



# Governance Briefing

## CORPORATE GOVERNANCE COMMITTEE (16 09 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 13 May 2019.

### Corporate Governance

#### Six Reasons We Don't Trust the New 'Stakeholder' Promise from the Business Roundtable

Minow, ValueEdge Advisors, **gives** six reasons why she is sceptical: we've seen this before; it does not really mean anything; it is not consistent with the principles of capitalism; we are waiting to see CEOs put their money where their mouths are; there is a 'bait and switch' element; and corporations are not designed for making public policy.

#### So Long to Shareholder Primacy

In a **press release** the Business Roundtable announced the adoption of a new Statement on the Purpose of a Corporation signed by 181 well-known, high-powered CEOs. Posner, Cooley LLP, **thinks that** what's newsworthy here is that the Statement moves away from shareholder primacy as a guiding principle and outlines in its place a modern standard for corporate responsibility that makes a commitment to all stakeholders.

#### Legal Implications of The Business Roundtable Statement on Corporate Purpose

Huber, Hall, and Goldberg, Davis Polk & Wardwell LLP, **discuss** the Statement on Corporate Purpose. A handful of roundtable members declined to sign the Statement, although for the moment it is mainly symbolic since legislatures and courts, not trade associations, define the scope of a director's fiduciary duties. The Statement of Purpose does not change the business judgment rule, which provides directors broad discretion in discharging their duty of care to the corporation and its shareholders. So long as in their decision making directors are acting in good faith, on a fully informed basis, and not grossly negligent, directors should be protected under the business judgment rule. Directors also owe a duty of loyalty to the corporation and its shareholders which is not shielded by the business judgment rule. It remains to be seen whether, in time, through legislation or otherwise, the concepts in the Statement of Purpose will lead to an evolution of the duty of care or the duty of loyalty, or to a new separate duty, that would encompass a requirement to balance duties to the corporation and its shareholders, as well as the interests of other stakeholders. However, Posner believes that the Statement is likely to fuel expectations of various shareholder and activist groups as regards ESG disclosure. Many corporations during this past proxy season have secured withdrawals of shareholder proposals on ESG topics by agreeing to provide additional ESG disclosures. The SEC has proposed a rule which, if adopted, would require additional human capital management disclosures.

## **Stakeholder Corporate Governance Business Roundtable and Council of Institutional Investors**

Lipton, Wachtell, Lipton, Rosen & Katz, **expresses the view** that the failure of the Council of Institutional Investors to join the Business Roundtable in rejecting shareholder primacy and embracing stakeholder corporate governance is misguided. Lipton feels that the argument that protection of stakeholders other than shareholders should be left to government regulation is an even more serious mistake.

## **Best Practice Principles for Shareholder Voting Research & Analysis**

Melis, Chair of the Best Practice Principles Group, **explains that** the reviewed principles are the result of a thorough review process which referred to the latest updated stewardship codes globally, the requirements of the revised EU Shareholder Rights Directive II and the **ESMA 2015 Follow-Up Report on the Development of the Best Practice Principles for Providers of Shareholder Voting Research and Analysis**. The key updates are: new governance oversight arrangements; new reporting arrangements; new monitoring arrangements; and updated principles and guidance.

## **Proxy Advisor Influence**

Tuch, Washington University, **reflects that** commentators point to a fairly standard set of factors to explain why proxy advisors exert the influence they do over institutional investors and corporate managers. They say that proxy advisors can mitigate institutional investors' collective action problems, that legal rules and high levels of institutional investor ownership have created demand for proxy advisors' services, and that the increased economic significance of investors' voting decisions has magnified their incentives to use proxy advisors. But a comparison of the US and the UK casts doubt on the completeness of these explanations.

## **Irrelevance of Governance Structures**

Goshen, Columbia Law School, and Levit, University Pennsylvania, start by **reciting** the central theme in the theory of corporate governance, which is that allocating more control rights to shareholders will allow them to hold disloyal managers accountable and reduce agency costs. The common empirical prediction that follows is that a weak governance structure will be associated with weak firm value and performance due to high agency costs. However, a review of empirical studies of the last forty years reveals that every aspect of corporate governance that was studied yielded conflicting empirical findings as to its effect on firm value and performance. For instance: the level of cash flow rights held by management; dual-class firms; anti-takeover defenses, such as poison pills, staggered boards, and protective state legislations; hedge-fund activism; and the strength of corporate governance as measured by several indices.

