Attachment

Independent Review of the Financial Reporting Council

This document contains the responses from UKSA and ShareSoc to the forty-four specific questions in the consultation document.

Background

Q1. What should the FRC's objectives be? Is its present mission statement the right one?

The mission statement is very broad The FRC states it as: '*to promote transparency and integrity in business.* This could equally well apply to the Advertising Standards Authority – a body with a very different remit to that of the FRC. The FRC's statement of how it will achieve its mission is much narrower (regulating accountants, auditors and actuaries and having responsibility for the UK's corporate governance Code). Specific objectives are conspicuous by their absence.

In its mission statement the FRC adds that it:

'*works in the public interest to ensure a strong flow of investment into UK companies so they can grow and support society'.*

This is grandiose to the point of absurdity. The FRC is not able to ensure a strong flow of investment into UK companies. It might be able to contribute to this outcome but there are many other factors that will determine its achievement and many other agencies which also need to be involved. Few, if any, are under the control of the FRC.

We would summarise the FRC's role as:

1. Setting and regulation of accounting and audit standards and provision of guidance and oversight for the profession
2. Discipline, and dealing with problem cases
3. Corporate Governance Code for UK listed companies
4. (Investor) Stewardship Code for fund managers investing in UK listed companies
5. In respect of actuarial profession similar to items 1 and 2 above.

Currently there is very little that is measurable in a meaningful way in the FRC's remit – although in some areas it is possible to make a binary judgement as to whether it has succeeded or failed. In the case of Carillion it appears to have failed. Carillion adopted an approach to corporate reporting which was not clear to many investors

The FRC has certainly done good work revising the Corporate Governance Code. But simply producing and updating the Code is not enough. There needs to be some form of sanction (perhaps naming and shaming) which the FRC can use to ensure that the Code is applied. Without this the Code becomes entirely voluntary and the FRC's role becomes ineffective.

Q2. Does the FRC's name remain right?

Better options might be 'The Financial Reporting Authority' or the 'The Financial Reporting Regulator'. These however, fail to take full account of some of the FRC's other responsibilities such as oversight of the Corporate Governance code and the Stewardship Code. One could consider something like the Corporate Conduct Authority but this is too close to the 'Financial Conduct Authority'. Ultimately, the name is probably the least of our concerns.

Q3. Are the functions and structure of the FRC still relevant and appropriate, or is there a case for any structural change? Should any of the FRC's functions move to other regulators?

This is difficult to discuss without a clear statement of what the FRC's role, remit and objectives actually are and how the remit and objectives cascade logically from the remit. As mentioned above (Q1) the linkages are not clear. There is a 'disconnect' between the grandiose mission statement and the much narrower remit. Measurable objectives are not stated. While the FRC is charged with the implementation of accounting standards, it has no frontline supervisory operation. By contrast, the PRA (and, we believe, the FCA) have strong frontline supervision, but little remit (or skill) in accounting standards.

Q4. What lessons can be learnt from other countries' regulatory systems? Which ones?

We are not able to comment in detail. However, the Federal Reserve https://www.federalreserve.gov/aboutthefed/financial-accounting-manual.htm does have an accounting manual. We are not able comment on how effectively it is supervised.

Q5. How effective has the FRC been in influencing wider debates that affect its ability to deliver its objectives – for example, around audit competition or it legal powers?

The FRC has not been good at influencing wider debate on these relatively high-level, strategic issues. Stephen Haddrill, the CEO, has from time to time said that the FRC's powers are too limited. In some cases this has come across as an excuse when things have gone wrong. There is no evidence of a concerted effort to achieve change and there is nothing in the FRC's strategy document for 2018 about lobbying for greater powers. Mr Haddrill has recently written to the two committees of MPs investigating the collapse of Carillion suggesting that the FRC should have greater powers to publicly highlight companies that are in a precarious position and to make it easier to take action against auditors that are guilty of misconduct. The FRC should have been actively promoting public debate on these issues years ago. Instead, it has given an appearance of accepting its current fairly narrow powers and using this as an excuse when things have gone wrong.

The FRC gives the impression of being an organisation which, up to now, has been happy to accept the status quo. Looking at the FRC's board and the background and interests of its members one has to suspect that promoting change has not been high on the agenda.

Audit competition is clearly an issue and the FRC has been far too slow to enter the debate. The same is true about legal powers. We comment further on these issues in Section 2.5 of our covering letter.

Q6. Is the current balance between cross-cutting reviews and firm-specific investigations most effective?

We are not able to comment meaningfully on this.

Impact and Effectiveness

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

The FRC is good at:

- Busying itself with short to medium term technical issues surrounding financial reporting;
- Running projects and events which help to engage investors;
- Consulting on and developing codes of practice (such as the Corporate Governance Code).

One of its strengths is that it employs very good people at a technical financial level – people who understand in detail the 'nuts and bolts' of accounting and audit.

The FRC ran a very good session for retail investors in Nov 2017, 'Lifting the lid on the FRC', at which its senior executives explained what they did.

