Governance Briefing

CORPORATE GOVERNANCE COMMITTEE (09 02 2021)

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For Information:

Updates on UK, US, EU and other international developments.

This paper provides an update on publications since the last Corporate Governance Committee meeting on 11 November 2020.

Corporate Governance

ICSA report and recommendations on independent board evaluation
The Chartered Governance Institute (ICSA) has published its final report on the effectiveness of independent board evaluation. It has concluded that there is scope for broader adoption of existing good practice in the way some external reviews are conducted and greater transparency about the process that was followed. The report covers: principles of good practice for listed companies using external board reviewers; reporting on board performance reviews; and a code of practice for board reviewers.

Compulsory COVID Workplace Vaccinations-Cause for Concern?
Employers are eager to get back to the 'old normal' as soon as possible. The key to doing so will be widespread vaccinations. However, the question of whether an employer can legally force staff to get vaccinated raises many legal and moral questions. CMS explores the issues.

Wirecard
The Institut Der Wirtschaftsprufer has a host of proposals including: strengthening supervisory bodies; revision of the CSR Directive; compliance management systems; a statement regarding the continued existence of the entity; risk management systems must cover IT; Audit Committee requirement; publication of financial statements; and development of criminal proceedings of suspected accounting fraud in the area of organised crime. A paper by the think tank, Bruegel, calls for EU level pooling of audit oversight and accounting enforcement, possibly through ESMA. Better Finance has also called for investigation of the 'supervisory, audit and corporate governance failures' and the European Parliament has issued a briefing on the case.

When That Problematic Board Member Just Won't Leave
Sometimes a corporate director who's the main source of a company's reputational problems is the last one to recognize it. That's why, in order to protect the company from unwanted controversy and reputational harm, boards benefit from discreet tools to remove problematic officers and directors before their terms are up, and without going through a formal removal process. These self-executing tools are intended to resolve concerns without making a bad situation worse for the company, the board, and the implicated director. Peregrine and McDermott, Will & Emery LLP, discuss.

Exiting Coronavirus with a Stronger Board
Bagge, Gill, Evans and Snowden from Bvalco identify ways in which the board can use the crisis advantageously to enhance its effectiveness and the company's posture. Every company is being redefined and characterized because of this crisis, whether deliberately or not.

Closing the Gender Pay Gap
ESG-focused investors are demanding more granular disclosure of companies' efforts to close the gender pay gap. Companies that fail to address gender pay inequality may not only see reputational damage but may find themselves at a competitive disadvantage as talent migrates to those companies that prioritize fair pay and opportunities for career advancement. Companies that do not keep up face the risk of potential legal action, as well as shareholder and consumer backlash. Lilienfeld and Behrens, Shearman & Sterling LLP analyse recent developments in the gender pay gap debate and offer practical advice to companies confronting deficiencies in this area.

Understanding pay gaps
Amadxarif, Angeli, Haldane and Zemaityte from the Bank of England use micro-data from the UK Labour Force Survey to estimate unconditional and conditional pay gaps for gender and ethnicity groups since the mid-90s. Both types of gender pay gap have decreased over the sample but remain in double digits. For ethnicity, the unconditional pay gap has been materially lower, compared to the gender pay gap, while the conditional pay gap is of similar magnitude to the gender one. Haldane gave a speech about how the UK's gender and ethnicity pay gaps have changed over time, what's been driving them and why it matters.

#MeTooCompliance
Kirkland identifies actions companies can take to reduce the likelihood of occurrence of a potentially damaging #MeToo incident and mitigate the fallout risks in the event an incident occurs. Importantly, while preventing an incident can never be assured, the suggested initiatives - if implemented and maintained - position the company to demonstrate that any incident that does occur is anomalous and otherwise inconsistent with the company's robust policies and procedures, and ingrained culture and values.

Better connection needed between AML rules and deposit protection
An EBA opinion addressed to the Commission sets out proposals on how to strengthen the connection between the legal frameworks, including preventing the EU's €100k deposit guarantee as a vehicle for cleaning money. The EBA has also issued a report on the progress made in setting up supervisory colleges to enhance AML cooperation.

Shareholders' Rights & Shareholder Activism 2020
Klein, Schulte Roth & Zabel LLP discusses COVID –19's impact on shareholder rights. As life dramatically changed in 2020, so did shareholder rights. The US witnessed a dramatic and substantial change to how companies conduct annual meetings, a reignited debate on the purpose of the corporation, new defensive strategies for companies, as well as a reshaping of the shareholder activist model, as some activists adopted tactics historically associated with private equity. Klein notes some of the major developments that took place over the past year.

Political & Social Issues: Whether & How to Respond
Insead's 'New Framework for Corporate Activism' suggests a logical decision-making approach accompanied by relatable examples for determining whether company CEOs should speak out on (frequently controversial) political or social issues. The framework - which can help companies ensure that their decision-making process is grounded and consistent over time - presents four alternative positions companies may consider in response to an issue. Determining which stance is appropriate depends on the particular issue raised, as well as the company's values and business operations and associated potential impacts on corporate performance.