## **Model Stewardship Code for Long-Term Behaviour**

Mirchandani, FCLTGlobal, **confirms that** a good stewardship code helps clarify the responsibilities of institutional investors, laying out core principles to foster a shared understanding among stakeholders including regulators, investors, and investees. To ensure that stewardship codes put primary emphasis on long-term value creation, FCLTGlobal has worked with its members to identify seven principles of long-term ownership that could be incorporated into new or revised stewardship codes.

## **Whistleblowing: the personal cost of doing the right thing and the cost to society of ignoring it**

**A report by the UK All Party Parliamentary Group** outlines a ten point action plan including: better legal definitions which focus on the harm (or risk of harm) to the public; mandatory internal and external reporting mechanisms; a review of the compensation available to whistleblowers; access to legal aid to address inequality of arms; a public awareness campaign; and the establishment of the Independent Office for the Whistleblower.

## **Norges Bank Investment Management**

NBIM publishes **position papers** on specific aspects of corporate governance, eg, industry expertise on the board, separation of Chairperson and CEO and time commitment of board

members. These papers form the basis of voting on relevant topics and serve as a starting point for NBIM's discussion with companies and standard setters.

### **Labor Representation in Governance as an Insurance Mechanism**

Kim, Maug and Schneider, **hypothesise** that labour participation in governance helps improve risk sharing between employees and employers. It provides an ex-post mechanism to enforce implicit insurance contracts protecting employees against adverse shocks. Results based on German establishment-level data show that skilled employees of firms with 50% labour representation on boards are protected against layoffs during adverse industry shocks. They pay an insurance premium of 3.3% in the form of lower wages. Unskilled blue-collar workers are unprotected against shocks. Their evidence suggests that workers capture all the gains from improved risk sharing, whereas shareholders are no better or worse off than without codetermination.

### **In the Boardroom: Risk Governance Review**

Eversheds Sutherland and Oxford Economics have published **the results** of a global survey of 350 board directors. Partners from Eversheds Sutherland interviewed 50 clients to gain a deeper understanding of their approach to risk and how their companies structure their operations and governance to mitigate risk.

### **Good Governance Academy: Value Creation in a Sustainable Manner**

The GGA has been established in South Africa. The GGA's **first colloquia** covered education of future corporate leaders, the Sustainable Development Goals and value creation through stakeholder management.

### **Index Fund Enforcement**

Platt, Harvard Law School, has **discovered that** three financial institutions now vote 25% of the stock in the largest US public companies. Soon, the figure may be closer to 40%. Vanguard, BlackRock, and State Street Global Advisors, the so-called 'Big Three', dominate the market for index funds and other passively-managed investment vehicles. As passive investing has grown increasingly popular with investors, these institutions have accumulated astonishing levels of economic power. There is reason to worry that the Big Three's rise could significantly undermine the current system of private and reputational mechanisms to hold companies and managers accountable for fraud and misconduct. Proponents of what Platt calls the 'Passivity Thesis' have argued that index fund managers have generally overriding incentives to refrain from meaningful corporate stewardship.

### **Do Index Funds Monitor?**

Macciocchi, University of Utah, **examines** whether index funds monitor the firms in their portfolios and hold corporate managers accountable to the same extent that actively managed funds do. Macciocchi examines each of these three monitoring channels using comprehensive data on US equity mutual funds from 2004 to 2017. She finds that, relative to active funds, index funds are weak monitors.

### **A Catch 22 for Asset Managers**

Sethi, Sethi Clarity Advisers LLC, **says that** asset managers have been caught in a difficult spot for several years. Some have pushed them to use their growing voting power to benefit social impact causes. Other experts have decried managers' power and blamed them for anticompetitive outcomes and even increasing inequality. The Big Three are victims of their own size.

