Institute of Business Ethics

17 February 2017

Submission of the Institute of Business Ethics to the Department for Business, Energy & Industrial Strategy Green Paper on Corporate Governance Reform

Foreword

Good corporate governance is vital to long term business success and therefore to the health of the economy as a whole. It is distinct from corporate responsibility in that, ideally practiced, it should create a framework of accountability and incentives from which both financial success and responsibility flow naturally.

We are pleased to respond to this Green Paper, coming as it does at a time of change and challenge. While the UK has a long tradition of world leadership in governance, this can be maintained only through willingness to adapt. We see the Green Paper in the context of timely and necessary evolution of the UK approach, aimed at strengthening public trust in business. This in turn involves broadening our understanding of the social impact of companies, promoting good governance in privately-held as well as listed companies and addressing the behavioural and cultural issues underlying some recent scandals as well as the issue of executive pay.

None of these issues are easy. More effort will be required beyond this Green Paper to find long-term solutions. Even where it does not plan specific regulation in the short term, government can and should use its convening power to facilitate the debate and help orchestrate a long-term market consensus around key issues such as the purpose of the corporation, reform of executive remuneration and the circumstances, if any, when the privilege of limited liability might be withdrawn.

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That said, a number of initiatives could be taken quickly to put us in the right direction. In our response, we have tried to suggest some simple measures which avoid the need for primary legislation but will drive behavioural change without adding to the compliance burden. At the IBE we do believe that “doing the right thing” is a recipe for long term financial success. We recognise the importance of a strong and vibrant business sector ready to take on the international challenges that lie ahead.

Governance should be about empowering business rather than just constraining. Getting the framework right is what matters and we look forward to playing an active part in achieving this.

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1. Executive Summary

A core issue raised by the Green Paper is the question of what should be the purpose of corporations. It is no longer sufficient to say their role is to generate returns for shareholders. To justify their social licence to operate they need to deliver something which society wants and values

However, there is no real consensus around purpose at present, and, in taking the Green Paper forward, the government should seek to facilitate a common understanding between business, society and policy-makers which will then create a better sense of priority. Too often regulation has been applied to companies in a scatter gun way which does not always make sense to them. Companies are simply obliged to comply with regulations without any clear sense of what is important. A shared understanding on purpose is therefore a pre-requisite to a coherent framework for governance.

The debate over corporate culture is a particular new challenge. It flows from our analysis of recent scandals here and abroad .The conclusion that culture and behavioural issues play an important role in these scandals suggests boards need to look not only at their internal processes and accountabilities but also at what drives behaviour throughout the business. They need to define the behaviour they want – for the IBE this involves the adoption of values likely to induce trust, such as, for example, reliability, honesty, respect and openness – and then ensure that these values are properly embedded in the organisation and in its relations with stakeholders. This requires boards to be more outward-looking than perhaps has been the case in the past.

Another new element is the focus on unlisted companies. The Green Paper is right to home in on this because private companies have public responsibilities and the role of large private companies in our economy appears to be increasing. While we are strong supporters of the comply-or-explain principle, this raises questions about enforcement.

We have sought to set our detailed answers in the context of these new challenges with particular emphasis on practicability. This means looking

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for measures with a real propensity to engender a positive change in behaviour while keeping compliance costs low so as not to harm competitiveness. *Our criterion has therefore been to propose measures that are credible and lead to outcomes that can be measured and disclosed.*

We prefer this to a crude enforceability yardstick because enforceability leads to mindless compliance rather than quality behaviour. *Besides, the objective is to restore trust and we have to remember that recourse to enforceable regulation always implies a breakdown in trust. You only regulate people who you do not trust to do the right thing.*

On this basis we offer three main conclusions.

