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17 February 2017

Dear Sirs

ICSA response to the BEIS Green Paper on Corporate Governance Reform

We welcome the opportunity to comment on the BEIS Green Paper on Corporate Governance Reform (the Green Paper).

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and are required by our Royal Charter to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries and other governance professionals. Company secretaries have a key role in advising companies and their boards on their governance arrangements and on governance reporting. In particular, they have more access to discussions on executive pay, through attending remuneration committee and board meetings, than most other professions. Other members are governance practitioners at major investment houses and are heavily involved in voting and engagement from the shareholder side. We therefore have an unrivalled position from which to understand the issues discussed in the Green Paper.

Whilst we believe that the UK corporate governance model is, generally, highly effective and much to be admired, it cannot be denied that the expectations which we place on it are very different from those which were considered during the Company Law Review between 1998 and 2005 or those which Sir Adrian Cadbury and the Committee on the Financial Aspects of Corporate Governance were asked to address 25 years ago. Whilst both company law and the UK Corporate Governance Code (the Code) have been amended to reflect changes over that period, the time is right to consider whether that model is still as effective as we would wish and whether it can be further improved. We are pleased that the Financial Reporting Council has announced plans for just such a fundamental review and will be keen to be involved.

There is a risk that UK corporate governance is losing some focus. There has been a conflation between corporate governance as it was originally defined by the Cadbury Committee in 1992 - 'the system by which companies are directed and controlled'[1] - and many other factors. We now look differently at corporate governance. For example, the OECD define its purpose as "To help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies."[2] In her introduction to this Green Paper the Prime Minister states that "both the Government and big business must rise to the challenge of restoring faith in what they do, and in the power of the market economy to deliver growth, opportunity and choice for all". As Chris Hodge comments in our own paper on the future of governance[3], "In the 25 years since the Cadbury Committee reported, our expectation of corporate governance has gone from 'improving control and accountability' to 'restoring faith in capitalism'".

We support sound governance principles and wish to improve the standard of governance in the UK. We made this point to the Prime Minister on 24 January in our joint letter with the Institute of Directors, the International Corporate Governance Network and the Trades Union Congress[4]. There are certainly some areas where improvement should be actively sought; others where more time should be given to assess the effectiveness of legal and regulatory measures that have already been taken; and still others where we are not convinced that an adequate case has been made for change. One of the principal challenges is that the way in which the current process works in practice is poorly understood. Our members, governance experts, many of whom are present in the boardroom, have unrivalled experience of how the process works, and what doesn't.

One piece of feedback that we regularly get from them is that the Code has been overused to react to problems in the market, whether or not the problem was a failure of governance, and consequently has been revised too frequently. There are mixed views on the level of detail. For some, it has become too detailed, so that some companies now focus on the reporting of exceptions. By reporting in this way, companies can sometimes take a liberal interpretation of their compliance with the provisions of the Code and we consider this to be unhelpful. The contrary view is also expressed: that the level of detail in the Code is helpful because it reduces the plethora of, often conflicting, codes that investors, proxy advisers and single-interest lobbying groups might otherwise seek to impose on companies. There are enough such codes as it is.

It might be better were the Code to provide a framework for companies to explain their governance arrangements – rather than requiring them to report on their compliance with so many detailed provisions, with an inevitable focus on explanations of where they do not comply.

The Green Paper recognises in paragraph 2.3 that the limited examples of poor corporate conduct are not representative of the UK business community as a whole. Fundamentally, UK corporate governance is of a high standard and we must avoid using individual examples of poor outcomes as a basis for change. It is important also to focus on all the good practice of the vast majority of companies. Otherwise there is a danger that the UK's high standard of corporate governance may be seen as having lost its way and will no longer attract business to the UK. With all the current uncertainty around the UK's leaving the EU, this is not the time to heap further uncertainty and

[1] 'Report of the Committee on the Financial Aspects of Corporate Governance'; 1992
[2] 'G20/OECD Principles of Corporate Governance'; OECD; 2015
[3] https://www.icsa.org.uk/assets/files/pdfs/Press/icsa-the-future-of-governance-report-1.pdf
[4] https://www.icsa.org.uk/assets/files/policy/lobbying/17-01-24-letter-to-pm.pdf

burden onto companies. An exhaustive cost/benefit analysis should, therefore, be undertaken before changes are made.

We have set out below our views on the specific proposals for corporate governance reform included in the Green Paper. We have made some general comments on each of the topics, followed by our responses to the specific questions.

Executive Pay

We believe that executive pay is sometimes excessive and that action needs to be taken to address it. Before we can meaningfully do so, it is essential first to be clear about the ill that we are seeking to cure, because not all of those who talk about ‘high pay’ are coming at the question from the same viewpoint and the solution to the problem depends very much on what the problem is. We understand the concerns over the level of executive pay and, in particular, the public perceptions that it has become increasingly disconnected from the pay of ordinary working people and the long-term performance of companies; and that there is a level of pay which is too high, regardless of performance.

In our view, there are three separate elements underlying this public perception and the issues surrounding them. The steps that need to be taken to address them differ. These elements are:

- that pay is disassociated from performance;
- that there is income inequality in our society; and
- that some people are simply paid too much.

Each of these are valid issues for the government to address, but they are different issues and so the appropriate solution to each of them will also differ.

In terms of the linkage of pay to performance, there has been a great deal of effective work done in relation to public companies to address this issue. This has primarily been led by shareholders, who have reviewed and approved, or not as the case may be, executive pay policies that are designed to align executive and shareholder interests, and which recognise, where appropriate, the need to reflect the international talent pool from which some companies must seek senior executives. Shareholders have powers to reject pay policies of which they disapprove and to indicate to boards that they do not agree with the manner in which a policy has been implemented. We consider this point in more detail in our response to your questions in Part A below.