The FRC is poor at:

- Dealing with wider, longer-term strategic issues such as concentration of power among the Big Four auditors,
- The problem of the 'ownerless corporation' and the fact that annual reports are no longer fit for purpose.
- Generating useful outcomes from, for example, its Reporting Lab projects. The projects are fascinating for the participants but fail to consider how the outputs can best be used to achieve maximum impact and meaningful change.
- Making best use of the powers is already has – for example, in the area of sanctions and enforcement.

The FRC's weaknesses are as follows:

- It lacks strategic vision and foresight (this is a cultural and resource-related issue);
- It is insufficiently proactive in identifying where major change in reporting is needed and bringing about that change;
- It is too close to the large audit firms - from whom it inevitably draws much of its professional resource;
- It is too keen, in most of what it does and says, to avoid upsetting those that are powerful and those with vested interests;
- It is far too deferential to those with power and prestige;
- It is timid in risking a fight with companies and firms which, while not breaking the law with their reporting, are engaging in practices which are misleading, unethical and unprofessional; the FRC would benefit from greater legal protection (immunity) in forcing transgressors into the open.

- The skills it employs are far too narrow; it lacks skills in communications, media, writing and design of media content, and how business contributes to the wider economy and society.

Q8. The recent joint report on Carillion from the Business, Energy and Industrial Strategy and the Work and Pensions select committees considered the FRC to be characterised by 'feebleness and timidity' and recommended that a change of culture and outlook is needed. Do you agree? If so please cite relevant evidence which informs your view.

We agree absolutely. See Appendix 1 on 'feebleness'.

There have been many cases in which the FRC could have moved more quickly and more resolutely to take firm action over apparent audit and accounting failings. Examples include:

- the prevarication over deciding whether to launch an investigation into HBOS;
- failure to follow up its concerns in 2015 about Carillion's accounting practices;
- failure to apply meaningful sanctions in cases of audit failure such as in the case of Tesco, Tech Data, RSM Tennon and Connaught to name but a few. In most cases fines in the low £ms have been levied on audit firms with global revenues of £20bn or more;
- Globo, Quindell, Blancco, Redcentric.

There are real concerns about regulatory capture at the FRC. Too many people at all levels in the organisation are perceived to be too closely associated with those the FRC is supposed to regulate.

Q9. Are there changes respondents would like to see to achieve the vision set out in the review's terms of reference?

Yes. These are discussed in our covering letter.

Q10. Are the arrangements for financial reporting, audit and corporate governance the critical elements for effective delivery of the FRC's mission, or elements missing?

'Stewardship' should also be a component of the mission. Stewardship (of other peoples' money) is not just an issue which applies to fund managers. It applies also to company directors and is a key component of promoting transparency and integrity in business. Other specific issue which need to be considered are:

- Financial standards need to be unified, rather the current arrangement which encourages regulatory arbitrage;
- audit should include repeat sampling, involving analysis by skilled people of financial reports;
- governance reviews should have less emphasis as they are easily gamed.

Audit Regulation

Q11. How effective is the FRC at driving quality improvements in audit? What further improvements would respondents like to see?

Analysis by the FRC of audit quality suggest that it has improved significantly since 2012 with 81% in of FTSE 350 audits in 2016/17 assessed as good or only requiring limited improvements versus 56% in 2011/12. However, there is still significant variation between firms; PWC achieved a 93% success

rate but KPMG only managed 65% with quality declining from 75% in 2014/15.

A greater willingness by the FRC to use the sanctions that it has at its disposal might help in raising standards. Where sanctions have been applied for audit failures they have been relatively anodyne. It is only very recently that the FRC has used its powers to exclude practitioners from the accountancy or audit profession – for example, Russell McBurnie of RSM Tenon excluded for 5 years and Steve Denison of PWC excluded for fifteen years in relation to the audit of BHS. Notably, others such as KPMG and Audit Engagement Partner, Peter Smith, simply received a fine and a reprimand over Quindell plc. In the case of the 2009 and 2011 audits at Autonomy plc the FRC issued formal complaints over the conduct of the auditors (Deloitte) and autonomy's senior financial officers.

There is a difference between audit processes and audit results. We cannot argue with the statistics produced by the FRC which say that since 2012 audits have improved. However there are far too many disasters which the audit process has either missed or is not part of their responsibilities. There are plenty of cases. Here are some examples:

Carillion	Bust
Conviviality	Bust
Persimmon	Excessive Pay
Berkeley Homes	Excessive Pay
WPP	Excessive Pay
Melrose	Excessive Pay
BAe	Alleged Bribes *
GSK	Alleged Bribes *
Rolls Royce	Alleged Bribes *
RBS *	Banks (multiple failings)
Lloyds (HBOS) *	Banks (multiple failings)
Barclays *	Banks (multiple failings)
HSBC *	Money laundering
Aviva	Irredeemable prefs $\Rightarrow$ brand reputation
BP *	safety
Shell	accounting, reserves
Tesco	accounting
GKN	FMs sold out to arbs

Q12. Where quality does fall short do the FRC's interventions have sufficient impact and deterrent effect?

In the past they have not. It is only recently, as outlined above (Q11), that the FRC has started to take tougher actions against individuals. Even in the case of BHS it is worth noting that PWC (the

firm) was only fined £6.5m – a derisory amount in relation to PWC's worldwide income and an outcome which will have little impact on any of the other senior partners in the business.

