ICAEW REPRESENTATION
23/17

Green Paper on Corporate Governance Reform

ICAEW welcomes the opportunity to comment on the *Green Paper on Corporate Governance Reform* published by BEIS on 29 November 2016, a copy of which is available from this link.

This ICAEW response of 22 February 2017 reflects consultation with the Corporate Governance Committee whose members are drawn from the business and investment communities. The Committee informs our thought leadership and policy work on corporate governance issues and related submissions to regulators and other external bodies.

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MAJOR POINTS

Executive pay

1. Most of the options outlined in the Green Paper are variations in the rights and responsibilities of shareholders and remuneration committees. Although any of these options may improve communications and transparency they are unlikely to significantly alter public opinion because outsiders will still need to rely on these groups. ICAEW supports the publication of pay ratios as a way of addressing this issue.

Strengthening the employee, customer and wider stakeholder voice

2. Directors' understanding of stakeholder views is key to improving public trust in business and the long-term success of companies. Directors have a legal duty to have regard to a range of stakeholders. We suggest extending the strategic reporting obligation so that it reflects this duty. We also suggest translating the duty into a main and supporting principle in the Corporate Governance Code and other codes. These measures will draw attention to the duty and apply it collectively to boards.

Corporate governance in large privately-held businesses

3. Applying codes to large privately-held companies could be beneficial, but monitoring compliance will be challenging given that there are no external shareholders. In fact the recent national focus has been on the behaviour of a limited number of directors of both publicly listed and large privately-held companies. For this reason we suggest that there is an exploration of the legal mechanisms which are already available to hold individual directors to account. We also suggest a greater focus on who can be a director of a publicly listed company or an economically significant privately-held company.

RESPONSES TO SPECIFIC QUESTIONS

Executive pay

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?

4. Shareholders have only very recently been granted annual advisory votes on Directors' Remuneration Reports and three yearly binding votes on Directors' Remuneration Policies. The majority of companies held their first binding votes in spring/summer 2014, but some shareholders voted for the first time in autumn 2014.

5. The second three-year voting cycle is about to commence, and therefore we suggest that the government assesses the voting at AGMs held in 2017 before deciding whether stronger powers are needed. Although this voting process and the underlying powers are new there are already signs that shareholders are prepared to vote against resolutions. Although some might describe this as a modest start there are a number of factors which may result in a rise in opposition voting in 2017: for the first time shareholders will have experience of how a pay policy which they approved is implemented in practice; media and political interest in executive pay seems to have reached an all-time high; and there is speculation that rises in executive pay might result from movements in currency and share prices since the Brexit vote. A short delay will allow an assessment of whether these predictions are accurate.

6. Active shareholders may welcome an opportunity to be more active, but where shareholders are passive the allocation of stronger powers would serve little purpose. If stronger powers are considered then in principle ICAEW can see merit in option (iv), increasing the frequency of annual binding votes on pay policies from every three years to every year. Remuneration policies should reflect the company's recent performance and the current operating context, including public sentiment. These areas can change very rapidly, and certainly more rapidly

than every three years. Increasing the frequency of voting could be complemented by option (v), strengthening the Corporate Governance Code (CGC) to provide greater prescription about how companies should engage with shareholders on executive pay.

7. Two other categories of information could improve the ability of shareholders to hold companies to account for executive pay and performance:

   - details of the circumstances which could trigger clawback and malus; and
   - an explanation of how performance-related pay is limited to an executive's personal performance by adjusting targets so that executives don't automatically benefit from improvements in market conditions.

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?

8. As in our answer to Q1, it is too early to come to definite conclusions about whether additional encouragement is needed, but in principle ICAEW supports option (i), mandatory disclosure of fund managers' voting records at AGMs and their use of proxies. Disclosure of the rationale for voting is more difficult as it would require consideration of what level of disclosure is appropriate for different audiences, and the timing of any such disclosure would also be important given the negotiations and discussions that take place between companies and fund managers.

9. ICAEW also supports option (iii), individual retail shareholders should be encouraged to exercise their rights by brokers suggesting that they receive information, and by brokers facilitating online voting. US style earnings calls could also improve engagement with individual shareholders.

Q3: Do steps need to be taken to improve the effectiveness of the 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?

10. ICAEW supports option (i), earlier consultation with shareholders on pay policies. Many companies already consult early as they acknowledge that it is better to hold constructive discussions which tease out points of disagreement at a preliminary stage rather than risk an opposition vote and all that entails.

11. We also agree with option (ii). There should be a presumption that chairs of remuneration committees will have served on the committee for at least 12 months before taking up the role. However, there will be circumstances when companies will want the flexibility to appoint a chair who is new to the committee because of their fresh perspective. For this reason we suggest that 12 months is a made a rebuttable presumption through the use of a provision in the CGC and the application of comply or explain.

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.