### **Share repurchases, executive pay and investment**

Share buy-backs occur when a company purchases its own shares from the market, often to reduce the number of available shares as a means to increase their value. There are valid reasons why a company may do this, but there have been concerns that a minority of companies use these tactics to push up executive pay while the behaviour could also reduce the financial reserves available for investment. However, a major **new study**, commissioned by the UK Government has looked into the reasons why companies buy their own shares. The research did not establish that

businesses purchase their shares as a means to inflate corporate earnings or increase executive pay.

### **Compensation Consultants and the Level, Composition and Complexity of CEO Pay**

Murphy, USC, and Sandino, Harvard Business School, provide **new insights** on the relationship between the use of executive compensation consultants and CEO pay. Most publicly traded firms retain consultants to provide advice on executive compensation. Firms which retain executive compensation consultants pay more to their CEOs than firms not using them. Among the subset of firms using executive compensation consultants, research has shown that CEOs are paid more in firms using consultants that provide other services to their client firms, eg, benefits management, advice on broad-based compensation plans, etc. Consultants providing other services could be conflicted, since the CEOs of their client firms could be more likely to offer other services to the consultants that advise their boards to pay them more.

### **UK R&D: How corporate incentives within the FTSE 350 inhibit innovation**

Innovation is a key driver of prosperity and growth. Firms and their shareholders typically say that they care about long-term value creation. One would therefore expect that the incentives given to company management would, on balance, encourage innovation. This **study by Nesta** suggests that the opposite is the case.

### **More than money: Venture Capitalists on Board**

Amornsiripanitch, Yale University, Gompers, Harvard Business School and Xuan, University of Illinois, **explore** the structure and functions of the private company boards. They found that venture capital-backed boards of directors are small and are mostly composed of venture capitalists and independent outsiders. The median number of board members is five. As financing rounds progress, board size increases. As board size grows, the number of venture capitalists and independent outsider board members increases, while the number of insider board members remains small.

### **Non-Employee Director Pay Practices**

Reilly, Pearl Meyer & Partners, describes Pearl Meyer's '**On Point: Non-Employee Director Pay Practices**' survey which provides real-time insights on the latest trends in non-employee director compensation practices and potential responses to increased external scrutiny. This online survey was conducted in March and April of 2019, with participation from 204 companies, including 143 publicly traded, 52 private for-profit, and nine not-for-profit organisations.

### **Director Overboarding: Global Trends, Definitions, and Impact**

Papadopoulos, ISS Analytics, **reports** that in the 2019 proxy season, 'overboarding' became a centre-stage issue for many companies and investors. Several large asset managers, including Vanguard, BlackRock, and LGIM, enhanced their voting guidelines to apply stricter criteria, while some directors serving on multiple public company boards faced significant opposition to their elections.

### **Are Share Buybacks a Symptom of Managerial Short-Termism?**

Kay and Martin, Pay Governance LLC **outline that** corporate share buybacks (also known as repurchases) have been somewhat controversial for many years, but have taken on even greater significance following the corporate tax cuts passed in the US in 2017 and implemented in 2018. It is estimated that buybacks reached \$1 trillion in 2018, likely fuelled by extra cash resulting from the tax cuts. Buybacks are also gaining attention across a broader cross-section of the political arena, as three US Senators and an SEC Commissioner have recently criticized share buybacks, with each commentary citing different criticism and potential solutions. However, the common charge is that US public companies are returning money to shareholders instead of investing in productive projects, equipment, workers, and long-term growth. Many buyback critics state the use of earnings per share as an incentive metric and stock options inappropriately rewards executives for short-term decisions that reduce long-term value. Specifically, buybacks are criticized for

mechanically increasing short-term earnings per share and ‘popping’ the stock price to generate executive payouts at the expense of long-term performance.

### **Firearms and the Proxy Season**

Posner, Cooley LLP, **reports that** corporate social responsibility is sometimes viewed to comprise issues related to firearms safety. With the renewed US national debate on gun safety, and in light of apparent continued government gridlock, will investors, customers, employees and other stakeholders turn to companies to ‘do something’? Will they begin to apply more pressure to companies involved with firearms, including retailers and banks, to reexamine their relationships with the gun industry?