Fines historically have been so small that they can be regarded as a cost of doing business. The level of fine was not enough to change behaviour. Arguably it reinforced the view that the existing practices did not need to change.

Q13. What force is there in the concern of some that the FRC may be too close to the 'big 4'? Or that the FRC is too concerned with the risk of failure of one of the 'big 4'?

We believe that these concerns are justified. Appendix 4 shows the composition of the FRC's board.

The FRC is effectively the regulator of auditors, accountants and actuaries, so should not be too close to any of these. More independent board members are needed.

At middle management levels the FRC recruits a significant amount of its resource from the large accountancy practices. This may be inevitable in that the skills that these people have are usually acquired working for the large accountancy and audit practices. However, this merely reinforces the perception that the FRC is prone to 'regulatory capture'.

Q14. Are investigations of audit work effective, transparent, satisfactorily concluded and unfettered?

Details of audit investigations, such as those at BHS and Quindell, are not easy to find on the FRC's website. It is therefore hard to tell if they are unfettered or satisfactorily concluded. The system certainly does not look very transparent.

Investigations currently take far too long to complete.

Q15. Could a different regulatory strategy or tactics result in greater avoidance of harm?

Yes. See comments contained in our covering letter which suggest that:

- A principles-based system of regulation might be more effective than the current rules based system.
- There should be a lower bar for regulatory action meaning that the regulator should be able to start an investigation at the earliest sign of any cause for concern
- The regulator should have immunity from prosecution by those it regulates.

Also see above (Q10) on a unified set of standards – e.g. credit instruments should receive different treatment depending on the nature of the firm, repeat audit etc.

Q16. Could or should the FRC's work promote competition and a well-functioning audit market? Does the FRC's work undermine competition or a well-functioning audit market in any way?

Clearly competition should be promoted. Whether this is for the FRC to actually do is another matter. Nor is it easy to see how it should be achieved. The issue excessive concentration of power into the hands of a few players within a market has more traditionally been for the CMA to investigate and resolve. There is no doubt however, that the FRC should be keeping a watching brief on competition in the audit industry and making clear any concerns it has in the strongest possible terms. Once again, 'regulatory capture' may compromise its willingness to intervene.

There is some evidence to suggest that the FRC has tended to worry about taking any action against Big Four auditors which might lead to the demise or withdrawal from audit of one of the firms leaving an even more restricted choice of just three big firms.

The fact that the FRC has been privately wringing its hands over this issue while hanging back from taking serious steps to enforce audit quality is a poor reflection on the Regulator. This is just the sort of strategic issue on which the FRC should be promoting and encouraging a very public debate. Given the composition of its board and other factors the FRC is currently culturally incapable of doing this.

Q17. Can questions regarding the effectiveness of the FRC be separated from the wider question on whether change is needed to audit arrangements to account of shifting expectations?

No. See Q16 above and our covering letter to Sir John Kingman. There are fundamental cultural problems within the FRC which start at board level. Some change is essential to begin to resolve issues of effectiveness.

Accounting and Financial Reporting

Q18. Has the FRC been effective in influencing the development of accounting standards internationally as well as accountable and effective in setting UK GAAP?

See the points in our covering letter about the need for standards over capital maintenance. The FRC has not exerted any influence over the development of such standards, despite persistent pressure from organisations such as LAPFF.

Q19. How else could the FRC improve the quality of financial reporting with a view to ensuring investor confidence?

See above on unified standards. These should also encourage methods of clear, unambiguous and verifiable reporting.

Q20. Are there wider issues of financial and other reporting on which a stronger regulatory role would be desirable to better meet the information need s of investors and other stakeholders?

See covering letter and the need for quick action by the FRC as soon as it suspects that not all is well.

Q21. Is the current combination of statutory and voluntary methods of oversight for professional bodies effective and do they remain fit for the future?

We are not able to comment in with confidence on this. However, the number of corporate governance disasters (see our answer to Q11) indicates that something is wrong.

Corporate Governance and Stewardship Codes

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

The FRC has done good work with the latest revisions to the Corporate Governance Code. However, corporate governance requirements are easily gamed and can easily become a compliance exercise. They provide an important but relatively weak method of regulation.

The powers of the FRC in relation to the Corporate Governance Code look modest. The Code is purely voluntary. The FRC has few powers to enforce it. For sound reasons the Code is not overly prescriptive. However, this carries with it the drawback that, aside from the most egregious examples of poor corporate behaviour and culture what is acceptable essentially lies in the eye of the beholder.

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

See Appendix 5 below – UKSA / ShareSoc response to the FRC's preliminary consultation on revisions to the Stewardship Code (February 2018). The Stewardship code has not been very effective and requires major overhaul.

Speed and effectiveness of Investigations; enforcement and compliance

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

See Appendix 2 below summarising press comment on feebleness and tardiness. We believe that the FRC already has the sanctions powers it needs but fails to use them to the full. In other cases the FRC is inclined to complain after the event that it doesn't have all the powers it needs in order to move quickly with investigations. These complaints tend to be heard following criticism of the FRC. It would be more convincing if the FRC had already been pushing for these powers on a more pro-active basis.