1) We believe *the current system of executive remuneration is broken and needs radical reform. Our preference is for a much simpler system relying heavily on a fixed cash salary, a large proportion of which should be used to buy shares which are then held for the long term, including for a period after the executive has left the company.* This would create a strong incentive to long term decision making, remove distortions to behaviour arising from misguided performance criteria, reduce volatility in results while still penalising underperformance, and create a level of transparency that should help rebuild trust. A worked-through example of what we propose is set out in the Appendix.
2) We believe that Section 172 of the Companies Act is a good starting point for addressing the factors that give companies a social licence to operate. *There is no need for primary legislation to change the Companies Act but it needs to be brought alive. Our central proposal is that chairmen of companies should be required to make a statement each year on how they have taken account of the Act in the way they manage the board, and decisions are taken.*
   This should not be a bland statement but should answer some specific questions, including how they have taken account of Section 172 in setting personal objectives for directors as well as collective priorities for the board. The chairman should also state how the board has taken account of Section 172 in decision-making and in its

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skills development. There is an important read-across here to diversity.

This change should be buttressed by two new provisions to the Governance Code. One, which reflects practice now being adopted in New Zealand and the Netherlands, is that companies should have an internal code of ethics which is overseen by the board. The other is that companies should have a Board Committee, looking at ethics and sustainability. It is worth noting that, since 2011, South African companies have been required to have a Social and Ethics Committee chaired by a board member.

3) We agree that reform should bring unlisted companies into the net. In this context *we are struck by the reference to the "privilege" of limited liability. It occurs to us that limited liability should not be an inalienable right but one which is earned by recognition of responsibility.* In cases of really egregious behaviour it should be possible to remove this right. Such an event amounts to a nuclear option and the power to use it would scarcely ever be used, but like the nuclear option it could act as a deterrent to bad behaviour. *We therefore recommend that the government should launch an enquiry into the circumstances in which limited liability might be removed as well as to remedies, such as the complete replacement of the board, which would allow companies to continue to benefit from it.*

The advantage of this approach is that it would affect both listed and unlisted companies. Some might raise concerns about the impact extending beyond shareholders and into debt markets, but this would provide a strong incentive to good behaviour by unlisted companies. Even managers of listed companies may at times be more sensitive to the operational constraints which flow from a deteriorating credit standing than to the reputational hit from what they see as a temporary blip in the share price.

The mandate of the FRC meanwhile needs to be expanded to give it an enhanced role in the quality of reporting and in calling out those who fall below the expected standard. It will need to look at corporate governance

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reporting by unlisted as well as listed companies and set standards for them.

The measures we propose fall into two categories. First come those which can be implemented quickly and set us in the right directions. None of these require primary legislative change, though some would require regulation or secondary legislation. Some could also be implemented by revisions to the UK Corporate Governance Code. *Our preference throughout this response is for measures that contain an incentive to good behaviour without a heavy compliance cost.*

Into the second category fall *measures which are concerned with long term change or where careful work is needed to build a consensus. These include our proposals for radical reform of remuneration, where we suggest the government should set up an enquiry headed by an impartial and respected individual tasked with exploring how a consensus might be achieved on radical reform and what changes to the current framework would be needed to implement it.* A precedent might be the Kay Review on Equity Markets. The other measure which requires careful consideration is the possible change to limited liability. We do not believe this can be imposed in the short run. Rather it must be carefully thought through and the markets need to be persuaded that it would work.

In summary the Green Paper has already provoked constructive debate and the identification of actions that will help address current challenges. It is important that the government now follows through both in the long and the short term.

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2. Introduction

1. Who we are and what we believe

The Institute of Business Ethics is an educational charity funded by business whose purpose is to promote high standards of business behaviour based on ethical values. We were founded in the wake of the Big Bang reforms to the City and have three decades of experience and knowledge gained through our network function and through the provision of independent impartial advice to companies. This has made us a recognised repository of best practice and led us to be invited by the Financial Reporting Council to be a supporting partner and major contributor to their new Culture Coalition.

