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15th May 2019

INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL
Initial consultation on the recommendations

Dear Sirs,

This is a joint response from UKSA and ShareSoc on behalf of individual investors.

UKSA and ShareSoc represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

Our responses to the questions in the consultation are given below.

Chapter 1 – FRC structure and purpose

Q1. What comments do you have on the proposed objective set out in Recommendation 4?

We agree with and fully support the broad strategic objectives set for the regulator.

Q2. What comments do you have on the duties and functions set out in Recommendations 5 & 6?

We fully support the wider remit of the new regulator although, as discussed below, we have serious concerns about the 'dead hand' of regulation itself. However, we applaud the inclusion of the duties which require that the regulator should:

- *Be forward-looking, seeking to anticipate and where possible act on emerging corporate governance, reporting or audit risks, both in the short and the longer term;*
- *Promote competition in the market for statutory audit services;*
- *Advance innovation and quality improvements;*
- *Promote brevity, comprehensibility and usefulness in corporate reporting;*

We have to add that some UKSA / ShareSoc members have commented that these duties are 'motherhood'. They sound great but in reality they are duties and functions that are so fundamental that they should hardly require stating.

With regard to the requirement for the regulator to work collaboratively, we believe that it should seek to work collaboratively with all parties as far as possible. Over the last two to three years the FRC has increased its collaborative working with private investors and we believe that we and the regulator have benefitted from this. It is worth stating again that the FRC's investor engagement programme is, in general, very good.

Two duties are specified which refer to the regulatory role of the new regulator, namely, that it should be:

- *proportionate, having regard to the size and resources of those being regulated and balancing the costs and benefits of regulatory action;*

- *Prioritise regulatory activity on the basis of risk, having regard to the Regulators' Code.*

With reference to the second bullet point above, UKSA and ShareSoc would like to see *less* rather than more regulation in future. We understand that regulation has a valid role to play but we are concerned that all too often regulation has been used when it is the wrong means of providing control. This tends to be true of all regulators. In many cases 'principles' work better. The problem with regulation is that:

- It can never cover all eventualities and, as such, it easy to 'game'.
- It can easily end up having unintended consequences.

Regulation used in the wrong circumstances ends up providing investors and others with a misplaced sense of reassurance that everything is under control when it is not. In the case of HBOS, for example, the FRC originally concluded that nothing was wrong (presumably on the basis that what had been done complied with all the relevant regulations) when clearly something was very seriously wrong. One suspects that the same will be true at Carillion: strictly speaking, no rules were broken and yet standards of behaviour, performance and culture on the part of many of those involved were clearly lacking.

We would therefore like the new regulator take a thoughtful and sparing approach to the use of rules (as opposed to principles), bearing in mind the limitations of rule-based regulation versus other options available to achieve the desired standards from those it oversees.

In addition to the duties proposed by Sir John Kingman's review of the FRC, we believe that they should also include responsibility for the appointment of auditors as set out in Sir John Kingman's

letter to the Secretary of State on auditor appointment. We have written to the Secretary of State about this. A copy of our letter is shown in Appendix 1.

Q3. How do other regulators mitigate the potential for conflict between their standard setting roles and enforcement roles as set out in Recommendation 14?

We are unable to comment authoritatively on this.

Q4. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We have no comment to make on this.

Chapter 2 – FRC: Effectiveness of core functions

Q5. How will the change in focus of CRR [Corporate Reporting Review] work to PIEs [Public Interest Entities] affect corporate reporting for non-PIE entities?

We welcome the proposals on the corporate reporting review (CRR) activity set out in recommendations 24 – 27.

We understand the emphasis that has been placed on PIEs but it is important that standards of reporting are consistently high for all companies. There have been too many recent blow-ups and scandals, particularly among AIM companies, to ignore this issue. Examples include Beaufort Securities, Conviviality, Patisserie Valerie, and London Capital and Finance. Failures of oversight, regardless of whether they relate to PIEs or non-PIEs, are very damaging to the credibility of the regulator and undermine confidence in the whole regulatory system. The notion that there is some sort of two-tier system also potentially sends all the wrong messages to the preparers of accounts and the auditors of non-PIE organisations.

Q6. What are your views on how the pre-clearance of accounts proposed in Recommendation 28 could work?

We support the recommendation and we believe that the idea of piloting the pre-clearance procedure is appropriate.

Q7. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We agree wholeheartedly with recommendations 23 and 29 – 31. In particular, we believe that:

- the corporate reporting review process should be extended to cover the whole of the annual report;
- At least once in every Parliament, the FRC should report to BEIS a public assessment of the extent to which the statutory reporting framework is serving the interests of the users of company reports together with any recommendations for how it can be improved.

