Governance Briefing

CORPORATE GOVERNANCE COMMITTEE (13 05 2019)

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For Information:

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

This paper provides a brief update on publications since the last Corporate Governance Committee meeting on 11 February 2019.

Corporate Governance

Embankment Project for Inclusive Capitalism
EY has collaborated with 31 CEOs and a 15 member Advisory Board to form EPIC. This project has produced metrics for measuring companies non-financial performance. A long term value framework provided principles, guidance and tools for companies to better articulate their long-term performance.

Investor Engagement and Activist Shareholder Strategies
Ruggen gives reassurance that it's not your imagination, shareholders and activists have asserted themselves more in recent years. For better or worse, activists are more numerous and more diverse than they were in the past, both in their agendas and their methods. This reinforces the need for management, with the board's oversight and guidance, to engage with shareholders proactively, to be prepared for friendly or confrontational activists, and to have a long-term plan for shareholder engagement. It's also essential for the board to consciously craft its role in this tricky area, where it is expected to both represent shareholders and advise management.

One is the loneliest number
Sneader and Yee of McKinsey say that for women, being an 'only' in the workplace is endemic. 20% of the women in McKinsey's latest report said they were commonly the only person of their gender in the room or one of very few. The figure is far higher in some sectors such as technology and engineering. For women of color, that number rose to 45 percent. For men, it was just 7 percent.

Are we long-or short-on talent?
McConnell and Schaninger offer hope to EOs and HR leaders worried about the viability of their talent strategy. After all, there's a closetful of bogeymen to pick from as disruptive technologies such as digitization, automation, and artificial intelligence combine with demographic forces to continue transforming the nature of work, how it gets done, and by whom. The resulting job displacement could be massive, think Industrial Revolution massive, affecting as many as 800 million people globally by 2030 and requiring up to 375 million of them to switch occupational categories and learn new skills.

Competitive advantage with a human dimension: From lifelong learning to lifelong employability
Davies, Diemand-Yauman and van Dam explore the advancement of AI-enabled automation. Organisations should embrace 'lifelong employability,' which stretches traditional notions of learning and development and can inspire workers to adapt, more routinely, to the evolving economy.

Industry as Peer Group Criterion
Lan of Equilar Inc discusses current trends in peer group disclosure among the Equilar 500 companies. They shed light on what is deemed effective in constructing peer groups. The SEC has detailed requirements for companies to disclose their peer group companies with appropriate justification. Peer group analysis has become a key step to ensure competitive pay practice. However, selecting which companies to consider as 'peers' can be a difficult process for many, especially for companies that have a foot in multiple industries.

As Luck Would Have It: Executive Compensation at Energy Companies
Davis, University of California, and Hausman, University of Michigan, confirm that fortunes are made and lost every year as oil prices rise and fall, impacting the macroeconomy, the stock market, investment, and of course the value of oil and gas firms. What happens to the fortunes of the leaders of those oil and gas firms? Davis and Hausman argue that the compensation of US oil and gas executives is much more closely tied to oil prices than economic theory would predict.

Public Markets for the Long Term: How Successful Listed Companies Thrive
Williamson of FCLTGlobal acknowledges that public markets are out of fashion. Detractors point to the decline of IPOs in developed economies and the growth of private capital pools over the last few years. She says that these trends tell only one side of the story. Private markets are doing well, but their success does not suggest the decline of public markets. Public markets continue to be an essential driver of wealth creation, innovation, and capital stability for high-performing companies. Despite the short-term pressures of public markets, the best-managed companies can and do take advantage of the benefits public markets have to offer. For companies playing at the highest level, public markets remain an integral element of their long-term growth.