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

We believe that FRC fails to use its current powers to the full. However, certain additional powers would be helpful. We have outlined these in our response to Q31.

Actuarial oversight

Q26. Have the arrangements put in place following the 2005 Morris Review stood the test of time or is there a need for change? Should actuarial regulation be a focus for the Review's work?

The Institute of Actuaries is the professional organisation responsible for regulating actuaries, but this appears largely autonomous and there is no evidence that the indirect oversight by the FRC has improved on the situation post-Equitable. For example, the IFoA did not attempt to stop the industry lobbying for the 'Matching Adjustment' addition to Solvency II, even though it was objected that 'there is not a single academic who will back the argument that discounting liabilities is a sound economic principle'.[i] The Institute's approach has also come under implicit criticism from the PRA's recent consultation paper 13/18.[ii]

[i] Danielsson, J., R. Laeven, E. Perotti, M. Wüthrich, R. Ayadi and A. Pelsser (2012) "Countercyclical Regulation in Solvency II: Merits and Flaws." VoxEU, 23 June
ii Prudential Regulation Authority, 'Solvency II: Equity release mortgages', 02 July 2018. https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages

FRC and corporate failure?

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

Impose a unified set of standards, and ensure they are rigorously enforced to provide effective deterrent.

It should also actively monitor the shorting of shares to see how many shares are shorted, by whom and what they see as the problems. Shorting by hedge funds is often an early warning sign that a company, if not already in trouble, is heading for trouble.

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

See our covering letter. The evidence suggests that the FRC is very slow to react. Its 2015 investigation into Carillion is one example. There are plenty of others. The FRC is also very good at putting up justifications / excuses for its slow speed of response. The problem is that it seems unable to understand the need for urgency in these situations. If it did, it would have made strong representations to government get the 'road blocks' removed a long time ago. It has never made any serious attempt to do this as far as we are aware.

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

Yes. This would require an addition to the existing standards, namely a measure of 'distributability' of earnings. Developments in financial economics over the past 50 years could greatly inform accounting standards (e.g. IFRS) but the accounting profession has been slow to follow those developments. The same applies to the actuarial profession. See the reply to Q26, but just as the actuarial profession has failed to adopt latest developments in financial economics and financial markets, so has the accounting profession. This is long overdue for change.

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

The viability report is often unenlightening, formulaic and is framed to absolve the directors of responsibility if the company runs into difficulty. It would be more helpful to consider the way in which risks are identified assessed and how this is presented to investors so that they can make up their own minds on viability. At present too much of what appears in the risk report can only be described as a statement of the obvious. Persimmon's annual report lists principal risks as:

- UK's exit from the EU (because of the uncertainty it causes)
- Government policy (because it 'has the potential to influence aspects of our strategy, operations and overall performance'.)
- National and regional economic conditions (because 'the housebuilding industry is sensitive to changes in unemployment, interest rates and consumer confidence'.)
- Mortgage availability
- Health and safety (accidents on our sites could lead to reputational damage and financial penalties).
- Materials (some may increase in price and/ or be in short supply)
- Labour (possible shortages of appropriate skills)

- Strategy (we've done our best but it could still go wrong)

This is not helpful. These are not risks they are a list of uncertainties. They are subjective and unquantified. Even those which could be quantified, such as health and safety (on the basis of past performance), are not.

This sort of boilerplate is fairly typical of risk reporting and is of little help in allowing investors to form their own views on viability. Business model reporting is another area that remains woeful in many cases. If investors are unable to understand the business model and directors cannot articulate it how can anyone begin to assess the viability of the business?

Powers and Sanctions

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

Our impression is the FRC has sufficient powers but hesitates to use them. However, it also suffers from certain constraints which need to be addressed. These include:

- Inability to take action against directors who are not members of the accounting profession;
- Lack of oversight of the narrative components (front end) of the Annual Report;
- Lack of immunity from prosecution by those it regulates;
- Ability to express concerns other than in relation to a formal investigation.

These are discussed in our covering letter.

Q32. Are the FRC's powers coherent in relation to those of other regulators?

See reply to Q3. Unlike the FCA the FRC appears to have no effective frontline supervision resource. It is also arguable that, from a technical point of view, it is not as close as it could to developments in modern financial science.

Q33. Taking account of Sir Christopher Clarke's review of sanctions, and subsequent changes, does the sanctions regime now have the right deterrent effect? Does the FRC make best use of the sanctions at its disposal?

The sanctions that the FRC has at its disposal appear adequate and appropriate. The problem lies in the FRC's reluctance (except in a few recent cases) to use them fully. Currently, there is no real deterrent effect.

The FRC's legal status and its relationship with government

Q34. Should the government legislate to put the FRC on a more conventional consolidated statutory footing?

Yes, if this helps to create a better, stronger FRC with a clear statutory role, remit and objectives.

Q35. What is the optimal structure for the relationship between the FRC and the government, best balancing proper accountability with enabling the FRC's effectiveness?