The IBE believes that businesses will be more sustainable when they base their activity on a set of values which recognise their obligations to their employees, suppliers, customers and to the society in which they operate. Their franchise – or their social licence to operate – will be more secure. Profit is legitimate when it rewards the delivery of value and the acceptance of risk. It is not legitimate when it is a rent derived from the extraction of value as, for example was the case with much of the banking sector in the run-up to the 2007/08 financial crisis.

Corporate governance has an important role to play in the articulation, embedding and monitoring of corporate values which drive a sustainable business. Some values are ethical, for example openness, honesty, respect and reliability. Some are commercial, for example innovation. The lesson of recent corporate scandals is that boards need to be involved in setting the values of the firm(both business and ethical values), be comfortable with them and satisfied that they are driving appropriate behaviour throughout the organisation. This, coupled with greater awareness of the social impact of their enterprise, is an important new task for boards, and one which should make them more outward-looking than has sometimes been the case in the past.

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At the heart of this debate is concern about public trust in business. The IBE's latest survey[1] shows that only 48% of the public believe that business behaves ethically, down sharply from 59% in 2015. The biggest two concerns are over the approach of companies to taxation and executive remuneration.

While the survey recorded a sharp year-on-year fall, the longer trend is fairly consistent with approval ratings fluctuating between 47% and 59% since 2003. However the raw number takes little account of the intensity of public mistrust which seems to have increased, prompting the current Green Paper. We are concerned that if business cannot make itself more trustworthy, then it is likely to be every more tightly regulated – a concern which is implicitly confirmed in the Green Paper itself.

2. Principles underlying this response

This response is informed by the core beliefs set out above, from which are also derived some key principles.

Business, society and policy-makers need to reach a common understanding on the purpose of companies. This cannot simply be the maximisation of wealth for the company and its shareholders because, if this comes at the expense of society, it will not be sustainable. Without such an understanding, it is unlikely that business will regain public trust and respect which it in turn needs in order to thrive in the long run.

The Green Paper is a step forward and contains many ideas that are potentially helpful in addressing immediate problems and improving the practical operation of governance. However corporate governance reform should not be a sticking plaster exercise. If we are to have "a society that works for all," as the Prime Minister suggests, we need to keep the bigger picture in mind. The government must be part of the shared consensus around the purpose of business and use its powers to facilitate delivery of

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[1] *Attitudes of the British Public to Business Ethics 2016*, published by IBE December 2016 http://www.ibe.org.uk/userassets/briefings/ibe_survey_attitudes_of_the_british_public_to_business_ethics_2016.pdf

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that purpose in a positive way which respects the potential contribution of business to society, and which empowers as well as constrains.

This means any new measures should be clearly set in the context of a consensus around the purpose of business and prioritised, according to their propensity to help deliver that purpose. Too many regulatory measures confronting business are scatter-gun reactions to particular problems which yield a confused and grudging compliance at best. When taking the Green Paper forward, the government should have a strategic view. High standards of governance, a reliable framework and public support for business help attract investment flows and should be a source of strength after Brexit.

The basic principles outlined above apply to unlisted as well as listed companies. Because of its higher profile and reliance on capital contributed by the public, the listed sector has born a disproportionate cost of regulation and intervention. *Yet the Companies Act and the directors' duties it contains apply equally to all companies and directors. Besides, even privately-owned companies have public responsibilities. The UK social impact of larger unlisted companies is every bit as great as that of listed ones – and indeed may be even greater given the high proportion of large listed enterprises which are to all intents and purposes overseas companies.*

Generally speaking we believe that higher standards of behaviour are best introduced through market agreement on best practice rather than additional regulation, though carefully calibrated disclosure requirements can be an incentive to improved behaviour. The Financial Reporting Council is already planning to look at revisions to the UK Governance Code and the attached Board Effectiveness Guidance as well as compliance with the directors' duties set out in Section 172 of the Companies Act and the application of governance standards to unlisted companies. The government should encourage this as well as the use of the comply-or-explain principle to promote higher standards, though there is a case for regulation to enhance disclosure and the delivery by boards of their obligations under Section 172.