12. Publicly listed companies and large privately-held companies already publish information which enables people to calculate the ratio between CEO pay and the average worker's pay. Calculations made by BEIS and the High Pay Centre are mentioned in the Green Paper. However, an explicit reporting requirement for publicly listed companies and economically significant privately-held companies will improve the accuracy and consistency of ratios, and

identify trends over time. The following matters will need to be clarified and ICAEW would be keen to contribute its expertise:

- workers in scope: it may be appropriate for the scope to be limited to UK-based workers;
- average pay or median pay: we believe that the public would have an easier understanding of average pay; and
- types of pay included or excluded: we suggest a broad definition which mirrors all of the components included in the single figure quoted in Directors' Remuneration Reports.

13. The second tier of senior executives immediately below the CEO are also vital in ensuring the long-term success of companies. Information about how their pay is structured and compares with the CEO's pay could form the basis of other ratios.

14. The publication of ratios would bring a new angle to discussions between those directly affected. For publicly listed companies this specifically means discussions between shareholders and directors. The publication of ratios may help to remind remuneration committees of the supporting principle in Section D.1 of the CGC which already requires them to be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases. Economically significant privately-held companies are likely to have conversations with a different range of stakeholders.

15. Ratios will add a new dimension to media coverage of executive pay. Comparisons across different sectors are inevitable and may highlight apparent anomalies, but such comparisons will probably diminish over time if adequate explanations are provided.

16. The major disadvantage of ratios is the risk that this transparency will inflate executive pay. Directors' Remuneration Reports have allowed comparisons which are seen to have contributed to increases in pay. The publication of ratios may compound this problem, at least in the short-term, and extend the problems to economically significant privately-held companies. Other potential disadvantages are intentional manipulation of ratios through job cuts or outsourcing.

17. A delay in implementation of pay ratio reporting would allow the UK to learn from the recent experiences of other countries. Appendix A of the Green Paper provides examples of recent executive pay reform in other countries, but it does not provide any assessment of the effectiveness of these measures. The US Securities and Exchange Commission's rule on CEO pay ratio reporting applies from the first fiscal year beginning on or after 1 January 2017. This rule allows companies some flexibility in their methodology, eg, identifying the median employee and their remuneration. It is too soon to say what impact this rule will have on 'say on pay' voting in the US or on executive pay levels. Given the close relationship between the UK and US CEO labour markets it might be advisable for the UK Government to have a clearer idea of the possible outcomes before anything is introduced here.

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?

18. Any advance disclosure of targets in pay policies raises the complex issue of commercial sensitivity, including the difficulty of challenging the use of this exemption. Appointing worker directors to remuneration committees could be beneficial because if worker directors are convinced that the exemption legitimately applies then this should provide reassurance to others.

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 answer.

19. The minimum holding period should be increased from three years to five years to bring the requirement into line with best practice, and/or executives should be required to retain share awards until they build up a shareholding equivalent to twice their gross total salary. In order to ensure long-term thinking during the whole period of employment it is critical that the structure requires executives to hold all or some of their shares for a considerable period after they have left the company. All of these measures would improve the probability of successful clawback.

Strengthening the employee, customer and wider stakeholder voice

Q7: How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large 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.

20. Companies can only achieve optimum long-term success if board directors consistently think about the interests of employees, customers, suppliers and other stakeholders. This forms the basis of directors' individual legal duties. We suggest two ways of ensuring a continuing and collective focus on these duties.

21. First, boards' consideration of stakeholder voices should form the basis of new code principles including the elements of s.172 of the Companies Act (2006) which are not currently reflected in Section A.1 of the CGC. The following could be added:

    - Main principle

    The board should act for the benefit of its shareholders as a whole and have regard to other stakeholder groups.

    - Supporting principle

    The board should analyse the company's stakeholder groups with reference to the business model and purpose of the company.

22. Second, the strategic reporting requirement should be extended for companies subject to our suggested new principles so that they are required to report on the application of the new principles. Companies should disclose who they think their key stakeholder groups are, how they stay up-to-date about their changing priorities and how they balance their different interests. They should also report how they have responded to stakeholders and made sure that their voice is heard in the boardroom.

23. Currently every main principle of the CGC has associated provisions which operate on a comply or explain basis. Our specimen wording does not include provisions, but as best practice develops it could be reflected in future provisions. There are a wide range of possibilities, but we have confined our comments below to the two options outlined in the Green Paper.

24. Boards could establish relationships with stakeholder panels. Panels could also play a useful role in relation to communications between stakeholder groups, and also serve a useful purpose in relation to the election of stakeholder directors. Having said this, the concept of panels is not an easy fit with the UK's current corporate governance framework, and therefore we feel strongly that voluntary establishment and participation is the best way to encourage the effectiveness and relevance of panels.

25. The appointment of stakeholder directors is one of the other ways that companies could demonstrate how they have applied our proposed new principles. However, there are some areas that need to be addressed for stakeholder directors to add value, to strengthen the unitary board structure, and to minimise the risk of decisions being taken outside board meetings.

    - Eligibility

    Stakeholder groups and companies should work together to develop eligibility criteria. For example, possible eligibility criteria for worker directors may include geographical factors, minimum periods of employment or levels of seniority. For supplier directors the eligibility criteria may centre on the length of the supplier's relationship with the company.

    - Selection

    Ideally a number of individuals will be eligible and wish to be considered. There will need to be criteria in place to choose between candidates. Provided panels represent a suitable cross-section of a stakeholder group they could play a useful role in selecting the candidates who are proposed to the board and shareholders for approval.