Capitalism at an Inflection Point
Lipton, Wachtell, Lipton, Rosen & Katz have noticed that dissatisfaction with corporations is near the top of the political agenda for both the left and for the right. The Accountable Capitalism Act, a bill that would make all corporations with $1 billion or more of annual revenue subject to a federal corporate governance regime (by requiring them to be chartered as a United States corporation), was introduced by Senator Elizabeth Warren. Among other things, this regime would mandate that not less than 40% of the directors of a United States corporation be elected by employees, and that directors must consider the interests of all corporate stakeholders, including employees, customers, suppliers, investors, and the communities in which the corporation operates.

Communicating with the Investment Community in the Digital Age
Doorley or Brunswick Group LLP thinks that having a sophisticated and current understanding of how the investment community gathers and processes information is critical for success when a corporate issuer is communicating with the market on an ongoing basis or during a complex situation such as a transaction or responding to a shareholder activist. He has been tracking the digital consumption habits of institutional investors and sell-side analysts around the world for a decade, and the results of our latest study reveal important trends that should be considered when formulating both ongoing and event-driven investor engagement programs.

Corporate Governance in Emerging Markets
Mishra, Institutional Shareholder Services, knows that analysing corporate governance at companies in emerging markets can be really tough. A combination of differing regulatory standards, disclosure requirements, market norms, local investor preferences, and more all collude to make the evaluation of governance structures difficult. Emerging markets continue to have a

unique set of characteristics which require special attention when assessing corporate governance at the country level and at the company level. At the country level, the legal framework, the strength of institutions, and the rule of law all affect the quality of governance of individual firms. At the company level, ownership structures will often determine the types of governance challenges a company may face, as concentrated ownership may lead to potential risks of management entrenchment or the risk of expropriation of minority shareholders.

Organisational culture in mergers: addressing the unseen forces
Engert, Kaetzler, Kordestani and MacLean, McKinsey, advise on steps to manage and integrate culture: diagnose how work gets done; set priorities; and hard-wire and support change.

Public Pension Trustees Launch Human Capital Management Principles
An institutional investor coalition composed of CalPERS, CalSTRS, the LA City Employees' Retirement System, and the LA County Employees' Retirement Association launched the 'Trustees United Principles' aimed at guiding their engagements with portfolio companies on managing and mitigating human capital management-related risks. The Principles promote corporate policies on workplace sexual harassment and violence, restrictive labour practices, workforce and board diversity, and workers' rights.

US

In Corporations We Trust: Ongoing Deregulation and Government Protections
Lebovitch and Spaid, Brnstein Litowitz Berger & Grossman LLP, warn that nearly two years into the Trump presidency, extensive deregulation is raising risks for investors. Several of the administration's priorities are endangering financial markets by reducing corporate accountability and transparency. SEC enforcement actions under the administration continue to lag previous years. The Trump administration has also instructed the SEC to study reducing companies' reporting obligations to investors, including by abandoning a hallmark of corporate disclosure: the quarterly earnings report. Meanwhile, President Trump and Congress have passed new legislation loosening regulations on the same banks that played a central role in the great recession. Lebovitch and Spaid say that it is important for institutional investors to stay abreast of these emerging developments as they contemplate the risk of their investments amid stark changes in the regulatory landscape.

Corporate Board Practices [available to committee members on request]
The report is a collaboration by the Conference Board, data-mining firm ESGAUGE, the John L. Weinberg Centre for Corporate Governance (successor to the Investor Responsibility Research Centre Institute), Debevoise & Plimpton and Russell Reynolds Associates. The report was covered by the Wall Street Journal. It documents corporate governance trends and developments at 2,854 companies registered with the SEC that filed their proxy statement between 1 January and 1 November 2018 and as of January 2018, were included in the Russell 3000 Index, as well as select findings from 494 companies listed in the S&P 500.

Non-Answers During Conference Calls
Gow, University of Melbourne, Larcker, Stanford University, and Zakolyukina, Univesity of Chicago, say that while much disclosure is governed by laws, regulations, standards and the like, much of the information investors rely on is provided voluntarily by firms. Since Regulation Fair Disclosure was introduced by the SEC, corporate conference calls have emerged as an important channel for firms to disclose information to capital markets. A feature of a typical conference call is that a portion of it is devoted to the firm's managers providing responses to questions asked by participants, who are primarily sell-side equity analysts. However, many of these questions are met by explicit non-answers, such as 'we do not disclose those numbers' or 'I can't give you any specifics' or, simply, 'I don't know'.