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Finally, the Green Paper talks of the privilege of limited liability. This privilege is a key one for all companies including those that are privately owned and it should not be unconditional.

3. Three key conclusions

Three broad conclusions follow from the principles outlined above.

1. As a next step, *the government should review the circumstances in which limited liability might be withheld from companies whose boards fail to meet expected standards*. To remain eligible for limited liability in such a situation boards would have to be reshaped or replaced. Such incidences would almost certainly be extremely rare. Most companies, especially smaller companies that stay within the law, would not perceive any change. However, even a very remote possibility of losing limited liability is likely to concentrate the minds of directors and promote high standards of behaviour as mandated by Section 172.
2. *There is considerable scope for raising governance standards without additional legislation*. Our contact with boards suggests inadequate awareness of Section 172 of the Companies Act. This needs to be corrected through a disciplined disclosure regime, backed up by some additional measures including requirements in the Corporate Governance Code for companies to have a board level committee to oversee ethics, values and sustainability and a code of ethical behaviour which is overseen by the board.
3. *There is a pressing need for root and branch reform of executive remuneration. The government should take steps to promote this.* The behaviour of individuals reflects the incentives that confront them. The current complex system of executive pay purports to align reward to performance but does not obviously do so. We propose that consideration be given to a simpler system aimed at encouraging managements to generate a growing volume of cash over the long term. Delivery of this requires the business to be sustainable, which in turn necessitates respect for social norms and expectations.

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Once again, our preference is that reform of executive remuneration should be a market-led exercise rather than something imposed by regulation. The recent review of executive remuneration by the Investment Association remains a start and could be taken further.

A general principle is important here and throughout this debate. The overwhelming imperative is to rebuild trust in business. This can never be done by regulation, because regulation only comes into play on occasions when, for internal conflict or other reasons, those being regulated cannot be trusted. At the end of the day, it is business, not the government which has to deliver.

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4. Specific responses

Executive Remuneration Section – general comments

We believe the present system of executive remuneration is fundamentally unfit for purpose because it lacks transparency, generates wildly fluctuating outcomes over a relatively short period, and fails to create a clear link with performance.

Whereas we initially felt that reform should be achieved by regulation, we now tend to favour a market-led approach that would avoid legal issues around freedom of contract. The government should facilitate a thorough reform, bolstered by appropriate disclosure arrangements, with the option of making remuneration simpler, fairer and more transparent, and therefore more capable of engendering public trust.

One approach might be to launch an official enquiry, perhaps along the lines of the official Kay Review of Equity Markets and Long-term Decision-making published in July 2012. This would look at the options for reform and aim to build a consensus around them.

Reform is important because the way in which remuneration is paid is an important driver of behaviour at the corporate leadership level. For companies to have a healthy culture, incentives must be aligned. This may be more important than specific regulation which drives pro-forma compliance rather than considered behaviour.

The present system not only yields very large amounts to some executives. It also leads to a very wide range of outcomes, as the examples set out in Appendix 1 show. While these may at times seem arbitrary and unfair, they may also involve performance criteria that may prompt short-termism in decision-making as executives seek to engineer a favourable outcome. There is some academic evidence of this link[2].

[2] See, for example, Robert C Pozen(2014), *Curbing Short-termism in Corporate America: Focus on Executive Compensation*, Brookings Institution and Ira Kay(2016), *Executive Pay, Share Buybacks and Managerial Short termism*, Harvard Law School Forum, 2016

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Our preferred approach would involve a greater reliance on cash with substantially less emphasis on bonus. We believe that options and long term share incentives should be abandoned in favour of a requirement on executives to use some of the salary they are paid to buy and hold shares over a long period. This should be a minimum of five years, preferably longer and should continue even after the recipient has left the company.