Trump Legacy: Boom in Corporate Political Disclosure
Freed, Carroll, and Sandstrom reveal that over the past four years, more large publicly held US

companies than ever before have adopted sound transparency and oversight practices for their political spending. Overall, the Trump years spurred the growth of corporate political disclosure and more robust oversight by company boards and review by committees of how company political money is spent or whether the company should engage in political spending. What's behind these developments? The recognition by companies that the risk posed by political spending has grown exponentially. The new level is a result, to a great degree, of the rise of social media and millennial activism and a hyperpolarized political environment.

All the President's Friends: Political Access and Firm Value

Access to political decision-makers is a scarce resource because politicians and their aides have limited time and can only interact with a limited set of people. Gaining political access can be of significant value for corporations, particularly because governments play an increasingly prominent role in influencing firms. Governments affect economic activities not only through regulations but also by playing the role of customers, financiers, and partners of firms in the private sector. In their paper Brown and Jiekun Huang of University of Illinois investigate the characteristics of firms with political access as well as the valuation effects of political access for corporations. Using a data set of White House visitor logs, they identify top corporate executives of S&P 1500 firms that have face-to-face meetings with high-level federal government officials.

Unions Are Democratically Organized, Corporations Are Not

Madland, Malkie Wall, and Root, Center for American Progress, report that in establishing the rules that govern engagement with the democratic process, including laws related to elections, campaign finance, and lobbying, unions and corporations are often lumped together under the incorrect assumption that these two types of organizations are roughly equivalent and thus should be subject to similar rules US law, however, does not always treat unions and corporations equally. For example, unions are subject to more stringent disclosure requirements for political and other forms of spending. In addition, workers covered by a collective bargaining agreement are able to opt out of funding political activity while corporate shareholders cannot. The authors focus on the leadership elections of unions and corporations. Beyond internal structural differences, unions and for-profit corporations also differ regarding their impact on democracy.

Horizontal Directors

Nili of University of Wisconsin spotlights the surprising prevalence of directors who serve on the boards of multiple companies within the same industry and who may also facilitate coordination that may lead to anticompetitive behaviour. Against this empirical backdrop, the paper explores the benefits horizontal directors provide to companies and investors, as well as the antitrust and governance concerns that they may pose and puts forward several policy recommendations to regulators and investors.

Financial Services

Bank lending in the knowledge economy

The European Central Bank warns of prudential risks associated with intangible capital. The growing stock of intangible assets is constraining bank lending to knowledge-oriented firms. In turn, banks are shifting away from commercial loans to mortgage assets with growing risks, particularly during crises.

Why Islamic finance has an important role to play in supporting the recovery from COVID-

How the Bank of England's new Alternative Liquidity Facillity can help. Hauser, Executive Director Markets, has announced the launch date for the Bank of England's new Shari'ah compliant non-interest based deposit facility, the first such account from a Western central bank. The facility, in which deposits from Islamic banks will be backed by a return-generating fund of high quality Shari'ah compliant assets, will further strengthen the United Kingdom's role as the leading international financial centre for Islamic finance outside the Muslim world.

Sustainability

Climate change and corporate value
This KPMG and Eversheds-Sutherland report reveals that climate change has become a significant boardroom issue requiring action; most companies treat climate risk as a serious business issue; companies are being pressured to implement decarbonization strategies; the new focus on climate risk is manifesting itself on companies' People Agenda; and critical barriers to decarbonizing business remain.

More transparency needed over sustainability ratings
A report by SustainAbility for the European Commission highlights issues around the accuracy, reliability and timeliness of ratings while also noting the lack of comparability, consistency and completeness in company sustainability disclosures. The report recommends industry-wide standards for green rating firms, including certification by supervisors. The findings feed into the Commission's work on a renewed sustainable finance strategy due this spring.

Study shows EU banks' significant climate exposures
A preliminary study of 29 banks referenced in the EBA's risk assessment report, suggests that more than half of banks' exposures to large corporates come with climate-change risks attached. A third of corporate exposures have over the median greenhouse gas emissions.

Interim study on integration of ESG factors into banking system
The study, prepared by BlackRock, provides a first overview of possible tools and mechanisms which banks can use to map, assess and manage ESG risks. It also looks at how ESG risks could be integrated into prudential supervision and outlines ways to scale-up green finance.

Auditing

Public audit oversight in 30 countries
A survey by Accountancy Europe shows that the national public oversight bodies now carry out many activities previously in the competence of the professional bodies. The survey also provides an overview of how the public oversight is organised in each of the 27 EU Member States, Iceland, Norway and the United Kingdom, ie, composition, funding, transparency and key activities of the national public oversight bodies and delegation of tasks to other bodies.