We also concur with recommendation 31. There tend to be too many consultations and discussion documents. With regard to guidance documents we feel that they are often badly framed. They give the appearance of being comprehensive and erudite but in reality they provide little helpful advice to users in turning guidance into practical application. All too often they are hedged around with caveats to try and make them applicable to everyone while giving meaningful guidance to no one. They nearly always lack practical examples of what 'good' or 'best practice' looks like (and why) and invariably shy away from giving any examples of poor practice (and an analysis of why it falls short). Examples, where used, should be professionally crafted to illustrate key points. They should not be selected (often out of context) from published Annual Reports etc.

We have said previously in consultations about the FRC that we believe that the Reporting Lab projects are an excellent initiative. We have also said that the ultimate outputs (usually a report) fall well short of what is needed to highlight issues and bring about appropriate change. Usually this is because they fall into the same trap as the guidance documents referred to above.

We are supportive of all the recommendations on Enforcement and Oversight of the Accountancy Profession.

We agree that the Stewardship Code needs to be demonstrably improved. We believe that the proposals for the revision of the Stewardship Code, in particular the introduction of annual Outcomes and Activities reporting, will substantially address the weaknesses inherent in the 2012 Stewardship Code.

With regard to Enforcement (Recommendations 32-38) we are remain concerned at the time taken to review many cases. The current target timescales for reviewing and processing cases is too long, in particular for simple cases like Redcentric and Blancco.

The inability to communicate on case progress has been a huge problem and greatly contributed to the general lack of confidence in the FRC. It is far from clear that these proposals will address this. Close monitoring of evidence of change is required. UKSA and ShareSoc will continue to be forthright in reporting unacceptable progress.

Chapter 3 – Corporate failure

Q8. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We explained our concerns in our response to the Insolvency consultation. So far BEIS has not, as far as we are aware, acted on them yet - other than to indicate that it might act. We are looking for actions as well as words of good intent.

We support all the recommendations in this chapter. The proposed 'Powers of the regulator in cases of serious concern' are a major step forward. The fact that the regulator has these powers will give boards very serious cause for reflection before:

- Issuing financial statement which they know to be strictly speaking compliant with legal requirements but nonetheless misleading to investors;

- Pressurising auditors to accept a presentation of the accounts which flatters performance with a view to ensuring that directors can hit performance targets so as to achieve large bonus / LTIP awards.

Chapter 4 – The new regulator: oversight and accountability

Q9. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We applaud all the recommendations in this chapter. In particular we are pleased that:

- the regulator will come within the ambit of FOIA (62)
- meaningful measures are being proposed (and are to be adopted) to deal with conflicts of interest (57)
- the way in which complaints are handled is to be more open and expeditious (59 – 61). This in itself will make companies and firms (and their boards) understand that complaints are likely to end up in the public domain very quickly and that it is their own responsibility to look after their own reputations.

Chapter 5 – Staffing and resources

Q10. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We are very supportive of all the recommendations in this chapter. In particular we applaud Recommendation 67. However, we note that:

- further specialists are needed – for example, people with skills in drafting guidance on governance, stewardship and good practice reporting (particularly the narrative elements of the AR). In particular, we would like to see expertise in drafting guidance and principles – not regulation. There will also be a need for people with specialist IT skills as audit itself moves from small-scale sampling to using big data and the identification of suspicious or unusual patterns within the data.
- salaries paid will need to be sufficient to attract and retain the brightest and best in these areas of specialism. This will be a costly but worthwhile exercise;
- attracting and retaining the right people in these areas will be crucial to the future effectiveness of the FRC.
- the proposals for increasing resources and remuneration have not been costed. We agree with the proposal that the FRC should be freed of recruiting constraints (such as having to obtain government approval for each role with a salary of over £100,000 p/a) but we would like to know more about the proposed revised budget for the FRC and how this will translate into ensuring adequate funding for the FRC to recruit and retain the high calibre staff essential to enable it to carry out its enhanced functions.

Chapter 6 – Other matters

Q11. Are there specific considerations you think should be borne in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

We agree that the new regulator has an important role to play in ensuring that there is competition in the audit market. The CMA has recently put forward draconian recommendations to bring about change in the audit market. The FRC (or ARGA) is the right independent body to oversee these changes and to monitor closely the effect that they are having. All too often, complex changes of this sort result in the law of unintended-consequences asserting itself. The FRC should be keeping a close watch to ensure that this does not happen.