Executives should be entitled to receive dividends in cash, subject to an agreement on cover. This would both substitute over time for bonus and create an over-arching incentive to run the company for long-term cash generation. Bonuses would then become a small residual. A further advantage of this system is that it would automatically penalize executives for failure without requiring the use of claw-back and malus clauses which, though, increasingly common, are generally not used[3].

This approach builds on the rather tentative recommendations of the Investment Association. We agree with them that a simpler system in which executives are much clearer about what they are going to receive could lead to a reduction in overall quanta over time, although base salaries would initially increase as our worked-through example in the Appendix shows. We recognise that changes of the type we are proposing would need to be phased in.

In our submission to the BEIS Select Committee we also suggested that chief executives and other directors subject to the remuneration report regulations should not receive a pay increase or bonus in circumstances where the company had a material pension deficit and there was no agreement in place with the Pensions Regulator to address this. We also said that when annual bonuses to directors exceed a given proportion of salary, then a bonus in the same ratio should be paid to all staff.

We suggested that the limit might be set at 25% of the enlarged salary that would flow from the structural changes outlined above. However, we would stress that this limit would only apply in the event of the other changes being introduced and should be seen in the context of full structural reform.

[3] See Grant Thornton(2016) *Corporate Governance Review*

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The changes we are proposing have two important advantages beyond clarity and simplicity. The outcomes would be less volatile as the Appendix shows, and they would focus corporate leadership on sustainable long-term cash generation. Because they would involve executives keeping shares after they had moved on, they would also encourage a more conscientious approach to succession planning, which has been identified by the FRC as a source of governance weakness.

Answers to questions

Question 1: 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 any other options that should be considered?

Shareholders already have extensive powers through the triennial binding vote on policy and the annual binding vote on the re-election of the board, including members of the remuneration committee. By and large the latter option is underused, though this may be changing, according to BlackRock, one of the world's largest asset managers.[4]

Withholding support for the re-election of Remuneration Committee members is an appropriate step for shareholders, when the RemCo abuses its right to exercise discretion or fails to react to clear evidence of concern from shareholders. The solution is already available and simple, unlike several of the options set out in the Green Paper. It would also address the problem that, having won the annual advisory vote by a small margin, some companies then decline to engage with shareholders or do so only half-heartedly.

Over time it might be possible with the reforms outlined above to replace the existing combination of periodic binding votes on policy and annual advisory votes on the Remuneration Report with a single binding vote on

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[4] In future BlackRock will vote against the re-election of Remuneration Committee Chairs if it feels there is a disconnect between pay and performance, according to testimony by its Managing Director Amra Balic to the BEIS Select Committee on December 6, 2012.

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the proposed salary increases and bonuses for executive directors. This would mean the executives would have to wait for any increment until after the Annual General Meeting. A simpler approach to remuneration would obviate the need for a vote on policy, although Remuneration Committees should be expected to explain why they have settled on a given quantum, something which few, if any, do at present.

Question 2: Does more need to be done to encourage institutional 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 any others that should be considered?

Most large UK institutional shareholders already disclose their voting record. It is not clear how mandatory reporting rules could be applied extra-territorially. Also shareholder committees already effectively exist through the Investment Association and the Investor Forum.

We do, however, consider that more should be done to enfranchise smaller shareholders who make up an important part of share registers and whose rights are often neglected by execution-only websites. This is not just relevant to remuneration.

Where companies have employee share schemes, the voting rights of employees should be actively facilitated. Consideration could then be given to requiring them to disclose in aggregate how their employees have voted on remuneration. This would be a useful way of involving employees in the process.

Question 3: Do steps need to be taken to improve the effectiveness of Remuneration Committees and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green paper? Are there any other options you want to suggest?