How do multidisciplinary teams contribute to audit quality?
High-quality audits contribute to the extent to which we can trust financial information. As stakeholders demand more and more diverse corporate information, companies use experts, beyond accounting, for reporting this. Likewise, auditors depend on other experts, scientists, engineers, actuaries, to supplement their skills to provide the highest quality audit of financial statements. Such multidisciplinary teams aim to meet the demands of a fast-changing and complex business environment. Multidisciplinary models have been the subject of debate in Europe and beyond. Accountancy Europe asked 18 people from practice, including regulators and audit committee chairs, how they view working with multidisciplinary teams. Based on their insight they concluded the following: multidisciplinary audit teams contribute to high-quality audits, auditors benefit from experts' input, especially from internal ones, firms should further develop their capability to work with internal experts, firms should stay multidisciplinary to meet evolving expectations from the audit and auditors' priorities remain audit quality, the public interest, independence and ethics.

Defining the Role of the Audit Committee in Overseeing ESG
Sullivan, Maureen Bujno, and Arthur, Deloitte & Touche LLP acknowledge the role that the 'G' plays in overseeing the company's transparency around sustainability initiatives continues to be a

primary focus in the ESG conversation. The ‘G’ can be described as the governing structure, policies, and practices employed by an organization to define responsibilities and decision-making rights that provide the foundation for overall accountability and credibility. Included in this is how the board defines its committee structure and delegates oversight responsibility across the board and its committees.

Reporting

Setting up for high-quality non-financial information assurance in Europe

As the importance of non-financial information (NFI) is growing, stakeholders also need to know if the information can be trusted. Independent, external assurance enhances the reported NFI’s reliability, strengthens confidence in markets and contributes to the global sustainable finance objectives. This Accountancy Europe publication explores three conditions to develop and ensure high-quality NFI assurance; EU regulatory framework mandating assurance, professional standards applicable to all assurance service providers and public oversight of assurance service providers

Investors Hold Boards Accountable—When Equipped With the Right Reports

Hamacher of Morningstar Funds Trust, summarises the US Securities and Exchange Commission proposals updating mutual fund and exchange-traded fund shareholder reports and disclosures to better meet the needs of retail investors. In her view the changes relegate vital information about the board to online documents shareholders are much less likely to read or ever see. She believes that there need to be room for board diversity disclosure.

Capital Markets

Recapitalising EU businesses post COVID-19

AFME and PwC have published a report proposing solutions to Europe’s emerging funding gap. The report suggests that Europe needs to bridge a gap of €450-600bn in equity needed to prevent widespread business defaults and job losses as COVID-19 state support measures are gradually reduced. The findings reveal that many mid-size and SME corporates do not wish to give up control of their business but are willing to pay a premium to avoid diluting their voting rights and distribute a share of profits to investors. The report states that hybrid instruments are ideally suited to address these needs. The proposed instruments are **C**OVID-19 preference shares or equity-like instrument, which can deliver returns to investors and enable corporates to preserve control.

Why central banks need new tools for dealing with market dysfunction

From lender of last resort to market maker of last resort. Hauser, Executive Director for Markets at the Bank of England, examines what he learnt from the ‘dash for cash’ in March 2020. He explores what features a new set of central bank tools *might* have.

The Fear and the Bright Side of Financial Fragility

Massa of INSEAD, Schumacher of McGill University and Wang of McMaster University confirm that the global asset management industry continues to consolidate and a small number of very large asset managers play an increasingly dominant role. At the same time, one of the main folk theorems in finance posits that asset managers do not pose a risk to financial market stability because they are not levered. This lack of leverage could make concentrated stock ownership in the hands of big asset management families a source of stock price stability.

Tax

OECD releases global tax reporting framework for digital platforms in the sharing and gig economy

The OECD has released a new global tax reporting framework, the Model Rules for Reporting by Platform Operators with respect to Sellers in the Sharing and Gig Economy (MRDP). Under the MRDP, digital platforms are required to collect information on the income realised by those offering accommodation, transport and personal services through platforms and to report the information to tax authorities.

Selected ICAEW CEO Insights since 11 November 2020

25/11/20 - A Manifesto for Audit

25/12/20 - ICAEW comments on post-Brexit trade deal

Related work across ICAEW

The FRC review of corporate governance

Elizabeth Richards considered this review and identified lessons which should influence how companies report on the lockdown period in due course. Overall, the FRC's opinion is that companies aren't reporting well on the new corporate governance code. Unfortunately, the new code hasn't stopped the use of boilerplate language or improved explanations for non-compliance with code provisions. Companies also aren't saying enough about what happens as a result of stakeholder engagement. Only 0.6% of companies have chosen the workforce director option for their engagement with this key stakeholder group.

ICAEW becomes first professional body to sign Black Talent Charter

ICAEW has become the first professional body to sign up to a new City Charter which calls for more representation of Black professionals at senior levels. As a signatory to the Charter for Black Talent in Finance and the Professions, ICAEW has six months to create a five-year plan and establish targets to improve equality of opportunity for Black professionals working for the Institute. ICAEW has also committed to looking beyond its employees to assess what more can be done to encourage Black representation on its committees and advisory groups.

Taking the green finance education charter into business

Recorded as part of London Climate Action Week this event asked what can we do to build the capabilities of institutions and individuals to lead and support business in a green recovery?