The Long View: The Role of Shareholder Proposals in Shaping US Corporate Governance
Papadopoulos of ISS Analytics takes a retrospective. Over the past three decades, shareholder proposals have transformed the corporate landscape in the US by spurring the adoption of

governance best practices. Annual director elections, majority vote rules for director elections, shareholder approval for poison pills, and proxy access bylaws are some of the critical governance practices that have become common practice thanks to investor support for shareholder proposal campaigns led by a wide variety of investors—some large; others small. Despite the advisory (non-binding) nature of most shareholder proposals in the US, successive waves of campaigns eroded boardroom entrenchment by convincing directors to respond to shareholders' calls for accountability, transparency and stewardship.

CEO Pay Mix Changes Following Say on Pay Failures
In response to the 2008 financial crisis, US legislation was passed in the form of the Dodd-Frank Act to bring some changes in the corporate environment. Say on Pay, which gives shareholders the right to vote on the remuneration of executives, addressed the issue of excessive CEO pay and was meant to give shareholders a voice and reduce CEO pay to a reasonable level. Bi, Equilar Inc., is of the opinion that the question of how long it takes for Say on Pay votes to exert a noticeable impact on CEO pay is difficult to address. Intuitively, it seems possible that CEO pay should decrease since it is under the scrutiny of a large number of shareholders. However, the data reveals a different story. CEO pay, instead of declining, actually experienced a small degree of growth after Say on Pay was put into law.

As California Goes, So Goes the Nation? The Impact of Board Gender Quotas on Firm Performance and the Director Labour Market
Women are still heavily underrepresented in leadership positions in the U.S. corporate sector. According to the Corporate Women Directors International 2018 report, women hold 21.4% of director positions on the boards of the Fortune Global 200 companies. Women are still heavily underrepresented in leadership positions in the US corporate sector. Solomon, University of California, Berkeley, examines the consequences of California's adoption of SB 826, a law attempting to cure this disparity. SB 826 mandates that a minimum number of female directors serve on public companies headquartered in California.

Whistleblower Award to Company Outsider
Park, Janghorbani and Wintering of Cleary Gottlieb Steen & Hamilton LLP announce that on 4 March 2019, the Commodity Futures Trading Commission (CFTC) announced a whistleblower award of over $2 million to an individual, unaffiliated with the company the CFTC charged, for providing expert analysis in conjunction with a related action instituted by another federal regulator. While the SEC which possesses a similar whistleblower award regime has previously issued awards to multiple claimants for both related actions , and to company outsiders, this is the first such award to be granted by the CFTC in either respect. The award demonstrates the CFTC's continued commitment to the Whistleblower Program, and to using all available means in conducting enforcement actions.

Financial Services

Information overload: effective boards and committees in financial services
ICAEW provides practical recommendations to reduce the size of board packs and make them more effective for boards. Our proposals will enable board chairs, management, executives and non-executives to improve their own papers, ensure that responsibilities are clearly defined and make certain that non-executives do not have to deal with information overload. The proposals we provide work in the context of three overarching principles.

Bank Boards: What Has Changed Since the Financial Crisis?
Rajgopal,Columbia Business School, Srinivassan, Harvard Business School and Wong, University of South California note that the Financial Crisis Inquiry Commission identified dramatic failures of corporate governance and risk management at many systemically important US financial institutions as one of the key causes of the 2008 financial crisis. If the crisis is viewed as the byproduct of failed incentives for managers, owners, creditors, and regulators, corporate governance could potential identify and address misaligned incentives to prevent undesirable firm

behavior in the future. However, the authors' view is that the prospects for significant improvement in the governance structure of banks remain limited.