If the central issue is that of income inequality in society, that is, in our view, not just a corporate governance issue and so not one for companies and shareholders to address in isolation. There is a considerable and, we would argue, socially unsustainable gap between the highest and lowest paid in society, but there are a whole range of fiscal and other remedies, including raising minimum rates of pay and giving greater employment rights to temporary workers, available to the Government to address these issues of inequality.

Similar arguments apply to quantum - the idea that there is a figure above which it is unreasonable for anyone to be paid. But executives of listed companies are a relatively small percentage of highly paid individuals. It important to consider earnings in all other areas of society, rather than focus on one small group. For good reason, the pay of senior executives in quoted companies is visible to all, but the same cannot be said of the income of those in equivalent positions in private companies, professional firms or private equity and other investment firms, to say nothing of entertainment or sports stars, or those who receive income from inherited investment. The

Government may legislate to restrict the quantum of pay should it wish to do so, but the argument for limiting such restrictions only to the employees of quoted companies has yet to be made and doing so will address only a small proportion of those concerned.

Finally, it is important to draw a distinction between executive pay for “managers”, however exalted, and for founder/entrepreneurs. They are too often conflated and there is certainly confusion in the public mind about the two. Reward with no downside for managers who are “hired hands” is very different from that of entrepreneurs who often risk everything.

A: Shareholder voting and other rights

Q1: Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

We do not believe that shareholders need stronger powers over executive pay <u>at this time</u>. Executive pay in UK companies has never been more regulated, but only a small minority of companies received objections to their remuneration policy from shareholders in 2016. The evidence is that, since the 2013 changes were introduced, three quarters of companies have received votes of 97% or more in favour of the remuneration policy and that executive pay has reduced over these three years. In our view the most effective policy intervention would therefore be one that addressed specific areas of abuse rather than the market as a whole.

It would be sensible to evaluate the impact of the 2013 regulations before considering further changes to shareholder powers.

Sections 79-82 of the Enterprise and Regulatory Reform Act 2013, which introduced the concept of the binding vote on directors’ remuneration policy, and the more detailed reporting requirements introduced in the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 were intended to address the issue of executive pay once and for all. The fact that there is still a public perception of a problem suggests that they have failed. However, these changes, effective from 2014, have already made a number of important improvements, such as reducing the discretion available to remuneration committees when negotiating a settlement with a CEO leaving the company. This discretion is now governed by the remuneration policy as approved by shareholders. Engagement between companies and investors on remuneration issues is highly effective and the GC100 and Investor Group guidance, in the development of which a number of our members were involved, has helped to build a common understanding of the issues.

That said, the changes introduced in 2013 have not yet been through a full cycle of reporting and so cannot be said to be fully established or, yet, to have been fully effective or otherwise. Remuneration policies were first put to the shareholder vote at 2014 Annual General Meetings and are due to be put to shareholders again at this year’s AGMs. Companies are currently engaging with shareholders and holding discussions on the remuneration policy to be put to them. Shareholders will then have the opportunity to vote against policies with which they are unhappy or where the effects of remuneration policies have been unexpected or unwelcome. Companies respond to investor requirements and, for the vast majority of well governed companies, it is our experience that this works well with remuneration reports being approved on an annual basis by overwhelming majorities of shareholders. Where there is shareholder dissent, this is not always for the same reasons and can, sometimes, be for conflicting ones.

At present it is unclear what level of shareholder support existing and new policies will have in 2017 or the extent to which policies will be amended in the light of shareholder feedback, although the recent examples of Imperial Brands and Thomas Cook suggest that shareholders are being much firmer in the exercise of their existing powers. A more appropriate time for a review of executive pay arrangements would be in autumn 2017, when the results of the 2017 AGM peak season and, therefore, the results of the 2013 reforms, can better be assessed.

One of the central issues at the heart of the corporate governance debate is that of trust. Public trust in business, indeed in organisations of all kinds, is very low. One of the most striking facets of the debate over executive pay has been shareholders' lack of trust in the non-executive directors on the remuneration committee whom they elect to represent their interests when dealing with management. This is highlighted by investor concerns over the application of judgement and discretion. Flexibility in remuneration matters, indeed it is very important in all aspects of the governance of an organisation. The impact of this lack of trust is that shareholders seek objective measures and to restrict the flexibility of the remuneration committee to exercise discretion. We understand why this is the case, but believe that it can be detrimental to the interests of the company and, indeed, its members as a whole.

With regard to the proposed options for changes set out in the Green Paper, we broadly support Section A Option (iii) but have concerns about options (i) and (iv) and, to a lesser extent, option (ii). Our analysis of the various options proposed is as follows:

Option (i) – executive pay package subject to a binding vote

We support the binding vote on remuneration policy and believe that the appropriate time for shareholders to raise concerns about executive remuneration is during the period before the remuneration policy is put to a binding vote at the AGM. Elements of remuneration such as the level of bonus and awards under Long-Term Incentive Plans are clearly set out in the remuneration policy. The policy also sets out where discretion may be exercised by the remuneration committee and the remuneration report describes where judgement and/or discretion has been applied. However, it is important that shareholders fully understand all elements of remuneration policy so that the potential quantum of remuneration paid, in line with the policy, is envisaged at the time the policy is approved.

A binding vote on remuneration policy provides certainty and the advisory vote on the implementation of that policy (i.e. the remuneration report) advises the remuneration committee on the degree to which investors have concerns about their work. Companies need to – and do – respond where the existing advisory vote on the remuneration report is lost or there is significant dissent.