In this context we also believe that the FRC has a valuable role to play in the appointment of auditors. The current system of appointing auditors is not satisfactory. Again, our letter to the Secretary of State (Appendix 1) explains why we believe that it would be better for the FRC to take responsibility for auditor appointment.

We have no specific comments to make on:

- the oversight of the actuarial function;
- local audit arrangements;
- quality monitoring of NAO audits.

Chapter 7 – Interim steps

Q12. Are there specific considerations you think we should bear in mind in taking forward the recommendations in this chapter? Are there other ideas we should consider?

What you propose is fine but we would like to see the timetable referred to in recommendation 83 published as soon as is practically possible. We would also like to see a clear implementation plan. Even recommendations that can supposedly be implemented 'immediately' may be dependent on other recommendations taking place first. Full implementation is likely to be a complex and time-consuming process. It will need to proceed at a pace which balances the need to move quickly while recognising the speed at with the new regulatory organisation can realistically cope with the scope and scale of the changes proposed.

Conclusion

Q13. What evidence or information do you have on the costs and benefits of these reforms?

We are unable to comment on the costs.

The benefits are potentially huge by helping to avoid the disastrous corporate failures which, in many cases, should have been foreseen but weren't. These include large-scale systemic threats to the financial system and the economy, the most significant recent example being the near collapse

of the banking system in 2008/9. It would also help to avoid corporate disasters and scandals such as Enron, Tesco, Carillion, Interserve, Conviviality, Patisserie Valerie and London Capital and Finance to name but a few. Not only have investors, suppliers, customers, employees and pensioners suffered loss, there has also been a serious and damaging erosion of trust in business.

Q14. What further comments do you wish to make?

Sound financial reporting is a basic prerequisite for good stewardship. However, no matter how good the financial reporting is, if a significant proportion of investors are disenfranchised and unable to make their voice heard many of the benefits of better financial reporting will be lost. This is exactly the situation that exists currently with regard to individual investors. According to ONS estimates, private investors own 12% of UK main market companies by value and 29% of AIM companies. They have an important contribution to make to governance, stewardship and shareholder oversight of listed companies. However, thanks to the way in which the system of nominee accounts currently works their views are currently not heard and they are disenfranchised.

It should not be difficult in this day and age of digital technology and electronic communications in which shares are held in electronic format to ensure that beneficial owners are identifiable to companies as the true shareholders and are able to exercise their shareholder rights. Reform of the way in which nominee accounts work is something which the new regulator should look at urgently in conjunction with BEIS. Allowing voting power to remain in the hands of conflicted parties explains the need for more regulation when in an ideal world we would call for less.

We have also commented to the FCA on this in our response to its consultation (CP 19/7 on Proposals to Improve Shareholder Engagement. Our comments to the FCA on this are shown in Appendix 2.

Two other areas in which change should be considered and which would strengthen corporate governance are:

- There should be a requirement for FTSE100 companies to hold meetings at least one meeting each year with individual shareholders. Some companies currently do this, for example, HSBC, BHP Billiton and marks and Spencer. Institutional shareholders are usually able to gain an audience informally with the senior management of a company at any time. Currently there is no effective line of access to senior management for private investors.

- The introduction of shareholders committees. These would include members who are aware of individual shareholders views and interests. This is the only mechanism that can give disenfranchised stakeholders influence while the fundamental causes of disenfranchisement remain un-addressed.

Further comments on these proposals for improving shareholder engagement are shown in Appendix 3.

Peter Parry – Policy Director, UK Shareholders' Association

Cliff Weight – Policy Director, UK Individual Shareholders' Society

Appendix 1. Copy of letter to the Secretary for State from UKSA and ShareSoc on auditor appointment.

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The Rt Hon Greg Clark MP
Secretary of State for Business, Energy and Industrial Strategy
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1H OET

18th February 2019

Dear Secretary of State,

Re: Appointment of auditors

We are writing to you on behalf of the United Kingdom Shareholders' Association (UKSA) and the UK Individual Shareholders' Society (ShareSoc). Our two organisations represent the interests of private shareholders. In addition to our own members, there are 5 million people who own shares and have investment accounts with platforms in the UK. The Office for National Statistics estimates that individual investors own 12% of the UK stock market by value. In addition to this there are many more who have money invested in shares via funds, pensions and savings products such as employee share ownership schemes.

Sir John Kingman in his letter to you in December 2018 made a very clear recommendation that auditors of Public Interest Entities (PIEs) should in future be appointed by the new regulator which would replace the Financial Reporting Council. He set out his proposals under the heading 'A different model'.