The FCA Directory

On 8 March, the FCA published the long-awaited final rules on the proposed new Financial Services Directory (the 'FS Directory'). The introduction of the FS Directory is expected to be welcomed by firms and consumers alike. Following the FCA's consultation during the summer/autumn of 2018, the emphatic industry view is that a directory of those working within financial services would be a positive move towards increased accountability and consumer protection. The FCA has been at pains to highlight that the FS Directory will promote transparency by requiring firms to disclose a relatively granular level of detail on their staff and by ensuring that the directory is rolled out using very user-friendly, online functionality. From the perspective of firms, the FS Directory will make it quicker and easier to check the work history of new hires, complimenting the regulatory reference regime. Wider regulatory benefits include enabling the FCA to better identify and prioritise high risk supervision cases as well as the creation of a robust information sharing network with intelligence partners including the police and other regulators.

When expectations meet the future

Sir Jon Cunliffe analyses the evolution of debt. He looks at how people make choices based on what they expect to happen in the economy and financial markets. Sir Jon then talks about what central banks can do at a national level (macroprudential policy) to identify and reduce the risks to financial stability and avoid a repeat of the 2008 financial crisis.

Stablecoins

Regnard-Weinrabe, Vasu and Pack of Allen & Overy UK LLP, and Al Nakib of Swisscom Blockchain AG report that with the value of cryptocurrencies fluctuating on an almost daily basis, there has been an increased focus on creating a cryptoasset which can be transferred digitally but also crucially benefits from stability and trust. Such an asset is known in the industry as a 'stablecoin', and over recent months, this latest innovation has seen a significant growth in adoption.

Positive Externalities

Martin Taylor reflects on his time as an external member of the Bank of England's Financial Policy Committee. He talks about what external members do and the skills and experience they can bring. He compares their role to that of a non-executive director in the private sector.

The impact of QE on liquidity: evidence from the UK Corporate Bond Purchase Scheme

Boneva, Elliott, Kaminska, Linton, McLaren and Morley from the Bank of England look at the Corporate Bond Purchase Scheme (CBPS) which purchased up to £10 billion of sterling corporate bonds. To investigate the impact of these purchases on liquidity, they create a novel dataset that combines transaction-level data from the secondary corporate bond market with proprietary offer-level data from the Bank of England's CBPS auctions.

Sustainability

Corporate Sustainability: A Strategy?

Ioannou, London Business School, and Serateim, Harvard Business School explain that in recent years, a growing number of companies around the world voluntarily adopt and implement a broad range of sustainability practices across the environmental, social and governance (ESG) domains. In doing so, they try to integrate sustainability into their strategy, business models, and organizational processes and structures. In fact, the accelerating rate of adoption of these practices has also provoked an academic as well as a wider debate about the nature of sustainability adoption and its long-term implications for organizations: specifically, is the adoption of sustainability practices a form of strategic differentiation that can lead to superior financial performance or is it a strategic necessity that can ensure corporate survival but not necessarily outperformance?

The Board and ESG
Jan, Deloitte Global, says that discussions of environmental, social, and governance (ESG) matters have taken hold in mainstream media, government bodies, coffee shops, the food industry, clothing manufacturers, and boardrooms. With such high stakes, this is an area that organizations, and their boards, cannot afford to get wrong.

Changing the Conversation-Redefining How Companies Engage Investors on Sustainability
When Ceres released The Ceres Roadmap for Sustainability in 2010 their vision for corporate sustainability leadership in the 21st century, sustainable business leaders were easily identified and few in number. Lang reports that it is now it is commonplace to find a 'sustainability' or 'corporate responsibility' section included on company websites. Increased public awareness, regulation and investor interest has made acknowledging environmental and social impacts, and claiming a commitment to be 'sustainable' a mainstream practice for doing business today.