We would be broadly supportive of amendments to the UK Governance Code to encourage companies to consult more widely with their shareholders and also their workforce on the development of remuneration policy. Also we support the Investment Association's proposal that no one

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should chair a remuneration committee without having spent at least a year as a member so that new NEDs cannot be parachuted straight into committee chair roles.

That said, we are wary about mandatory consultation, since this could create a vast workload for shareholders which would completely stymie their ability to engage on other important issues. Instead, companies should be required to disclose what opportunities they have given to shareholders and other stakeholders, including, in particular, the workforce to comment on their proposals.

There would be much less need for long remuneration reports and lengthy consultations if the whole pay process were simpler.

Question 4: 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.

Publication of the ratio assumes we have a reliable figure for CEO pay when this is not the case given the complexity of current arrangements.

The case of Bart Becht, former Chief Executive of Reckitt Benckiser, is instructive. Press reports in April 2010 said he had received over £90m in remuneration the previous year[5], but on closer examination the figure included an amount of £74m from cashing in share options granted as far back as 2001 and a further £13m from cashing in performance shares granted in 1999 and 2005. According to the company his salary and bonus for the year amounted to just £4.5m with an additional £296,000 paid into his pension fund as well as a further 900,000 share options of indeterminate value.

Clearly the figure of £90m does not represent his remuneration for the year 2009 alone, since a very large part of it relates to share-related awards made as far back as ten years previously. On the other hand his salary and

[5] See *Cillit Bang Boss Bart Becht takes home £90m*, The Guardian April 7 2010

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bonus does not provide a complete picture either, because, like the current UK disclosure regulation, it ignores the value of the share-related rewards received in that year but which would only pay out later. Any ratio would fluctuate wildly, depending on which number was chosen and give a potentially inaccurate picture.

A similar, though less dramatic example is offered by BHP-Billiton's annual report for 2014. This gave two different calculations for the Chief Executive's salary, one of $7.99m based on the UK reporting rules and one of $7.12m based on international accounting standards. Once again the ratio could vary substantially[6].

Simplification of remuneration along the lines suggested above would open the door to publication of more reliable ratios, though, even then, care would have to be taken when making comparison between sectors as well as the methodology used to calculate the median pay level in the workforce.

Question 5: 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?

The Green Paper points out that disclosure of bonus targets is increasing as a result of shareholder pressure on companies to refrain from using the commercial sensitivity exemption under the present rules. While this trend continues we see no reason for further regulation.

In any case our approach to remuneration would lead to strict limits on the use of bonuses and share incentives. We are sceptical of bespoke performance targets as there is little evidence that these improve overall performance, although they can distort behaviour. That said we would like to see adherence to the company's ethical values and standards to be a routine criterion for both bonuses and regular increases in base pay. A "good citizen" criterion should apply to pay increases for all employees.

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[6] For analysis see IBE Board Briefing by Peter Montagnon (2015) *Fair or Unfair: getting to grips with Executive Pay*, page 16

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As stated in our answer to Question 1 we believe that Remuneration Committees should do more to explain the reasons why they have chosen a given quantum rather than merely the mechanisms by which variable pay is awarded.

Question 6: How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

The Green Paper refers to the proposal from the Investment Association that restricted share awards be used as an alternative to long term incentive plans and also that holding periods be extended to five years. These go in the right direction, though not far enough. For example we believe that shareholding requirements should continue for at least two years after executives have left the company.

Strengthening the employee, customer and wider stakeholder voice - general comments

In our submission to the BEIS Committee of the House of Commons we argued that more should be done to bring Section 172 of the Companies Act to life. This section requires directors to take a long term view and have regard to the interests of a wide range of stakeholders as part of their duty to act in the interests of members of the company. We do not believe that this law needs to be changed, but we are concerned that directors are insufficiently conscious of their obligations.

