12 Do you agree that the remit of the audit committee should be expanded to include narrative reporting, including sustainability reporting, and where appropriate ESG metrics, where such matters are not reserved for the board?

We strongly disagree. We think it would be a mistake to codify an approach at this point. This is a fast-moving area – boards should be left to decide the most appropriate way to deliver helpful narrative reporting. A better option would be for the FRC to monitor how best practice develops and report on it in a few years' time. More generally, to assign responsibility for monitoring the integrity of narrative reporting (the scope of which is not made clear) to the audit committee is overly prescriptive, unduly onerous and may risk unbalancing board accountability.

We consider ESG/sustainability factors to be an integral part of our investment process given their potential impact on long-term value creation. In this respect we support the ambition of the FRC to promote high quality narrative reporting to provide good linkage to financial reporting. However, ESG/sustainability is a multifaceted, expanding and complex area that requires both wide and deep understanding of evolving issues, regulation and stakeholder expectations. We are not surprised, therefore, that the FRC has found 'wide ranging differences in how companies report on and seek assurance, in relation to their sustainability-related disclosures'. In our experience, boards have been building expertise and developing approaches that fit with their individual businesses. We think the FRC should welcome this individualistic approach; it is consistent with the Code being flexible to accommodate the wide variety of UK listed companies.

Q13: Do you agree that the proposed amendments to the Code strike the right balance in terms of strengthening risk management and internal controls systems in a proportionate way?

No, we do not agree. Implementation would represent gold plating of UK governance expectations and make the UK uncompetitive relative to other markets. We think the proposed changes are too wide in scope, overly prescriptive and correspondingly burdensome. While the additional cost to businesses of compliance with the control proposals is unknown, we expect it would be material and include higher fees for non-executives serving on audit committees and directors' liability insurance. In extremis it may reduce the appetite of directors to serve on audit committees.

Q14. Should the board's declaration be based on continuous monitoring throughout the reporting period up to the date of the annual report, or should it be based on the date of the balance sheet?

Our first observation is that the board would have to make a declaration on the effectiveness of controls throughout the period rather than being expected (as currently) to review their effectiveness at one point during the period and then report on it in the ARA. There is risk this enhanced provision would require boards to put in place costly new processes or systems for continuous monitoring even if the scope of the declaration is restricted to financial reporting and balance sheet date sign-off. This is particularly likely to be required given the provision states the board should set out 'an explanation of the basis for its declaration, including how it has monitored and reviewed the effectiveness of these systems'.

Regarding the declaration period, our view is that the board's declaration should be based on the balance sheet date. Using the date of the ARA would, for example, exceed expectations in certain international markets and make the UK unattractive by comparison. It might also, from time to time, cause unexpected delay to ARA publication with potentially disproportionate market impact.

Q15 Where controls are referenced in the Code, should 'financial' be changed to 'reporting' to capture the controls on narrative as well as financial reporting, or should reporting be limited to controls over financial reporting?

As 'reporting' is undefined, it is not clear what non-financial reporting would be brought into scope. However, from a market and practical perspective, we are strongly of the view that control references should be limited to financial reporting. At a high level, a change from 'financial' to 'reporting' would make the UK unattractive relative to other markets where current reporting requirements do not go beyond financial reporting. In this respect the proposed change would be an example of unhelpful gold plating of UK governance. If the FCA pursues its proposal for a single market structure the wording change would again raise the hurdle that standard listed companies would face in reporting against the Code. Furthermore, the audit committee's responsibilities as per DTR sourcebook are focused on financial reporting. As such we disagree that the Code is the appropriate mechanism to redefine these responsibilities.

More generally, our view is that the international reach of UK listed businesses, the complexity of global supply chains and influence of geopolitical and other factors outside the board's control would make it highly impractical to broaden the scope of controls to include non-financial reporting. It is not clear what form or level of assurance boards would require to be comfortable that the non-financial controls framework is sufficiently effective to enable them to make the annual declaration. There is also no clarity as to what capacity or appetite there might be to provide assurance of non-financial reporting were it to be more widely requested by audit committees.

Q22 & Q24 Remuneration

Our view is the proposals, aimed at strengthening the linkage of pay to ESG performance and reporting of malus and clawback, should be withdrawn. Investor engagement has moved both matters forward. Codifying requirements would add to the disclosure burden on companies without material benefit.

As an active investor, we commit significant resource to engagement with companies on pay proposals. Our experience is that remuneration committees have a good understanding of the evolving expectations of investors and the potential consequences should they not deliver appropriate company-specific pay proposals. There is evidence that remuneration committees are responding well to encouragement from investors, including Baillie Gifford, to develop approaches that align reward with both financial and non-financial performance. As regards the linkage of reward to ESG for example, many companies now incorporate ESG metrics into incentive plans and make related disclosures. Others have confirmed their intention to do so. On the FRC's malus & clawback proposals, our view is that remuneration committees and boards are acutely sensitive to the attention investors (and wider stakeholders) pay to the use of these provisions if bad things happen. It is at that point that disclosure matters and accountability is determined. We do not think that muti-year historical disclosure will add meaningful value.

Q26: Are there any areas of the Code which you consider require amendment or additional guidance in support of the Govt's White Paper on artificial intelligence?
No. The White Paper will have put AI on the board's agenda if it was not already there. We expect AI will be considered by boards in the context of their ongoing attention to emerging risks/opportunities.

Should you have any questions regarding this submission, please let us know.

Yours faithfully

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