### **Board oversight of corporate political activity and CEO activism**

Gregory, Sidley Austin LLP, **identifies** the issues that have given rise to ‘CEO activism’ as; hate speech evidenced in the protests in Charlottesville, Virginia; the ‘zero-tolerance’ immigration policy and family separations at the southern border; the current administration’s policy on climate change; state and municipality adoption of anti-LGBTQ+ laws and policies; and gun violence and its perceived link to National Rifle Association policies. Gregory believes that how a CEO responds to sensitive social and political issues on the company’s behalf will vary, and there is a risk that constituents may be offended when a corporate leader takes a stand, especially when the link between the issue and the company’s business interests is unclear. However, failure to take a position on certain issues may also expose a company to criticism.

### **Implicit Communications and Enforcement of Corporate Disclosure Regulation**

Ali, University of Texas, Fisch, University of Pennsylvania, and Kyung, University of Missouri, **describes** how corporate disclosure regulation and enforcement attempt to regulate the information publicly-traded corporations disseminate into the market. Although the federal securities laws focus primarily on explicit quantitative disclosures, corporations and corporate officials also make extensive use of implicit communications, eg, qualitative information, tone and non-verbal cues. One of the key sources of implicit communication is private meetings in which there are only a select few market participants, providing the attendees with an opportunity to observe not just what is said, but how it is said. The authors believe that the scope of potential liability exposure that corporate officials face for such private communications has a critical effect on the effectiveness of corporate disclosure regulations in regulating implicit communications.

### **Shareholders and Stakeholders Around the World: The Role of Values, Culture, and Law in Directors’ Decisions**

Licht, Interdisciplinary Center Herzliya, and Adams, University of Oxford, take a **clear-eyed look** at the law of corporations in Delaware. They reveal that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare.

### **An Overview of Vote Requirements at US Meetings**

Papadopoulos of ISS Analytics **confesses that** the vote requirements in the US can be mindboggling to anyone unfamiliar with governance practices and proxy voting. This article provides an overview of some important factors to consider when assessing proxy vote results and meeting agendas in general: vote requirements vary significantly by proposal type; supermajority vote requirements are very difficult to remove; broker non-votes can play an important role in determining a voting outcome; and the plurality vote standard remains common practice at small-cap firms.

## **Financial Services**

### **Stylish regulation**

Sam Woods from the Bank of England **discusses** what our system of financial regulation might look like after the UK leaves the EU. He argues for retaining the existing British approach, ie, the Senior Managers and Certification Regime.

## **The Job Rating Game: Revolving Doors and Analyst Incentives**

Kempf, University of Chicago, **notes that** investment banks frequently hire analysts from rating agencies. A widespread concern is that this ‘revolving door’ encourages leniency among rating analysts who hope to exchange optimistic credit ratings for well-paying future jobs. For example, a prominent narrative of the financial crisis is that conflicts of interest due to the revolving door contributed to inflated credit ratings, which in turn enabled the financial meltdown.

## **Solving Banking’s ‘Too Big to Manage’ Problem**

Kress, University of Michigan, **presents** an analysis of the TBTM issue. He contends that big banks face unique governance challenges, including extreme opacity, run risk, and weak market discipline, that expose these institutions to excessive risk taking and misconduct. Despite these managerial impediments, however, TBTM banks will not voluntarily break themselves up because they benefit from implicit government subsidies unavailable to smaller firms. Thus, while there are many reasons to believe that some banks are TBTM, there is little reason to trust that banks will solve the issue on their own. A public policy response is therefore necessary to fix the TBTM problem.

## **Race influences professional investors’ financial judgments**

Investors are being urged to tackle institutional racism after a major study found black fund managers are often overlooked due to their colour even when they are high performing. **A study** published last week by Stanford University and venture capital firm Illumen Capital, found evidence of racial bias in the investment decisions of asset allocators who manage money for companies, governments, universities, charities, and foundations. The **research** revealed that it was high performing, black fund managers who were most at risk of being harmed by racial bias.