We are not qualified to comment on this in detail. However, we would like to see an FRC which has the full backing and support of the government but which retains a high degree of professional and intellectual independence. The FRC should look towards it stakeholders and should reflect their needs. There will always be political pressures and imperatives. It is important that the FRC does not become a vehicle for promoting eye-catching political initiatives which have little practical merit. Nor should it be in a position in which it can easily become a 'political football'.

Q36. In terms of the FRC's broader accountability, is there a case for further transparency in its actions or functions?

Yes, see our covering letter. If the FRC has concerns about a company, it's reporting and / or aspects of the audit it should be able to make this information publicly available on its website. It is not acceptable that, is 2015, the FRC should have kept quiet about its concerns over Carillion. Transparency in this area would have three benefits:

- It provides an early warning for investors;
- It puts a shot across the bows of the company concerned;
- It puts the FRC on the spot to decide what follow-up action is to be taken.

With regard to the level of detail provided, we would expect the FRC to:

- Name the company concerned
- State the issue (i.e. which aspects of the company's reporting is it unhappy about)
- State why it is concerned.

The second two items above each require nothing more than one or two sentences. There is no need to go into detail. Investors can take the prompt and do their own research.

Governance and Leadership

Q37. How effective is the current leadership and board of the FRC? Please cite relevant evidence which informs your views.

The leadership lacks strategic vision. The FRC's strategy document lists its strategic priorities. One of the strategic priorities is 'Promoting corporate governance and investor stewardship with a long term focus'. The words sound plausible but it is not clear what the FRC means by 'a long term focus', how it plans to achieve this or how it will measure and assess achievement. Much of the strategy is based on simply 'considering' a number of issues. It is vague and very undemanding.

We also have concerns that the FRC often fails to make full use of its existing powers – for example, with regard to sanctions.

The FRC tends to call for greater powers after things have gone wrong rather than before. Recent calls from the CEO that 'it would be valuable to investors if we could do more to signal concerns before problems become terminal' are indicative of an organisation fighting a rear-guard action over Carillion. The FRC tends not to be forward looking. The fact that the comment is framed in terms of 'valuable to shareholders' is very telling. He might also have mentioned the company's employees, its suppliers, its customers and its pensioners. The fact that he didn't suggests that the FRC's senior management has an astonishingly narrow view of life.

We worry also that the FRC is subject to 'regulatory capture'.

Q38. Is the Board's composition appropriate? Is it the right size? Does it have appropriate membership?

See Appendix 4 below – FRC Board and Board members. The board is a mixture of people with current or previous senior positions in banking, investment management, audit, regulation/civil service, insurance (private and mutual), professional bodies and charities.

- Audit firms are grossly conflicted.
- Academic specialists not represented at all
- Analysts (who have a strong interest in transparent reporting) not represented!
- Regulators, civil servants and professional bodies are not necessarily unconflicted.

Q39. Is the balance of decision-making between the Board, its Committees and its Executive described in paragraphs 34-36 above right, given relevant legal constraints?

We are unable to comment. The FRC has what appears to be a complex structure. Reporting to the Board are two committees – The Conduct Committee and the Codes and Standards Committee. Each of these has a number of committees or councils reporting to them.

There is then an executive structure with five directors reporting to the CEO. Below this are ten more directors.

It is not possible for us to comment on how well this works in terms of the balance of decision-making.

Q40. Is the Board's structure appropriate, including given the FRC's roles on standard setting assessment and enforcement? Does the Board's accountability appropriately reflect its role and functions? Are its decisions appropriately transparent bearing in mind the need to balance public interest and confidentiality?

See answer to Q39 above

Q41. How should the Executive's effectiveness be assessed and ensured?

The first requirement is for the FRC itself to have clear and measurable objectives. At present these are conspicuous by their absence.

Funding, Resources and Staffing

Q42. Who should fund the FRC and how? What are the impacts of current funding arrangements, including of having a partially voluntary funded regime?

The current levy arrangement with money coming (sometimes via the circuitous route of the accountancy professional bodies) from those the FRC regulates is not satisfactory. It reinforces perceptions of an organisation which is 'in hoc' to those it is supposed to regulate. We would prefer to see the FRC properly funded by central government which would raise the money through corporation tax. There are good arguments for some sort of levy on investors and pension funds. They are key stakeholders of the FRC. This might encourage them to take a more proactive interest in the FRC and its work.

It is tempting to suggest that the FRC should be able to keep the money from any fines it levies. However, this is potentially fraught with dangers of perception that the FRC will not be impartial in the imposition of sanctions. It also creates potential budgetary problems. Ideally, we want a situation in which the FRC never has to levy any fines. Building fines- based income into the FRC's budget would look perverse.

Q43. What skills are needed for the FRC to be most effective? Does the FRC have the people, skills and resources it needs of the quality it needs?

See comments in our covering letter (Item 2.5) about the skills and resources that the FRC requires.

Q44. Are there conflicts of interest in the FRC's structure, processes or culture? Are there deficiencies in the FRC's approach to managing conflicts of interests?

Yes. See reply to Q38.

Other matters

Are there any other issues relevant to the terms of reference respondents would like to raise?

No.