Top 10 Sustainability Developments in 2018
Riesenberg of the Sustainability Accounting Standards Board says that investor, regulatory, and corporate interest in environmental, social and governance (ESG) issues seems to be growing by leaps and bounds. Here is a list of the top ten developments of 2018; institutional investors are insisting on better sustainability, Investors are focusing on evidence of financial materiality, Sustainability accounting standards board publishes its codified esg standards, Standard-setters are focusing on complementary frameworks and better alignment, Corporate lawyers are devoting more attention to esg disclosure, Disclosure risks are assessed, Accountants are increasingly working in this area, Some legislators express interest in better disclosure, The rest of the world takes steps towards better sustainability disclosure and Concerns about climate change and cyber security greatly increase.

Auditing

Audit insights: construction report
This ICAEW report examines four key areas that need to be addressed by construction firms if they are to run sound, well-managed businesses: bidding for lasting value and ending the practice of producing unsustainable tenders; better contract management; rebuilding confidence in the sector through increased transparency; and taking steps to ensure the industry is fit for the future through investing in technology, innovative practices and young talent.

Audit Committee Agenda 2019
Protiviti's 'Setting the 2019 Audit Committee Agenda' suggests a number of thoughtful considerations for the audit committee's annual agenda that reflect the changing macro-environment, including the significant influence of technology on enterprise risks that may impact the business and company's disclosures, talent management challenges in the Finance and Internal Audit functions, and ESG and integrated reporting. The bulletin includes an instructive list of sample audit committee self-evaluation questions.

Audit Committee Oversight of Audit Quality: Good Practice Guidance
This 'Report on Good Practices for Audit Committees in Supporting Audit Quality' from the International Organization of Securities Commissions shares sound practices for audit committees including audit committee composition, operations, and access to appropriate people and other resources.

Reporting

Financial reporting: Who does what
The complexity of the UK financial reporting system and the role of auditors is explained in this ICAEW paper which launches ICAEW's Future of Audit series of thought leadership papers. The

papers will look at who is involved in the preparation of financial statements for UK companies, how they are involved and the role of auditors in challenging those responsible. These papers are designed to inform the various inquiries relevant to audit reporting and regulation that are in progress, including the Brydon review into the quality and effectiveness of audit.

The state of corporate sustainability disclosure under the EU Non-Financial Reporting Directive
The Alliance for Corporate Transparency reveals that even if most companies acknowledge in their reports the importance of environmental and social issues, this information is not clear enough in terms of concrete issues, targets and principal risks.

Capital Markets

Financial Conduct Authority Business Plan 2019/20
In the FCA's Business Plan 2019/20, matters of interest from a corporate finance perspective are, in the ongoing cross-sector priorities, the FCA will continue to work on extending the Senior Managers and Certifications Regime to FCA (solo regulated firms). This impacts on ICAEW member firms that are FCA-regulated ,eg, for corporate finance and wealth management). In the Wholesale sector, the FCA will focus on firms' controls, particularly how inside information is controlled in merger and acquisition activities and corporate broking.

The Life Cycle of Corporate Venture Capital
Ma, Yale University, notes that in recent decades non-financial firms have made forays into venture capital by creating Corporate Venture Capital (CVC) divisions. Specifically, firms create corporate-affiliated VC divisions to make systematic minority equity investments in innovative start-ups. CVC has become a common form of corporate investment adopted by hundreds of firms and has emerged as an important source of entrepreneurial capital. CVC's nature as corporate investment distinguishes it from the traditional intermediary VC model that seeks pure financial return.

Encouraging Smaller Entrants to Our Capital Markets
In his speech Roisman, from the SEC says that encouraging and facilitating the entrance of companies, especially smaller companies, to our capital markets is incredibly important to him and the Chairman of the SEC. He remains focused on market structure issues not only for the equities market, but for the fixed income and treasuries markets as well. The SEC is in a unique position to take a close look at how these markets work, to assess whether they work as intended, and to explore where there is room for improvement.