The proposal that there should be a binding vote *ex post* on the remuneration report is potentially of significant detriment to the competitiveness of UK companies in the international labour market. Whilst companies aim not to overpay when recruiting, people need some certainty. The level of uncertainty over remuneration which would be created by such a binding vote would cause problems.

The process of recruiting a senior executive is usually reported on by the nomination committee. Most large companies will consult with their major shareholders ahead of the appointment on both the appointment and remuneration package being offered. There is ample opportunity for shareholders to raise concerns during this engagement. A binding vote on the remuneration report would mean that companies were faced with trying to recruit executives using a pay package that is not binding – in effect saying to those individuals, 'come and work for us but we can only tell you what we will pay you at the year-end'. The recruitment of executives, particularly a CEO, is already a difficult, time consuming process and uncertainty over the remuneration package offered will make it much more so. It is difficult to see how a company could retain its executives or its credibility amongst potential executives in the event that a binding vote on the remuneration report is lost and it is obliged to row back from an offer previously made and accepted in good faith.

We are also concerned that this proposal would unduly restrict mobility of labour and senior executives would be reluctant to move to a new company – particularly a troubled company – where their expertise would be to the benefit of both the company and shareholders. This proposal also runs the risk of talented senior executives leaving the listed sector and moving into areas such as private equity, where the rewards can be greater and both the uncertainty and public attention reduced.

Option (ii) – stronger consequences for losing the advisory vote on the remuneration report
Companies take a failure to secure a significant majority in favour of the advisory vote on the remuneration report seriously, and take action accordingly. There is already a requirement that a company make a public announcement on how it will address the concerns of shareholders in such circumstances. However, if a company loses the advisory vote on its remuneration report, but the remuneration reported is within the company's policy which has been approved by shareholders, it is difficult for companies to understand the issues unless these have been clearly communicated to them. There is an important distinction to be drawn between situations where investors no longer consider the policy to be appropriate and where they have concerns over the subjective elements of implementation – for example application of judgement and discretion.

We believe the current system works well but we would support the proposal that there be stronger consequences for companies where the advisory vote on the remuneration report is lost at more than one AGM. We suggest that, if the advisory vote is lost for a second year, the remuneration policy should be subject to a supermajority of 75% when it is submitted to the AGM the following year. We think this is more likely to achieve the aims set out in the Green Paper. However, if there are to be stronger consequences for losing the advisory vote, they should be supported by a requirement that investors communicate their explicit reasons for a negative vote to the company.

As discussed above, it is important to have the certainty provided by the binding vote on the remuneration policy; but it is also important that shareholders fully understand the remuneration policy and envisage the level of remuneration that could be paid under the policy.

Option (iii): Require or encourage quoted company pay policies to (a) set an upper threshold for total annual pay (from all elements of remuneration), and (b) ensure a binding vote at the AGM where actual executive pay in that year exceeds the threshold.
The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 already require that the remuneration policy states the maximum that can be paid under any element thereof, and section 80 of the Enterprise and Regulatory Reform Act 2013 introduces a new s226E of the Companies Act 2006, which provides for significant sanctions where a payment is made outside the policy unless approved by shareholders. These include personal liability of the responsible directors should the company be unable to recover the payment from the director. These maxima do not include payments arising from the appreciation in the market price of shares granted under the pay policy – as the Green Paper points out in paragraph

1.25, this is difficult in practice. We are not convinced that this option provides anything more than the existing position.

Option (iv) – binding vote on remuneration policy to be held more frequently
We do not agree with the proposal that shareholder approval of the remuneration policy be sought annually. Companies are being encouraged to focus on the longer term and remuneration policy needs to be aligned with the company's long-term strategy. This proposal would undermine companies' efforts to focus on long-term strategic objectives and encourage regular tinkering with remuneration structures which would lead to short-term thinking

We are also concerned that institutional shareholders do not have the capacity to engage with companies on their remuneration policy on an annual basis. Some institutions seem to find the three-year cycle challenging enough and focus their resources on companies where they have specific concerns about remuneration. Given that, at one level, there is some concern that investors do not adequately use the voting powers that they already have, expecting the issue to be addressed by giving them more seems to be a triumph of hope over experience.

Option (v) - Strengthen the Corporate Governance Code to provide greater specificity on how companies should engage with shareholders on pay, including where there is significant opposition to a remuneration report
The Financial Reporting Council already provides guidance on engagement between companies and shareholders on all issues, not just on pay. In our members' experience, all companies are different, as are the views and interests of their members; some investors prefer one pay structure, some another. We therefore believe that this should be a matter of guidance, rather than a Code requirement. In 2013, ICSA published our guidance on *Enhancing stewardship dialogue*[5], which we will be revising during 2017 to this end, and will be happy to work with the FRC and investors when doing so.

B: Shareholder engagement on pay

Q2: Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

There have been significant improvements in governance over the past 25 years, since the 1992 Cadbury Report on The Financial Aspects of Corporate Governance, and these changes have been embraced by the vast majority of companies. We believe the governance of UK listed companies is of a good standard.

Institutional shareholders will, quite rightly, focus on engaging with the companies where they have concerns, including concerns over remuneration. However whilst some investors are very good at engagement, overall investor engagement with companies could improve. The Stewardship Code has had some effect, although our members experience is that those investors who were good stewards have improved, whilst others continue largely to pay lip service. We were pleased to see the recent efforts of the Financial Reporting Council to encourage greater investor commitment through the tiering process.