Peter Parry – Policy Director, UK Shareholders' Association

Dean Buckner – UK Shareholders' Association

Cliff Weight – Policy Director, UK Individual Shareholders' Society

1st August 2018

Appendix 1: FRC Mission

https://www.frc.org.uk/getattachment/931ad43d-62f1-4726-8ca3-d665e7e9824e/The-FRC-About-Us-Leaflet-February-2018.pdf 'The FRC's mission is to promote transparency and integrity in business.' 'We implement standards for company accounts and monitor their annual reports to ensure all who rely on them have confidence in their performance and prospects. We challenge companies where we have concerns with their accounts and we report on our overall findings.'

Appendix 2: Feebleness, timidity and tardiness

2.a. https://www.cw-uk.org/single-post/2017/08/17/It%E2%80%99s-time-for-the-UK%E2%80%99s-audit-regulator-to-start-taking-corruption-seriously

2.b. http://www.taxresearch.org.uk/Blog/2017/10/17/how-many-audit-failures-will-it-take-for-the-frc-to-admit-that-the-failures-are-systemic/ Failures are systemic. 'In June it cleared PWC over the Tesco accounting scandal. The supermarket group lost £326 million over the affair, but its auditor was found to have done nothing wrong.' 'In August it cleared KPMG over its audit of HBOS during the financial crisis. KPMG had given the bank a clean bill of health in February 2008, only eight months before it collapsed and had to be rescued with £20 billion of taxpayers' cash.' 'And last month it cleared PWC over its checks on Barclays. The lender had already been fined £38 million for improperly mixing up client assets with its own money, yet PWC, which repeatedly had signed off on official reports saying that Barclays was complying with client asset rules, was declared innocent.' 'The FRC is particularly well-stocked with former bank auditors in powerful positions.'

2.c. https://www.standard.co.uk/business/jim-armitage-no-point-to-the-frc-as-long-as-it-carries-on-firing-blanks-a3651496.html 'The problem is, bar the odd freak, its regulatory rifle only ever fires blanks. In nearly every major financial scandal we've had since the financial crisis, the FRC decides none of its charges have done anything wrong .' 'No sooner had the regulator cleared PwC in June over Tesco's accounting scandal, than it let KPMG off for failing to spot HBOS was on the brink in 2008.' 'Today, it has declared PwC (again) had nothing to be embarrassed about over Barclays' failure to record where £16 billion of its customers' funds were. In each case, the miscreant clients have been fined and punished for their sins. Yet according to the FRC, like Macavity the Mystery Cat, the auditor wasn't there.'

2.d. Parliamentary report (intro) 'The FRC identified concerns in the Carillion accounts in 2015 but failed to follow them up.'

Ibid 149: The FRC was far too *passive* in relation to Carillion's financial reporting. It should have followed up its identification of several failings in Carillion's 2015 accounts with subsequent monitoring. Its limited intervention in July 2017 *clearly failed to deter* the company in persisting with its over-optimistic presentation of financial information. The FRC was instead happy to walk away after securing *box-ticking disclosures of information*. It was *timid* in challenging Carillion on the *inadequate and questionable nature of the financial information it provided* and *wholly ineffective* in taking to task the auditors who had responsibility for ensuring their veracity.

Ibid 188. The timid and reactive engagement by the Financial Reporting Council with Carillion underlines the conclusion of the previous BEIS Committee that *enforcement of corporate governance responsibilities is not strong enough*. The Committee's report recommended *a more interventionist approach from an expanded and better-resourced FRC*, including *spot checks* on

companies to act as a deterrent against poor practice, and *increased powers* to allow it to initiate legal action against any director.

2.e KPMG

https://www.ft.com/content/14247c88-731a-11e8-b6ad-3823e4384287

(Comment) Professor Atul K. Shah, University of Suffolk 'Something I have been saying for a long time in my research and books - has now been 'officially' proven. Half of the audits, and this is only a sample that the FRC reviews, shows how low things have come. In fact if you look at their reports over the last ten years, KPMG has consistently scored low. In this paper, there is a detailed interview of their Head of Audit Quality revealing a number of serious internal contradictions and conflicts of interest https://www.academia.edu/19497525/KPMGS_REGULATORY_ARBITRAGE_CULTURE and here is a whole book on KPMG's audit and consulting failure over HBOS - http://blogs.lse.ac.uk/lsereviewofbooks/2018/06/05/book-review-politics-of-financial-risk-audit-and-r

Appendix 4: Board and Board members

https://www.frc.org.uk/about-the-frc/structure-of-the-frc/frc-board/frc-board-members Board members

Win Bischoff: Chairman of JP Morgan Securities plc (investment management)

Gay Huey Evans: Ex FSA, now Director of Standard Chartered PLC and other large firms.

Stephen Haddrill: previously Director General of the ABI (insurance lobbying organisation)

David Childs: was Managing Partner of Clifford Chance (large law firm)

Paul Druckman: was President of the Institute of Chartered Accountants in England & Wales (professional body, probably captured by industry?)

Nick Land: was Chairman of Ernst & Young LLP (auditing firm)

Olivia Dickson: non-executive Director of Royal London Group (insurance mutual)

Mark Zinkula: Chief Executive Officer of Legal & General Investment Management (asset management)

Mark Armour: current Non-Executive Director and member of the Audit Committee of Tesco PLC (was not involved in FRC investigation of Tesco due to perceived conflict, although noted above that PwC cleared of any wrongdoing by FRC).