Tax

Taxation and the future of work: how tax systems influence choice of employment form
A recent OECD policy discussion has highlighted the variety of ways in which the world of work is changing. One development prevalent in some countries has been an increase in certain forms of non-standard work. Differences in tax treatment across employment forums may create tax arbitrage opportunities.

Taxing wages
This annual report provides unique cross-country comparative data on income tax paid by employees, cash benefits received by in-work families and the associated social security and payroll tax contributions made by employees and employers across the OECD.

Selected ICAEW CEO blogs since 11 February 2019

02/05/19 – Splits and joins

03/04/19 – Reporting on the future of audit

26/03/19 – Information overload

13/03/19 – No spring in this statement

05/03/19 – Brexit considerations

08/02/19 – The future of audit

Related work across ICAEW

CIPD and ICAEW joint pay ratios roundtable
ICAEW member firms, investors, companies, HR professionals and professional bodies had an opportunity to speak directly to the BEIS officials. Approximately 400 companies will soon be required to publish three pay ratios. Roundtable attendees asked about the possible introduction of maximum ratios sometime in the future, perhaps in certain sectors, eg, for house builders. There was also a question as to whether ratios will be extended beyond CEOs to other senior executives. BEIS confirmed that these possibilities aren't being discussed at the moment but the reporting regulations will be reviewed by 2023 at the latest. Directors who do not comply with remuneration reporting requirements can be prosecuted.

Audit Committees today: how effective are they?
This event was held by the ICAEW Corporate Governance Community. The role of audit committees is broad and timing consuming. 40 years ago all the numbers were verifiable. There is now greater reliance on judgement, but in time technology may supersede judgement. There are differing views as to whether members of audit committees need sectorial experience. Audit committee members of financial institutions need experience of being regulated, but access to sectorial expertise may be sufficient for other sectors. Aspiring NEDs must understand that it is not their role to dig into the weeds. In fact the bigger the company the more process driven it will be. NEDs need the confidence and tenacity to ensure that executives listen to their concerns and implement their ideas. Asking somebody questions is compatible with trusting them. It's important to know about failures, eg, business that's been lost and job offers which have been turned down. Talking to apprentices can provide a new and refreshing perspective.

Ethics for directors
ICAEW's Technical Strategy Department convened this discussion. Although there are over 100 criminal offences in the Companies Act (2006) these offences are very rarely enforced, except for a small number of cases brought by shareholders and some short disqualifications for a small number of directors. On this basis there could be a place for a code for company directors. A new code could be referenced in court cases. Alternatively (or in addition) it could be enforced by the new Audit, Reporting and Governance Authority. Similar codes already exist, eg, the Nolan Principles of public life. New Zealand's Institute for Directors (NZ IOD) has developed a code for directors which is linked to the listing rules, and members of the NZ IOD must undertake compulsory training and agree to follow a code. There was a discussion about whether a code should be enforceable and what enforcement means. There is academic evidence which suggests that the process of signing-up to standards has a psychological impact on individual signatories. It may be possible for five or six high-level principles to apply to wide group directors, with more detailed requirements for the directors of the biggest companies. A code must reflect the differing roles of EDs and NEDs. It may be appropriate to link the application of a code with those directors who are subject to remuneration reports.

All Party Parliamentary Group on Corporate Governance – The Future of Audit

On 30 April, Iain Wright spoke in the House of Commons at the APPG event attended by about a 12 parliamentarians and 20 representatives from business. Iain was the opening speaker, setting the scene by describing the Brydon review on the purpose and effectiveness of audit, the Kingman review of the Financial Reporting Council and future role of the regulator, and the CMA study into the audit market. The other speakers were Jock Lennox, Chair of the Audit Committee at Barratts plc and Lucinda Bell, former Chief Financial Officer at British Land and current Chair of the Audit Committee at Rotork. Discussions were wide ranging, covering the future roles and responsibilities of non-executive directors, the role of investors and stronger stewardship in corporate governance, and the relationship between chairs, chief executives and audit committees. The new Audit, Reporting and Governance Authority will need to decide the best way to raise audit quality.