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https://www.icsa.org.uk/assets/files/pdfs/guidance/Enhancing_stewardship_dialogue/icsastewardshipreport.pdf

Option (i) – mandatory disclosure of fund managers' voting records at AGMs and the use of proxy voting

We would support a requirement that institutional shareholders disclose their voting with a clear and specific explanation of their reasons for their voting decisions, particularly where they are voting against the recommendation of the directors. In the event that an institution votes against a company's remuneration policy and/or remuneration report or, indeed, any other resolution, it is important for the company to understand the reasons for that decision so that it can respond appropriately. It would not be helpful were the reasons for voting decisions to degenerate into 'boiler plate' such as "undemanding targets".

Option (ii): Establish a senior "shareholder" committee to engage with executive remuneration arrangements

We have carefully considered the arguments in favour of "a senior shareholder committee to scrutinise remuneration and other key corporate issues such as long term strategy and directors' appointments", but we do not support this option. Whilst this model has been cited as working effectively in some Scandinavian countries, it does so under different company law and market structures, and was established for different purposes. We do not believe that it is suitable for transposition into the UK market given that the largest shareholders on most plc boards are drawn from a relatively small group of institutional investors or, in some cases, activist shareholders, for whom this proposal could give an influence in excess of their economic interest.

Option (iii) - Consider ways to facilitate or encourage individual retail shareholders to exercise their rights to vote on pay and other corporate decisions

Retail shareholders are an important constituency and companies go to considerable effort to ensure that they are able to exercise their voting rights. Some retail shareholders choose, often for perfectly understandable reasons, to hold their shares through an intermediary which means, under UK company law, that they forfeit those voting rights. This is not an issue that companies have the power to solve. The Government and the Financial Conduct Authority do have the power to do so, however: the Government by removing the requirement for those shareholders who invest in tax shelters, for example ISAs, to hold their shares through an intermediary; and the Financial Conduct Authority by requiring all nominee providers to pass through voting rights at no cost to the underlying investor. Whilst these changes might be possible, a proper cost/benefit analysis would need to be carried out before any such action is taken, as it is possible that it is only a small, but vocal, minority of retail investors who would be interested in taking advantage of such changes.

We should add that this issue is not solely one that affects retail investors. It affects pension funds and some quite large asset owners who can effectively be disenfranchised because their investment is held in a pooled fund whether through an asset manager or a custodian who does not allow pro rata voting.

C: The role of the remuneration committee

Q3: Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

We believe that option (ii) is sensible and proportionate, but do not support option (i) for the reasons given below.

There is a mistaken perception that remuneration committees do not take into account wider stakeholder interests and do not exercise challenge. This is not the experience of our members, who regularly attend remuneration committee meetings. The Code requires that "no director … be involved in deciding his or her remuneration" and that remuneration committees "should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases"[6]. Remuneration committees employ their own independent advisers, separate from the company's remuneration advisers. The remuneration committee gives instructions to its advisers and works with them to adjust recommendations they receive. There is evidence that remuneration committees have scaled-down or rejected executive pay packages which they consider unnecessarily high and that base salary increases are currently at or below CPR[7].

Remuneration committees comprise non-executive directors only[8], who are conscious of public perceptions and the need to justify their remuneration decisions. The remuneration committee members regularly challenge all executives attending the meetings and the recommendations of their remuneration advisers. Non-executive directors understand the reputational penalties, both for themselves personally and for the company, if they make wrong decisions. This is understood by directors within the context of being subject to re-election every year and the policy of some institutional shareholders to automatically combine a vote against the remuneration policy or remuneration report with a vote against the re-election of the remuneration committee chairman.

Option (i) – require the remuneration committee to consult shareholders and the workforce in advance of preparing remuneration policy

We do not support this proposal. Companies already welcome engagement with their major shareholders and remuneration is a frequent topic of discussions. However, investors will focus their engagement towards companies where they have concerns about remuneration and we have had feedback from members that investors do not always have the resources to engage on this issue. It is also the view of some investors that their policy on remuneration voting is clearly and publicly stated, and they expect companies to bear those views in mind when making their own decisions about the appropriateness of remuneration arrangements, without further reference to them.

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[6] UK Corporate Governance Code Main Principle D.2 and Supporting Principle D.1.

[7] Into focus FTSE 350 Executive and Board remuneration report January 2016 http://www.ey.com/Publication/vwLUAssets/EY-Into-focus-FTSE-350-Executive-and-Board-remuneration-report-January-2016/$FILE/EY-Info-focus.pdf or KPMG Guide to Directors' Remuneration 2016 https://assets.kpmg.com/content/dam/kpmg/qm/pdf/Directors_Remuneration_Guide_2016.pdf or a PwC one?

[8] UK Corporate Governance Code Provision D.2.1.

We reiterate the point made above that the overwhelming majority of remuneration reports are overwhelmingly supported by shareholders. This suggests to us that consultation with shareholders, at least, is effective.

As far as engagement with the workforce is concerned, we are not clear how it is perceived that this would be beneficial, but in any case it should be a matter for guidance rather than regulation.

Option (ii) – require chairs of remuneration committees to have served on a remuneration committee for 12 months

We support the proposal that twelve months prior experience of remuneration committee work should be required for remuneration committee chairs, although we do not believe that it need necessarily be in the same company. It is already a requirement, and widely accepted as a sensible one, that one or more members of the audit committee should have recent and relevant financial experience. The work of remuneration committees has become more complex and onerous, and a level of competence in remuneration matters is now essential. A requirement that the chair of a remuneration committee have at least twelve months experience on a remuneration committee before taking the chair would be very helpful; perhaps as helpful might be a requirement for at least one other member of the committee to have at least as much recent and relevant remuneration committee experience. It is important that members of the remuneration committee have an understanding of shareholder priorities and expectations, but this should be a Code requirement on the usual 'comply or explain' basis – there may be exceptional circumstances in which the most suitable candidate may not meet this criterion.