We believe that Sir John's proposals for the appointment of auditors make eminently good sense. The current system for appointing auditors has failed miserably. It is riddled with conflicts of interest and effectively creates an unhealthy and inappropriate dependency between the auditors and the executive directors of the client companies. It creates a situation in which there is every incentive for auditors to acquiesce to the blandishments of the executive directors over the presentation of the financial statements and to suspend professional scepticism.

We are most unhappy about the resistance from the Investment Association (IA) and its members to Sir John's proposals on auditor appointment. The large institutional shareholders have for many years been complicit in going along with a system which patently fails to protect the interests of their customers, the end-investors. Even in cases recently in which there have been serious audit failures, it has been common for the auditors be reappointed at the AGM by an overwhelming majority of votes.

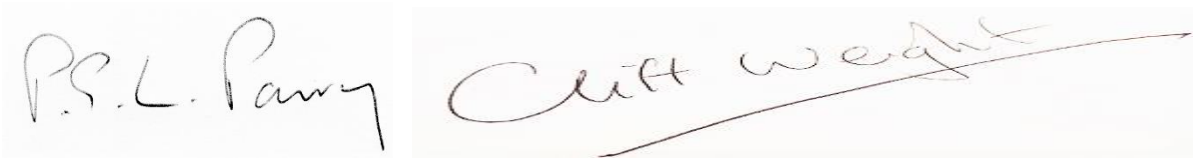
We are particularly concerned that Sir John in his letter to you appears to row back so readily from pressing his case for serious reform in the face of stiff resistance from the IA. The fact that the IA is a powerful lobby with a loud voice is not a reason to cave in to its call for retention of the status quo with minor amendments. The time for fiddling around on the periphery is over. Radical change, as suggested by Sir John, is overdue.

Appointment of auditors by a third party with the relevant skills and expertise would, once and for all, **break the current link of excessive dependency between auditors and those they audit**. It is a change that should not be difficult or costly to implement and would be effective in achieving much greater auditor independence than at present. Auditors are currently appointed for a maximum term of ten years. If, on a trial basis, the Regulator started by managing the appointment of auditors for FTSE 100 companies this would mean an average of ten appointments a year. This should not be a particularly onerous workload for a team of experts. It is low-risk and requires relatively little investment.

We strongly urge you and your Department to consider very seriously the recommendations that Sir John has made. Many of those arguing for minimal change have shown themselves to be very poor stewards of other people's money. Please do not give in to their Siren voices.

We would appreciate the opportunity to meet with you to share our experiences and observations in more detail.

Yours sincerely,



Peter Parry – Policy Director – UK Shareholders' Association

Cliff Weight – Policy Director - UK Individual Shareholders' Society

Appendix 2. Extract from joint UKSA ShareSoc response to the FCA (CP 19/7) on Proposals to Improve Shareholder Engagement

Voting of shares held by Retail Investors: The ability of beneficial shareholders who hold their shares in nominee accounts being able to vote their shares easily and at no additional cost is a critical aspect of shareholder rights and shareholder democracy. **Any regulatory proposals that fail to address this point can only be a partial solution.** The Law Commission Review of Intermediated Securities (see para 4.13 of the DP) must be given a much higher priority.

Currently only 6% of retail shareholder vote at AGMs. This is because of the difficulties, for those holding shares via nominees, that platforms have created. The platforms are not facilitating shareholders exercising their voting and other rights.

In addition, the shareholder register does not require the name on register of the beneficial owner of shares held via nominees. Currently, HM Government has no plans to change this, despite it being a clear objective of the EU Shareholder Rights Directive. The Law Commission review of Intermediated Securities must (as noted above) be given a much higher priority. The FCA/FRC support in this issue would be most welcome. Being able to communicate with shareholders would allow the registrars to offer an alternative service to platforms.

In our response to the Platforms Consultation, UKSA-ShareSoc called upon the FCA also to examine these issues:

1. **A new "name on register" electronic system** needs to be provided if "dematerialisation" is to fully happen so that investors can buy and sell shares through any broker and not be locked into one broker as happens at present.
2. The protection of holdings in nominee accounts by alleged "ring-fencing" of client holding and cash which is totally undermined by the rules in the Special Administration Regime (e.g. the case of Beaufort).
3. The relatively low protection provided by the Financial Services Compensation Scheme in relation to the amounts likely to be invested in platforms, e.g. in pension SIPPs and ISAs.
4. The basic poor legal protection offered by nominee accounts and the failure of almost all stockbrokers to offer personal crest accounts (i.e. where your name is on the share register of the company and your holdings therefore clearly legally your own and not the platform operators).
5. Similarly, the requirement to use nominee accounts for ISAs and SIPPs is deeply uncompetitive because it locks clients into one platform from which they have difficulty withdrawing.