Brian Bender: served as the Permanent Secretary of the Ministry of Agriculture, Fisheries and Food

John Coomber: was Swiss Re board member (large general insurer)

Roger Marshall: was at PwC (large audit firm)

Keith Skeoch: ex Standard Life Aberdeen (asset management co)

Julia Unwin: ex Chief Executive of the Joseph Rowntree Foundation (charity)

Jenny Watson: Chair of the House of St Barnabas (homeless charity) and other charities.

Appendix 5: UK Stewardship Code. UKSA / ShareSoc Response to the FRC's preliminary consultation on revisions to the Code – February 2018.

Q17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of investment chain help drive best practice?

We believe that the Stewardship Code should more properly be renamed "The Investor Stewardship Code". Most of the stewardship of the company is done by Board of the company and its management. The current name sets the wrong expectation and one that is unachievable.

The code needs to be more explicit about the expectations of investors. The current code is superficial and quite vague. It encourages fund managers to vote the shares they hold but there is little guidance on how fund managers should vote to ensure the best interests of investors. This is particularly true on issues such as executive pay. The Code needs to recognise that the interests of asset managers and the investors (beneficiaries) are often divergent. Fund managers are often driven by short term measures of asset growth and total return. Investors, particularly in pension products, may have a horizon of 20 - 40 years or more.

Standard Life (now Aberdeen Standard Life) is a Tier 1 signatory to the Stewardship Code. However it was one of the largest investors in Carillion when it went into administration. Our understanding is that it had also loaned out a significant number of Carillion shares to short sellers.

Aberdeen Standard Life has been back in the news as recently as 22nd February. An article in the Financial Times on the £110million paid to Persimmon CEO Jeff Fairburn stated:
"Aberdeen Standard Investments, the Company's (Persimmon's) sixth-largest shareholder, criticised Jeff Fairburn's bonus as grossly excessive, adding that it remained a huge concern despite Mr Fairburn's decision to give some of the money to charity. Aberdeen standard Investments called on fellow shareholders to 'consider their voting positions on Persimmon's board members' which include Mr Fairburn, ahead of the company's annual general meeting in April".

This sounds like an excellent example of a major shareholder exercising the sort of stewardship that we expect from fund managers. Except that it is not. It is an example of utter bare-faced hypocrisy.

Aberdeen Asset Management was one of five major shareholders in Persimmon who in 2012 voted in favour of the Company's LTIP for directors. Subject to a dividend paying performance condition (the 'Capital Return Plan' - CRP), LTIP gave away 9% of the company (1 for 10, 30million shares) after 10 years – or earlier if dividends were paid earlier. UKSA easily identified the scheme as little more than a scam and tracked (and reported) its steady increase in value (from £300m - 2012 to £750m - now). At the time, we wrote to the six major shareholders in Persimmon (AXA was the only one that voted against the scheme) and asked them to clarify why they voted as they did. Aberdeen asset management wrote back with a number of dubious reasons for backing the scheme and adding:

'Part of our responsibility as long-term investors is to police the scheme and hold management to account, if it appears that not just the letter but also the spirit of the scheme is being breached then we will look to take appropriate action'.

Aberdeen, however, (and other major shareholders) sat back and watched as an already fundamentally flawed pay scheme was allowed to spiral out of control as the total payout to directors and senior mangers ballooned from £30m in 2012 to £750m 2017. Their current response of grandstanding and wringing their hands over the whole debacle while sniping at the Persimmon directors is a damning reflection on their integrity.

The fact is that the institutional investors have a corrupt process of cosy, secretive meetings with directors that suits them. Many who claim to be applying the letter and the spirit of the Stewardship Code are paying it little more than lip service. The hypocrisy of their self-righteous attack on the Persimmon directors does not sit well with their unacknowledged responsibility for what has happened. It is time for the FRC as the Regulator to step up to the plate and explain how, in the case of Persimmon, a transfer of value of this amount from shareholders to employees can go unacknowledged for six years. This whole scandal makes a complete mockery of the Stewardship Code.

On the question of having separate codes or enhanced separate guidance for different categories of investment chain, **i**t might be appropriate to have different guidance for say nominees and asset managers (for example).

Q18. Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

Yes, there is scope to apply comply or explain. However, there are also other fundamental issues to address. These include communication with investors on a more regular basis and demonstrating to investors that the asset manager is really acting in their best interests (e.g. not lending out shares to short sellers and certainly not without explaining the reasons for doing so to the investors).

Q19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

This needs further careful consideration. The tiering at present seems to be based largely on self-certification by asset managers / owners etc. Their web sites simply provide fine word and reassurances. The Standard Life website shows the number of company engagements during the quarter. This came to 209 in Q4 2016 – the latest data available in January 2018. It looks impressive but 'engagement' includes an email or a phone call. And why is no data available since December 2016? Company visits came to 26 in the quarter - approximately one per day across the whole investment team. There is a tick box list of issues discussed. I wonder if Carillion was visited in Q4 2017 and what was discussed? It all looks plausible but the information given is tick-box and process oriented. We need something more than this to demonstrate real stewardship. Asset managers should also be emailing their clients every quarter with a link to an updated stewardship report on their website. It shouldn't just be left to the clients to have to remember to go and look for this or access it via the FRC website.