Finally, it is our members' experience, gleaned from board evaluations and from observing remuneration committee meetings, that there is a need for induction and on-going training for members of the remuneration committee. The best examples of good practice in this area tend to come from larger listed companies where many provide annual training for the remuneration committee, carried out by the independent advisers.

D: Transparency in executive pay

Q4: Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

We believe that, as for other suggested changes, it is too soon to consider changes in addition to those introduced in 2013. Sufficient time needs to be given to assess the effectiveness of the requirement for single figure reporting before further changes are considered. Pay ratios should be one of the potential changes considered at that time.

The disclosure of pay ratios would be an interesting statistic and would provide useful information for and about a company when compared over a period of time. It should not be used to enable comparisons between companies for the reasons set out below. In our view, there are a host of other metrics, disclosure of which would be more meaningful and effective. These would include a comparison of:

- non-salary elements of pay;
- what companies do for their other employees, compared with executives, in terms of pension and other benefits including share plans;

- the level of salary increase of employees generally with the increase awarded to the executives; and
- the pension contributions provided to the executives with the pension contributions companies provide to other employees.

These measures are readily comparable and could be easily understood.

We are aware that reporting pay ratios is required in some other jurisdictions such as the US and therefore some UK companies are now subject to this requirement. However, there are numerous problems with reporting pay ratios and, unless these can be overcome, the reporting will be misleading. The difficulties of misleading reporting and unintended consequences such as incentivising outsourcing and offshoring of lower paid work are acknowledged in paragraph 1.54 of the Green Paper, but we would highlight the following additional concerns:

- Companies with a simple structure, operating in one sector and one geographical area may be able to provide some meaningful reporting but large companies with complex structures operating across a number of geographical areas will find this impossible to do.
- Pay ratios cannot provide for reliable comparisons between companies – even those within the same sector.
- The requirement to publish pay ratios would be for quoted companies only. For many quoted companies their competitors are private companies for whom comparable information would not be available.
- The need to attract the right CEO for the needs of the business, and to pay enough to secure the individual, is based on a global market rather than a market within a certain sector.
- Ratios would require detailed contextualisation in the annual report, which is unlikely to be read and taken into account.
- The headline ratio figures are likely to be reported by the media without the context and this would lead to unwarranted public criticism for some companies.
- Using other CEO pay packages as a benchmark will further increase the ratcheting up of pay seen since the reporting of pay was first introduced.

E: Long-term executive pay incentives

Q5: Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

Commercial confidentiality around performance targets is a difficult area. Companies argue that they disclose as much detail as possible about confidential bonus targets once those targets are no longer commercially sensitive; many investors, on the other hand, believe that this ‘safe harbour’ has been overused. As the figures in paragraph 1.58 of the Green Paper show, disclosure of bonus targets and performance measures has increased substantially under the requirements introduced in 2013 and, after the GC100 and Investor Group guidance was strengthened on this point, we expect this trend to continue. One area where disclosure could be strengthened without compromising commercial confidentiality is disclosure of the personal objectives set as targets for annual bonuses.

Q6: How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

Many companies are already moving towards a three-year performance period for long-term incentive plans plus a requirement to hold the shares for a further two years. We therefore have no objection to this proposal. However, it should be acknowledged that in regulated financial services companies, there is already a requirement that the shares are deferred so the proposal should not require further holding periods by executives of financial services company. Furthermore, with the average term of a CEO being around five and a half years, a five-year holding period is a very long time, and for some global companies, particularly those with US exposure, the current three-year holding period is considered very restrictive.

That said, we are not convinced that holding periods are generally perceived to be a problem: the concern appears generally to be about the quantum of awards, which is, in many cases driven by a tendency to discount the value of potential future payments, sometimes referred to as 'jam tomorrow'. Ensuring executives have a long-term stake in the company is essential but this can be achieved in a number of other ways such as setting additional shareholding requirements for executives, which are generally supported by all.

Using restricted shares would give more certainty and predictability – and would create a long term interest. However it is our experience that most shareholders currently prefer awards to be based on performance conditions. It is accepted that increases in share price are not necessarily linked to company performance, but shareholders are aware that they also reap the benefit of this increase in share price. It is this link between shareholder gain – in terms of earnings per share and/or total shareholder return - and executive remuneration that is important to many shareholders. The challenge with this type of remuneration is twofold: because their value is linked to share price, the quantum of awards can be high in the event of a substantial increase in share price; however, because the realisation of the award is, at the time of its being set, in the distant future and not guaranteed, the value of such awards tends to be heavily discounted by executives, with the result that they can be higher.

Use of restricted shares can also facilitate these opportunities being offered to all employees, rather than a small number of executives. Wider all-employee share ownership should be encouraged and companies should consider whether performance based incentives and other employee benefits should not be offered on an equal basis to all employees.

Strengthening the employee, customer and wider stakeholder voice

The experience of our members is that boards already take into account the interests of employees and other stakeholders. Examples of existing good practice by companies include customer forums or representative panels to obtain feedback from customers; employee engagement surveys and forums, employee councils, data on employee retention and whistleblowing; information on environmental matters and sustainability, and other stakeholder groups. The results of these exercises will be reported to the board as it is very important to boards to understand what suppliers think and the level of engagement of their employees.

ICSA: The Governance Institute is working with the Investment Management Association on a joint project to develop some guidance on good practice in this area.