We believe that companies (listed and unlisted) should make an annual disclosure of how they have taken account of Section 172 in:

- setting objectives for directors individually
- setting priorities for the board as a whole
- decision-making
- skills development and board evaluation

This could take the form of a collective statement by the board, which would remind all directors of their obligations under the Act. However, we

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consider that a personal statement by the Chairman on how he or she has taken these issues into account in leading the board would be more likely to be meaningful and less vulnerable to legally-driven blandness. Such a statement should include an explanation of how the chairman has ensured that the board operates in such a way that all directors live up to their duties under the Act.

The statement should not be bland. This is why we have singled out four specific areas for comment. Guidance should encourage companies to give practical examples of relevant board arrangements and of actual decisions made. Skills development should include an assessment of whether the board is suitably diverse.

Disclosure on objective setting does not need to give details of each director's objectives but should explain the process by which Section 172 is made relevant to each director's role.

The proposed statement might be part of the strategic report but goes beyond the current regulations in scope[7] as it would be much more a statement of responsibility and accountability. We have also proposed that all companies should be encouraged, on a comply or explain basis, to have a board level committee[8] looking at sustainability values and ethics, and that the UK Governance Code should be amended to enjoin companies to have an internal code of ethics[9] which should be overseen by the board.

We reaffirm these proposals here with the additional comment that large groups should ensure that the parent company board does not become too

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[7] Section 414C of the Regulation reads: "The purpose of the strategic report is to inform members of the company and *help them assess how the directors have performed their duty under section 172* (duty to promote the success of the company)." However, the required disclosure is focused on principal risks and uncertainties (including non-financial risks) and on the prospects for the business as well as certain EU inspired disclosure requirements on diversity and environmental emissions. It does not require directors to state specifically *how they have taken account of Section 172 in their skills development, decision-taking and priority-setting*. This IBE proposal would thus not be fulfilled by the general nature of the Strategic Report and should be seen as complementary to the current strategic report or as an enhancement to it.

[8] For further information see IBE Survey by Peter Montagnon (2016) *Culture by Committee: the Pros and Cons*. This paper shows that, even though it is not yet a requirement under the Code 57 companies in the FTSE350 have a board level committee responsible for oversight of these issues

[9] For an analysis of codes and how they operate, see IBE Core Series *Codes of Business Ethics, a guide to developing and implementing an effective code* by Simon Webley and Dan Johnson (2016), and IBE Core Series *Codes of Business Ethics, examples of good practice* by Simon Webley and Guendalina Donde 2016

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remote from its subsidiaries. Subsidiary boards might also appoint their own committees and stakeholder advisory groups (see below) with responsibility for reporting to the centre and keeping it in touch with the grass roots.

Answers to questions

Question 7: How can the way in which the interests of employees, customers and wider stakeholders are taken account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

Our starting point for responding to these questions is Section 172 which both sets out a clear expectation that companies should take stakeholder interests into account and directs the responsibility towards directors. Boards should therefore be fully responsible for arrangements for addressing stakeholder issues even if their involvement entails oversight and assurance rather than an operational role. Any new approach should be judged by its likely impact in strengthening boards' ability to fulfil this responsibility.

A number of IBE subscribers have and have had stakeholder advisory panels. These mostly cover issues around corporate responsibility and corporate responsibility reporting. Some report to senior management and some provide advice at a more operational level, but there is rarely active board involvement.

Thus, while some companies find them useful, we would not see such panels at present as providing critical support to boards in delivering their obligations under Section 172, although they could evolve further and the option for a company to appoint such a panel should be left open. They could also be particularly useful at subsidiary level.

However, we do not believe that a stakeholder advisory panel is the right way to address remuneration, not least because it would be very difficult to make such a group representative in large companies. As stated above, we

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do expect remuneration committees to take account of attitudes to executive pay in the workforce.

The Green Paper suggests that boards might designate one of their number to take responsibility for stakeholder issues. We are cautious about this because a single NED with this responsibility might find him or herself isolated within the board. Such a person would also be less able to challenge the executive, which is an important board function.