## **Auditing**

### **Emerging Technologies, Risk, and the Auditor’s Focus**

Emerging technologies are altering the financial reporting environment substantially, and this change is accelerating. For example, artificial intelligence, robotic process automation, and blockchain are changing the way business gets done, and auditors are leading by transforming their own processes. In this evolving environment, it is more important than ever for the key players in financial reporting to have a strong grasp of roles and responsibilities. Park, UCLA, **identifies:** the key technology risks to watch for; what auditors are focusing on when it comes to the impact of emerging technologies on business; and how auditors are evaluating whether management is properly assessing the impact of emerging technologies on internal control over financial reporting.

### **What auditors do: the scope of audit**

Recent corporate failures have increased public concern about the value of audit and the role of auditors. To help inform debate on the scope of audit, this **second supporting paper** to ICAEW’s Future of Audit thought leadership essays explains what auditors do, why audits are necessary, the limitations of audit, and what gets audited and what doesn’t.

### **Internal control effectiveness: who needs to know?**

Reporting on the effectiveness of controls over financial reporting features prominently in the current reviews of UK audit and regulation. To help inform debate on financial reporting controls, this **ICAEW essay** explores the current position in the UK, compares it with what happens in the US and elsewhere in the world, and sets out the case for change and potential options.

## **Reporting**

### **Corporate Reporting**

Wilcox, Morrow Sodali, **think that** disclosure rules and audit standards still dictate strict and relatively uniform financial reporting requirements, but expectations for big-picture corporate reporting have become more complex and open-ended. This results primarily from the introduction

into the company narrative of factors referred to collectively as ESG. Corporate reporting about these topics is now deemed by institutional investors, and increasingly by issuers, to be essential for an accurate picture of a company's culture, risk profile, financial health and long-term outlook. While financial reporting at many companies is still largely a compliance exercise, how a company should 'tell its story' now opens the door to nearly unlimited possibilities.

### **Task Force on Climate-Related Financial Disclosure 2019 Status Report**

Coleman, Promontory Financial Group, Childress, Bloomberg LP, **reiterates** that there is a growing demand for decision-useful, climate-related financial information by investors and by financial regulators. As part of its efforts to promote adoption of the recommendations, the Task Force prepared this status report to provide an overview of current disclosure practices as they relate to the Task Force's recommendations, highlight key challenges associated with implementing the recommendations, and outline some of the efforts the Task Force will consider undertaking in coming months to help address some of the implementation challenges.

### **Pension fund readiness for the climate rules under question**

The UK's pension watchdog, The Pensions Regulator, has uncovered a disturbing lack of readiness for the DWP's upcoming ESG regulations. In a **survey of the 100 largest schemes**, 80% were found to have not taken steps to integrate climate change issues in their investment strategy statement.

### **Smaller listed and AIM quoted companies: how to improve financial reporting**

This ICAEW **guide**, written in association with the Financial Reporting Council, offers advice for audit committees and boards of smaller quoted companies on evaluating the adequacy of a company's financial reporting function and process. With improvement, audit committees can bring about a step change in the quality of financial reporting.

## **Capital Markets**

### **Shareholder Protection and the Cost of Capital**

Houston, University of Florida, Lin, University of Hong Kong and Xie, The Chinese University of Hong Kong, **look at** whether the legal environment and the level of shareholder protection meaningfully influence the cost of capital, and explore how changes in shareholders' rights affect their required risk premium, which in turn generates important influences on both corporate valuations and the overall depth of financial markets. Specifically, they focus on shareholders litigation rights, which entitle them to make legal claims against corporate management.

### **How Do Venture Capitalists Make Decisions?**

Gornall, University of British Columbia, **describes** the results of a survey of almost nine hundred venture capitalists (VCs). He asked VCs about eight different topics: deal sourcing; investment selection; valuation; deal structure; post-investment value-add; exits; internal organization of firms; and relationships with limited partners.