Given the wide range of companies and the wide range of stakeholders that each will have, we believe that any legislative or regulatory solution around employee, customer and stakeholder engagement should be dependent on size and societal impact, by which we mean the impact that that company has on the society in which it operates, whether through the number of people it employs, its position in the marketplace etc. rather than simply a feature of its ownership structure.

Q7: How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

There is clearly a case for the activity that companies undertake to address the interests of employees, customers and wider stakeholders being better reported to shareholders. For this reason we support option (iv) of those presented in the Green Paper. Practice varies across different countries, and companies need to remain free to use whatever methods are appropriate for them and their markets. There will, undoubtedly, be companies for which options (i), (ii) and/or (iii) would work well and they should be free to adopt them. However, we have concerns about these options being mandated for all companies, as follows:

Option (i) – stakeholder advisory panels

The concept of stakeholder panels or advisory groups feeding information into the board might be effective in some companies. Indeed this would appear to be similar to the way in which information is obtained at present. We support the suggestion in section 2.38 of the Green Paper that it would be for individual companies to decide whether, and if so how, to develop such panels, as there may be some challenges in selecting the individuals to sit on such panels, especially for global companies. It is not clear how, for example, employee representatives could easily represent a global workforce or how a group of suppliers could be chosen to represent all suppliers. As the Green Paper states, companies could draw "on corporate governance guidance which would set out a range of options, including the ones described in this paper". As mentioned above, ICSA, together with the Investment Association, is in the process of preparing such guidance.

Option (ii) – designating an existing non-executive director to be the voice of employees and other key interested groups at board level; and

Option (iii) – appointing stakeholder representatives to the board

Companies are already able to appoint specific employee or other stakeholder representatives to the board if they wish and/or designate a specific board member with this responsibility, and they should continue to be able to do so. However, it should be remembered that directors have common duties so it is not possible for an individual director to have an additional responsibility to represent someone else or a specific group of people. In addition, the challenges in choosing an individual to represent the workforce, or other stakeholder, would be same as for an advisory panel. In most companies the CEO will report regularly to the board on employee views and the board will receive valuable information from stakeholder panels and forums. Information on how employees think and behave is also an important part of the information the board receives to ensure it is setting the culture and values for the organisation. All these options already exist and companies will use whatever method is of the greatest value to them.

Option (iv) – reporting on stakeholder engagement
A useful, non-prescriptive way of tackling this issue would be for all companies above a threshold of societal impact to be required to report on how the board understands and has regard to stakeholder interests. We would support such a recommendation but would suggest this information should be reported on companies' websites rather than in the annual report, which already contains much information which would be better placed on companies' websites.

It is our members' experience that board members are clear in their understanding of their duties as directors and, as the Green Paper points out in paragraph 2.30, larger companies already have to prepare a strategic report, the purpose of which is "to inform members of the company and help them assess how the directors have performed their duty under section 172"[9]. In addition to this reporting, some voluntary systems, such as the Dow Jones Sustainability Index, exist already. However, it is the quality of reporting that is important and, based on the board's reporting, stakeholders are then free to engage with the company, or not – according to how they view the board's commitment to their directors' duties.

It is also important that the scope of board decision making is understood. The remit of the board extends only to setting strategy and major decisions such as acquisitions and disposals. In other respects the board's role is largely oversight of the management of the business. The board remains accountable at all times, but day- to-day decisions are delegated to management and management decisions are made within the governance and cultural framework set by the board.

Ensuring that the stakeholder voice is heard at board level is important, although it must be remembered that the statutory duties of directors do not require that voice to be given overriding effect. To help those companies who are concerned that they need support in this area, and to share existing good practice, ICSA and the Investment Association are working on a joint project to develop some guidance in this area.

There is, however, another option for strengthening the employee, customer and wider stakeholder voice which the Green Paper does not appear to cover. As mentioned above, our members tell us, and we firmly believe, that boards already do take into account the interests of employees and other stakeholders. We also noted that we are working with the Investment Association to provide guidance that builds on examples of good practice. Notwithstanding that good practice, we accept that, in a small minority of cases, directors do not fully comply with their duties under s172. The Companies Act provides little real sanction in such cases. It is open to shareholders to take derivative action on behalf of the company should the directors be in breach of their duties, but only shareholders have that right and, if insufficient regard has been had to the interests of another group or groups of stakeholders to the benefit of shareholders, but there has been no illegality, it is difficult to see shareholders' motivation for derivative action.

We do not believe it to be appropriate for anyone other than shareholders to take derivative action. They are, after all, low in the hierarchy of those who can recover funds from a failed company and other stakeholders have significant protection under employment law, consumer law, pensions and insolvency legislation, contract law, etc. It should be expected that this raft of legislation will cover most relevant circumstances and it is open to the Government to strengthen any of this law if it is deemed appropriate to do so. When considering such action, it is important not to forget that companies are, by their nature, risk-taking enterprises and some of them will, inevitably, fail – that

[9] S414C(1) CA2006

is one of the reasons why the limited liability model has been developed. Such failure is not, in and of itself, evidence of any failure of governance or failure to consider stakeholder interests.

If it is deemed necessary to create additional protection for stakeholders in company law, and we are not persuaded that it is, then one model that might be effective, subject to detailed arrangements, could be a sort of ‘corporate ombudsman’ that could assess stakeholder complaints and make a recommendation as to whether the Government or the complainant should take action under existing legal powers. We would have no objection to such a role being given to the FRC, bringing to corporate governance some of the role that it has for audit.

Q8: Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

We agree that it is important for companies to understand stakeholder views. However, we do not agree that any steps to strengthen the stakeholder voice should be mandated according to an employee number or size threshold. As noted above, this is a matter best left to individual companies and legislation would be inappropriate.