Furthermore, most reporting is done in PDF format, which makes it very difficult to analyse and compare fund manager voting and engagement practices. The FRC should insist that fund managers reports include Excel easily analysable versions of the data.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

There needs to be much more reference in the CG Code and CG Guidance to investors. There is reference to large shareholders, shareholders and stakeholders but nothing about investors. This is a serious omission.

Q21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

Fund managers should organise at least one and ideally two events each year to which all their investors are invited. The managers should give an account of how they have exercised their stewardship of other people's money. See also suggestions under Q19 for better engagement with investors. It would do no harm for asset managers to organise visits for their investors (similar to those run by UKSA and ShareSoc for their members) to some of the larger companies in which they are invested.

Q22. Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code refer more explicitly to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas that should be addressed?

Probably not; it should be sufficient for them to be covered in the CG Code if asset managers think these things are not being properly addressed by companies in which they are invested they can raise them as a GC issue with the company concerned.

Q23. How should the Stewardship Code encourage reporting in the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside the Stewardship Code?

It is important that this happens. The GC Code and the Guidance document provide a common benchmark for investors as to what 'good' looks like in relation to GC. The same should be true for the Stewardship Code. As indicated in Qs 17 and 19 above there is currently plenty of scope for asset managers to score well and be rated in Tier 1 on Stewardship despite the fact that when you look closely at what they are actually doing it doesn't amount to very much.

Q24. How could the Stewardship Code take account of some investors' wider view of responsible investment?

We cannot answer this open ended question, without examples of what these 'wider views' might be.

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

Yes, certainly in the context of issues like the use of child labour at very low rates of pay in some parts of the world. There are also issue with people not being paid the minimum wage (particularly women) in places like India because, although the country has a minimum wage, the government does not enforce it. Even if a company is purely UK-based, if it sources product from overseas (and particularly from third world countries) the Stewardship Code should take into account its supply chain.

Q26. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

We need more information on what is being suggested. If managers are reporting meaningfully (i.e. providing useful information to investors, then third-party monitoring and assurance shouldn't be necessary. As indicated above, the current code is too superficial and to vague to allow investors to hold managers to account on stewardship issues. In this situation independent assurance would be helpful – but it could be expensive and is sure to be a cost which will be passed on to investors.

Q27. Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

Yes.

Q28. Should board and executive pipeline diversity be included as a specific expectation of investor engagement?

This is covered in the CG Code. Asset managers should push companies to address this as part of their commitment to the CG Code.

Q29. Should the Stewardship Code explicitly request that investors give consideration to company performance reporting on adapting to climate change?

Only where it matters and in a form that is relevant. Clearly, for large energy users (glass, steel, bricks etc.) then reporting on CO2 emissions is important. For companies like supermarkets the situation is more complex. They are not ultimately big emitters of CO2 gases. However, they are major contributors to food waste in Britain. UK households throw away some 7 million tons of food each year – partly because they are encouraged to over-buy by food retailers. Supermarkets also generate waste with absurd aesthetic requirements for fruit and vegetables. Much is discarded because it doesn't conform to standards of appearance. They also encourage growers to over-plant so that minimum order quantities can be fulfilled even if there is a poor crop. Up to 30% of salad and root crops is regularly ploughed back into the ground without ever being harvested. Failure to address the problem of absurd 'best before' and 'use by' dates is another problem. The result of this is that more and more land is being brought into productive use so that we can all throw away enormous amounts of food. In Brazil the rain forest is being steadily depleted (contributing to climate change) to bring land into production to produce soya to feed to animals in rich countries so that more meat can be produced. Yet much of that meat is being thrown away. These are the complex environmental issues that need to be addressed with the food retailers. The UK government's big contribution to all this is to make everyone pay 5p for a plastic carrier bag. At the same time it seems keen to stoke up demand for air travel despite the damage that this is known to cause to the environment. So, yes, companies should be required to state what they are doing to reduce their own impact on climate change. But is must focus on those activities which really are damaging. Platitudes and obfuscation about how Sainsbury's uses rainwater harvesting off its shop roofs to reduce water usage in its stores in west Wales is an irrelevance in the context climate change.

Q30. Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

Yes, this would be a good idea. It would help to ensure that they do not just treat it as another compliance issue. Some guidance on this would be helpful for investors as well – i.e. What might investors expect to see from signatories in this context? What would 'good' look like?

Q31. Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

This would be very appropriate. We have no particular views at present on how it should be achieved.

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[i] Danielsson, J., R. Laeven, E. Perotti, M. Wüthrich, R. Ayadi and A. Pelsser (2012) "Countercyclical Regulation in Solvency II: Merits and Flaws." VoxEU, 23 June

[ii] Prudential Regulation Authority, 'Solvency II: Equity release mortgages', 02 July 2018. https://www.bankofengland.co.uk/prudential-regulation/publication/2018/solvency-ii-equity-release-mortgages