The above issues do not seem to be covered by this consultation paper nor the other discussion paper but are major contributors to the current uncompetitive environment for retail investors in respect of platform operators and hence for retail investors to vote their shares and engage pro-rata to the amount of their investments in companies (on average 29% of AIM companies and 12% of main market companies).

Hence, we call upon the FCA to begin a CMA review of the conduct of platforms and custodian banks, the primary operators of nominee services. The shareholder voting plumbing is broken and there are many vested interests who are interested in tinkering at the edges than ensuring that the law works as it was intended. This review will review how retail shareholders rights can be restored. In doing so, companies will be able to develop productive relationships with their providers of capital.

Appendix 3. Additional extract from joint UKSA ShareSoc response to the FCA (CP 19/7) on Proposals to Improve Shareholder Engagement.

How to involve Individual Investors in shareholder engagement.

As well as the AGM, we suggest regular meetings between companies and groups of individual investors. Such meetings with companies and UKSA/ShareSoc have been held for over 10 years.

Three examples of good practice are HSBC, BHP Billiton and Marks and Spencer.

BHP Billiton

We (UKSA AND ShareSoc) organise a series of events for individual investors to meet the companies they invest in. Probably the best model for this is BHP Billiton who (in conjunction with UKSA+ShareSoc) have **very successfully** run such investor events for over 10 years. Here is a link to the recent event. https://www.sharesoc.org/news/bhp-billiton-retail-shareholder-event-18-sept-2018/

The BHP example is particularly relevant, as BHP suffered very well planned, coordinated actions by various action groups at its AGM which somewhat highjacked it from what many would view as the main purpose of the AGM, to interact with its shareholders and to vote on important resolutions. Cliff Weight was one of those real shareholders at the BHP AGM and found enlightening the degree of concern and the range of issues that were covered. The fact that meetings outside of the AGM had not been able to satisfy employees, labour unions, conservation groups, environmentalists, local communities, etc raised concerns for shareholders about how well the BHP Billiton Board were listening. It was difficult as an observer in what was a highly emotional atmosphere to evaluate the issues. However, having been present at the previous shareholder event (2 months previously) where many of the same the issues had also been raised and discussed he felt that the BHP management are doing a pretty good job in very difficult circumstances. One factor that swayed his view was the time that BHP had dedicated to talking to its retail shareholders in Australia and the UK and also the BHP commitment which was reflected in the length of time they had been engaging in this way.

HSBC

HBSC are another role model and they tend to schedule their event about a month before their AGM which gives the Chairman a chance to rehearse some of the likely AGM questions. These meetings with UKSA/ShareSoc have been held for over ten overs.

Meeting agenda and how it is run:

The presentation is usually similar (or the same) as that given to institutional investors/fund manager/analyst events. We don't wish to demean issues like branch closures, customer complaints, etc, but investors in shares want to know about and focus the event on factors that are crucial to the share price now and in the future.

M&S Shareholder Panel

M&S ask for volunteers each year to join a panel of shareholders. About 6 meetings are held each year including a Christmas lunch event. These meetings provide an opportunity for M&S directors and senior executives to discuss issues of concern and for shareholders to raise questions and issues that they believe are important. M&S have done this since 2016.

More information is at https://corporate.marksandspencer.com/investors/shareholder-information/faq/shareholder-panel which explains:

> Why is M&S doing this now?
> In 2016 we invited a number of shareholders to M&S's Head Office for our very first Shareholder Panel, providing a platform for them to offer their views on the issues that are of most concern to them as investors, and to hear about how the Company is addressing these directly from members of the senior management team. This was hugely successful, and very well received by those who attended, and it was therefore decided to introduce a regular event and for which all registered shareholders can apply to attend.

Shareholder Panels and Shareholder Committees

We see a role for meetings between companies and representatives of shareholders on a more formal and structured basis as part of a successful engagement policy with shareholders. The current ad hoc approach fails to build trust.

We have submitted a shareholder resolution to RBS to include a resolution at the AGM to implement a shareholder committee, for the 2017, 2018 and 2019 AGMs. At the 2018 AGM 5.5% of votes were in favour of the shareholder committee (the 5.5% figure excludes majority shareholder UKGI who voted against our proposal).