Companies need to be able to decide who are their key stakeholders and engage with them accordingly. A smaller company in a single market can often identify their main stakeholders, but for a global company in a number of different markets, this can be impossible. Companies use many different initiatives to obtain stakeholder feedback. Also, different stakeholders need different approaches. All companies want their employees and customers to be content but companies have a contractual arrangement with suppliers in which they would wish to have a competitive advantage. The company’s relationship with a regulator would be different again and based largely on compliance. Companies need to be free to assess which stakeholders will have the greatest impact on the company and this will vary according to their particular circumstances.

Q9: How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

We support a voluntary approach to reform in this area. Good companies are already making use of the methods discussed above, but the practicalities can be challenging. Other companies should be encouraged to embrace good practice in this area by way of guidance based on current good practice and allowing for companies to use the methods they find the most effective. As noted in our response to question 7, we are working with the Investment Association to develop such guidance.

As discussed above under reporting on stakeholder engagement, we would support the introduction of a requirement that all companies above a threshold of societal impact should report on how the board gains an understanding of stakeholder interests, but this information should be reported on companies’ websites. Much information already contained in companies’ annual reports would benefit from being moved to websites and this disclosure is a good example of such information. As a general point, we believe that far more information can be put on a website than it is reasonable or practicable to include in an annual report.

C: Corporate governance in large, privately-held businesses

As ICSA: The Governance Institute, we understand the importance of governance. The Code is good practice for UK quoted companies. Many private companies already comply with much, if not all, of the Code because it is simply good business to do so, and some larger private companies choose to report on their governance voluntarily. However, the governance of private companies is an area that could benefit from improvement, most notably in terms of transparency.

As we said in a letter to the Prime Minister in August 2016, “the fact that a large company may be privately owned does not reduce the public impact when it fails. Arguing that there should be different expectations on the board of directors simply because there is a different ownership structure is a red herring.

The Companies Act 2006 already recognises this to be the case, which is why the duties of directors set out in Part 10 of the Act – which include a requirement to consider the long-term consequences of their decisions and the impact on their employees and the community – apply to directors of all companies, not only publicly quoted ones.

… the boards of larger private companies should be expected to aspire to the same standards of governance as those in the listed sector”.

Q10: What is your view of the case for strengthening the corporate governance framework for the UK’s largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

Private companies that currently comply with the Code tend to be companies that used to be publicly quoted; that have aspirations to quotation in the future; or want to demonstrate they are compliant with the Code for other reasons, for example those private equity owned entities that report as a result of the Walker review[10]. Mutual companies frequently report to members and many have adopted the Code as standard. Growth companies close to an initial public offering (IPO) are sometimes taken by surprise by the corporate governance expectations, although this is improving and most are now putting the appropriate governance measures in place earlier. We are aware that the Investment Association take the view that being newly listed is not an excuse for non-compliance with the Code.

The benefits of having good governance arrangements in place are common to all companies, including private companies. Although some provisions of the Code are not applicable to private companies, many find it a useful document from which to take the parts relevant to them, in order to develop their own governance framework.

However, there are different types of private companies and each will need different governance arrangements. In many family businesses there is no distinction between the directors and the owners. There is evidence that family controlled businesses are successful as the directors all have a direct stake in the success of the business. Some private companies are managed by the shareholders whereas some are managed by others. However, in private companies managed by

[10] Guidelines for Disclosure and Transparency in Private Equity, published by the Walker Working Group in November 2007 - http://privateequityreportinggroup.co.uk/wp-content/uploads/2015/11/wwg_report_final.pdf

others, the shareholders are generally much more 'hands on' and often have daily interaction with the managers.

The different types of private companies will all need different governance arrangements and consequently, there may be challenges in simply copying across the Code to private companies. We discuss this issue in more detail in our response to question 12 below.

Q11: If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

We note the figures on page 56 of the Green Paper and the large number of private companies with a significant number of employees. However, the current requirement that quoted companies report on their compliance with the Code is a consequence of raising capital and the risks being taken by the shareholders. It is unrelated to the size of the business, although interestingly, there is no such requirement to report to investors in circumstances such as crowdfunding, which seems anomalous.

Current reporting requirements are focussed on reporting by the users of capital to the providers of capital, and raising capital from the public should continue to be the main threshold for requiring that governance arrangements be reported. There is an argument to extend the reporting of governance arrangements to those organisations which have a significant societal impact, as defined on page 14 above[11]. The exact qualification criteria will need to be defined, perhaps through further consultation, and there will be a plethora of views. We believe that the threshold should be set sufficiently high that the additional regulatory burden is truly proportionate.

As noted in our response to question 7 above, stakeholders other than shareholders have a variety of legal safeguards protecting them and it is open to the Government to strengthen any of this law if it is deemed appropriate to do so, but our view is that companies with significant societal impact, whether private or public, also have a responsibility to report to society at large – reporting by the users of societal capital to the providers of societal capital.

Whilst there have been some high-profile failures in private companies - BHS being a case in point - there is little evidence that the existing governance model for private companies is not working in the overwhelming majority of cases. It is therefore important that any enhanced rules governing private companies should be proportionate to the benefit such rules bring. We would therefore expect that the thresholds set at which a company is deemed to have sufficient societal impact to bring it within the scope of reporting requirements should be set at a high level, in which case it is likely that they will already largely be meeting such requirements.

Q12: If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

It is important that the purpose of any requirement to strengthen governance in private companies be defined before a method by which to achieve it is considered.