## **Tax**

### **Study and Reports on the VAT Group in the EU-28 Member States: 2019 Final Report**

The European Commission has **announced** that EU countries lost Euro 137 billion in VAT revenues in 2017 due to uncollected VAT. The 'VAT Gap' has reduced somewhat compared to previous years but remains very high.

## Selected ICAEW CEO blogs since 13 May 2019

15/05/19 [How whistleblowing helps companies](#)

04/06/19 [Financial reporting for smaller listed and AIM quoted companies](#)

02/07/19 [The quality and effectiveness of audit](#)

10/07/19 [Financial reporting: who does what?](#)

## Related work across ICAEW

### Mauritius Institute of Professional Accountants

On 7 and 8 August, Elizabeth Richards gave presentations at MIPA's annual conference. She spoke about whistleblowing and developments in UK corporate governance. Elizabeth was also the speaker for a separate event organised by Mauritius Institute of Directors, the Financial Services Institute and the Financial Services Commission.

### Fighting economic crime-a shared responsibility!

On 5 September, Elizabeth Richards and Martin Martinoff delivered a workshop about how far auditors should go in blowing the whistle. This formed part of the programme for the international symposium on economic crime held at Jesus College, University of Cambridge. This session was preceded by a workshop held at Chartered Accountants' Hall on 2 September which was attended by ICAEW firms, the FRC and BEIS officials responsible for implementing the independent review of the FRC.

### Building a regulatory framework for effective stewardship

On 30 May, there was a meeting between some members of ICAEW's corporate governance committee, ICAEW staff and FCA staff. The revised Stewardship Code and a feedback statement on [the joint FCA and FRC discussion paper](#) will be published by the end of the year. Integrating stewardship with investment decisions is critical. Stewardship by passive funds was discussed, particularly the issue of commercial confidentiality.

### Workforce engagement

'[How employee directors add value](#)' provided the basis of a Next Gen NED Network event held on 2 July. The Network supports aspiring and existing NEDs, and it is sponsored by KPMG, Odgers Berndtson, and others. Elizabeth Richards participated in a panel discussion which was chaired by Charles Mayo of Simmons and Simmons. The two other panellists were Andrew Cripps, whose NED roles include Howden Joinery, and Lynne Weedall whose NED roles include Greene King.

### British Hellenic Chamber of Commerce

On 8 May, Michael Izza, CEO of ICAEW, delivered a key note speech on developments in corporate governance in the UK at a British Hellenic Chamber of Commerce conference entitled, "Corporate governance and effective management practices as a value driver for Greek companies." Other participants included practitioners from major accounting firms and listed company executives in Greece. Mr Izza focussed on audit, executive pay and stakeholder engagement.

### Executive pay: time for a new approach

On 3 July, ICAEW's Corporate Governance Community and Hermes Investment Management convened an event to discuss how companies and investors can incorporate new thinking into executive pay structures ahead of binding shareholder votes on remuneration policies in 2020. The audience heard from senior investors and remuneration committee chairs. Remuneration committees must invest significant time and energy with investors to drive reform, leaving space to change their ideas. Investors need to signal their openness to change. Simplicity in remuneration packages isn't everything as more nuanced measures could bring about better results in the longer term. Non-financial performance measures could be given greater weight. The event was given a political context by Anna Turley MP, member of the Parliament's BEIS Select Committee, which



published a report earlier in 2019 calling on companies to link top bosses' pay to that of the rest of their workforce.

### **ICAEW partners with Chapter Zero bringing climate governance to Boards**

Launched in June 2019, **Chapter Zero** is a network of company Chairs, Committee Chairs and Non-Executive Directors, committed to developing their knowledge of the implications of climate change for UK business. Given the far-reaching impact and implications, the purpose of the network is to enable these directors to better understand how it is likely to affect their companies and sectors, and to encourage their boards to hold informed and strategic discussions and respond effectively to the climate change challenge. The name of the network, Chapter Zero, reflects the drive towards a net zero carbon economy and the major role business will play in achieving it.

### **Climate change learning**

**ICAEW's new climate hub** has been launched in collaboration with Deloitte. The intention is to help businesses and finance professionals learn more about tackling climate change.