    - Appointment

    Stakeholder directors must be formally appointed in exactly the same way as all other directors. Shareholders usually elect directors. This process will be particularly important in the early days of stakeholder directors when there is likely to be greatest need for clarity about their role and duties, and how their performance will be evaluated.

    - Role

    The chair would be responsible for the integration of stakeholder directors so that their contributions are properly taken into account. Clarity about the role of stakeholder directors is essential for them to add value to the company. It must be made clear to all those concerned that the role of stakeholder directors is to provide a new perspective rather than to represent a stakeholder group. In other words, all directors must still have regard to all stakeholders even if a director has been appointed from one or more stakeholder groups. For example, even if there is a worker director, executive directors would still be expected to engage with workers on a day-to-day basis, and non-executive directors would still be encouraged to engage with workers through making site visits.

    - Duties and responsibilities

    Stakeholder directors would be subject to all of the statutory duties for directors in the Companies Act (2006), the CGC, common law duties and contractual obligations in key areas such as the duty of confidentiality and conflicts of interest. This approach is critical in order to retain the cohesive and effective nature of unitary boards.

    - Overall board composition

    Although the Companies Act (2006) does not prescribe a maximum number of directors Section B.1 of the CGC states that the board should include an appropriate combination of executives and non-executives (and, in particular, independent non-executives). If stakeholder directors are appointed then other additional directors may be required in order to retain an optimum balance of executives and non-executives. Increasing the overall board size risks inefficient decision making as well as increased costs.

26. The concept of worker directors poses particular potential benefits as well as challenges:

- Potential benefits

Workers are often described as a company's greatest asset. Therefore there must be benefits in finding an explicit way for their operational knowledge and experience to be reflected in board decision-making. Employees who are already board directors have C-suite management responsibility for particular business areas or operations. In contrast, worker directors would be selected for the role rather than being automatically appointed by virtue of their position in the company. If worker directors become common this could significantly improve board diversity and the pipeline of future executive and non-executive directors.

- Potential challenges

In order for the role to be effective both the board and the workforce must be clear about the role, duties and responsibilities of worker directors. They would not have any role in relation to individual or collective grievances and, in common with all other directors, they must take a holistic view of the best interests of the company at all times, including in times of decline or change for example in relation to proposed takeovers and redundancies. The exact status of worker directors would also need to be clarified given that they would not fulfil the definition of independence in the CGC.

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?

27. We have suggested additions to the CGC. This would directly affect companies with a premium listing on the London Stock Exchange. However, there will be a broader impact because the CGC is applied more widely on a voluntary basis, and it forms the basis of the codes used in other countries. We have also suggested that similar new principles are added to codes for economically significant privately-held companies. We have also proposed extensions to the strategic reporting requirement for these companies.

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.

28. Our suggestions would utilise all of these methods of implementation.

Corporate governance in large privately-held businesses

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?

29. We believe that there is a case for strengthening the framework for economically significant privately-held companies, either through a single code or multiple codes. The proposed new CGC principles should be included in all these codes.

30. However, the application of codes to economically significant privately-held businesses poses a significant challenge as to who will monitor compliance in the absence of external shareholders. One answer is to require certain categories of government and regulated organisations to contract with economically significant privately-held companies only if they are satisfied that the company complies with a code, and they are satisfied with their strategic reports. However, it is important to acknowledge that any code for privately-held companies should be lighter touch than the application of the CGC.

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?

31. Elsewhere in this response we suggest that some privately-held companies should publish pay ratios, follow codes and that the directors of these companies should be subject to a certification regime. The cost of these measures means that their application must be limited to economically significant privately-held companies, based on carefully developed criteria.

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

32. Currently individuals who wish to become company directors do not have to make personal declarations as to their good standing, and, as far as we are aware, no checks are made by Companies House. However, there is an argument that greater scrutiny is justifiable for directors of publicly listed companies and economically significant privately-held companies. We suggest that a suitable variant of the certification regime in financial services is applied to directors of these types of companies. Companies House or companies themselves could confirm the fitness and propriety of directors, with reference to criminal convictions and employment history. The opportunity could also be taken to require directors to confirm their understanding of their legal duties and the legal action they could face if they fail to discharge those duties.

33. Any new requirements could not just be a paper exercise but would need some teeth. We envisage an amendment to the Companies Act (2006) which applies to the companies intended to be in scope, with a direct link to the power of Companies House to disqualify directors.

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?

34. The scope of non-financial reporting requirements should depend on the objective of the specific reporting requirement. Size will often be more relevant than legal form.

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 the Green Paper can you suggest any other improvements to the framework?

35. Historically the UK's corporate governance framework has achieved a good balance of encouraging compliance and business growth, backed up with the threat of sanctions if things go seriously wrong. The UK's approach has been emulated worldwide.

36. Other issues not addressed in the Green Paper where improvements may be needed are:

    - treatment of foreign takeovers;
    - enforcement of directors' duties;
    - effectiveness of whistleblowing;
    - scope for derivative actions; and
    - the role of social media.