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[11] the impact that that company has on the society in which it operates, whether through the number of people it employs, its position in the marketplace etc. rather than simply a feature of its ownership structure

The different types of private companies will all need different governance arrangements and consequently there may be challenges in simply copying across the Code to the private sector. Some provisions would not directly apply and the governance structure set out in the Code may not be appropriate in some privately held companies. There is also the additional problem of reporting. Quoted companies are required under the UK Listing Rules to report to shareholders on their compliance with the Code. Private companies often do not have the same separation of ownership (shareholders) from management which requires this reporting, so it is not clear to whom private companies would be reporting other than to society at large.

As noted above, compliance with the Code is essentially voluntary. Companies can choose whether or not to list and, therefore, fall within its scope, and can choose whether to comply with or explain to shareholders against its specific requirements. Shareholders can then decide whether or not to remain owners of the business on the basis of the explanation, or to engage with the company to discuss concerns over their governance arrangements. This provides an ‘enforcement mechanism’ ensuring compliance with the Code or alternative governance arrangements that are sufficiently robust to satisfy shareholders.

Effective governance requires this external ‘tension’ in reporting – i.e. someone to whom to report and a reason to be transparent both about compliance with the Code and/or about alternative governance arrangements where there is non-compliance. It is difficult to see to whom the private company might owe that duty of reporting. The substitute for the shareholders in the mechanism is a problem. Imposing the Code on private companies would require a change in the law or regulation to provide the necessary ‘enforcement mechanism’, which could blur the line between legal requirements and ‘comply or explain’ governance. A mandatory code with an inflexible enforcement mechanism would no longer be principles-based as it is now, allowing companies to put in place the governance arrangements that suit their circumstances; it would become a list of rules with no flexibility.

We understand the argument that the audience for the annual report is wider than just shareholders, although the report is written to and for them. We also understand the debates around whether a governance model is right for society as a whole. However, if it is the intention to focus on wider society and for companies to provide a disclosure document for stakeholders, there is no governance process by which the quality and acceptability of explanations can be assessed. The requirement to disclose would need to be set out in company law or regulation. This is not the same as governance reporting on the basis of ‘comply or explain’.

The best solution might be for a governance code for private companies to be described as ‘guidance’ for private companies and focus on transparency rather than accountability, although the challenge of an effective and proportionate ‘enforcement mechanism’ remains. ICSA would be very willing to work with the FRC to develop such guidance.

An additional measure to strengthen the corporate governance framework for the largest privately-held businesses would be to require that they have specialist governance support for the board. The company secretary and the chairman are key to governance practices within a company. Larger private companies tend to have a company secretary but there is no requirement for them to do so. This is detrimental to good governance, and we believe it essential that large private companies should have a qualified company secretary. It is also important that a company intending to make an IPO has a suitably qualified company secretary to guide them through this process and ensure they already have appropriate governance arrangements in place.

Q13: Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

As discussed above, we believe there are a number of difficulties in a mechanism for requiring private companies to report on their corporate governance arrangements against either the Code, or another code for private companies. There are already a number of codes available to assist companies which wish to have good governance arrangements within their companies for good business reasons. These include codes from the IoD and QCA (as noted in the Green Paper in paragraph 3.8) and we understand the FRC has suggested a separate Code for private companies. However, the questions remain of how reporting could be required and to whom private companies would report to provide the 'enforcement mechanism'. In order to ensure reporting, the requirements would need to be included in company law or regulation.

If such a requirement were introduced for all companies, it would be an unacceptable burden on the smallest companies. As set out under Q11 above, we do not believe the distinction should be based on the size or ownership structure of the company but, rather on its societal impact.

Companies of all kinds have the right to operate as they wish within the law. Reporting on compliance with the Code is the price publicly quoted companies pay for raising capital from the public; for other companies with a significant societal impact, perhaps reporting on compliance with a similar code should be the price they pay for the use of societal capital and the benefit of limited liability. This is a significant benefit and it seems reasonable that such companies accept some public responsibility in return for it.

D: Other issues

Q14: Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

We note the acknowledgement in paragraph 4.1 that the strength of capital flows into the country reflects confidence in the UK's framework of corporate governance and regulation and that the … "clarity of roles between shareholders and boards, … leaves directors free to get on with the day-to-day running of the business". We also note that "…The overall aim is to combine high standards with low burdens" (paragraph 4.2) and the desire to "… build on the strengths of our corporate governance framework and retain its international pre-eminence" (paragraph 4.3). We agree with and fully support these aspirations.

As the qualifying body for governance professionals, including company secretaries, it will be unsurprising that we believe a qualified and independent professional to be at the heart of good governance. With that in mind, we would propose two further changes to strengthen the independence of that role:

- The Code already requires that the appointment or removal of the company secretary be a matter for the board as a whole[12]. We believe that provision D.2.2. should be amended to bring the remuneration of the company secretary within the purview of the remuneration committee, as follows:

[12] Code provision B.5.2.

*"D.2.2. The remuneration committee should have delegated responsibility for setting remuneration for all executive directors**, the company secretary** and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level."*

This will have the important benefit of increasing the independence of the board's principal governance adviser by removing the company secretary's pay from the direct influence of other executives.

- The Companies Act grants[13] a number of rights to an auditor who ceases to hold office including, for example, the provision of a statement of the circumstances in respect of which the company must take certain prescribed actions. In order to reduce the risk of the company secretary being removed in an attempt to 'cover up' a governance concern, we would suggest that the Act be amended to provide a similar safeguard for that officer.

I hope you find our comments useful and if you wish to discuss any of our comments in more detail, please contact me.

Yours faithfully

Peter Swabey
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[13] S517 *et seq.* CA 2006