Oversight of values and behaviour involves critical issues like health and safety, environmental risk and probity in treatment of customers. These are and must remain a whole board responsibility, just as boards have always been collectively responsible for financial risk. Board arrangements must reflect this core principle.

We therefore conclude that boardroom focus on these issues could be strengthened by the creation of a committee whose terms of reference would mandate detailed and systematic monitoring with the objective of ensuring that the important issues were addressed by the full board. We also believe that a code of ethical behaviour, which was championed by the senior management as well as being overseen by the board, would underpin a commitment to responsible behaviour.

Question 8: Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

We believe that a requirement to make a Section 172 disclosure should apply to all companies who are already required to publish a strategic report (essentially all companies, listed and unlisted, apart from those qualifying for the small company exemption from audit). Though there is some cost involved in making the statement, it is not particularly large. Encouraging smaller companies to do this may help their integration into the supply chain of larger companies. We are starting to see some evidence of smaller companies wanting to raise their standards for this reason.

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Question 9: 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 costs and benefits.

We consider that a requirement to make a Section 172 statement should be embodied in regulation for all companies required to publish a strategic report. This should not require primary legislation. The issue of board level committees dealing with ethics, values and sustainability as well as the encouragement of companies to have an internal code of ethics could be addressed through the UK Corporate Governance Code.

Corporate Governance in large privately held businesses section – general comments

In our submission to the BEIS Committee we noted that the Companies Act applies to all directors of all companies. Our proposal for disclosure around Section 172 would apply to all companies required to make a strategic report. The problem is that, while in listed companies such statements are directed to shareholders who have the right to dismiss the board, there is no such enforcement mechanism in the unlisted sector.

We therefore proposed that unlisted companies should have the responsibility to push their Section 172 statements by actively drawing the attention of major stakeholders (employees or their representatives, suppliers and large customers) to them. We also said the FRC should do more to promote the use of the current governance code by unlisted companies as a large majority of its provisions are potentially relevant to all companies.

As far as sanctions are concerned, we noted that a failure of chairmen or directors of unlisted companies to make adequate statements on Section 172 should be taken into account when the authorities are dealing with regulatory and other infractions.

It is worth noting in this context that the Green Paper itself speaks of the privilege of limited liability. This privilege has to be earned at the very least by compliance with the law. We suggested above that the government should examine the circumstances in which the privilege of limited liability

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might be withdrawn. One possibility is that in cases where the provisions of Section 172 are shown to have been wilfully flouted, the government should have power to remove the privilege of limited liability unless the entire board is changed. This would be akin to a nuclear deterrent in that it would rarely if ever be used, but its existence would focus the minds of boards. The potential sanction would apply equally to listed and unlisted companies.

Answers to questions

Question 10: 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 existing examples of good practice in privately-held businesses that you would like to draw to our attention?

Question 11: 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?

Question 12: If you think that strengthening is needed how should this be achieved? How could compliance be monitored?

The principal underlying question in this part of the Green Paper is whether the UK Corporate Governance Code should be made to apply to unlisted companies or whether bespoke arrangements are needed. The Green Paper talks of the possibility of involving the Institute of Directors as well as the Financial Reporting Council in setting out best practice.

In the first instance, we consider that the simplest solution is to encourage unlisted companies to adopt the Governance Code by giving the FRC a specific mandate to do this.

Some have suggested the possibility of a separate code for unlisted companies. Yet, while the Governance Code contains a number of principles and provisions covering the relations between companies and shareholders, a large part of it addresses the way in which boards should organise themselves to make decisions and oversee the management of

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risk, including through committees and the representation of independent directors. These parts are certainly relevant to privately-held companies. There should be no need to start from scratch and that approach could easily lead to a weaker than desirable result. The final decision about a separate code should not be made without a careful analysis of how far the existing code could be relevant to unlisted companies and some experience of trying to make this work.

The FRC is in a strong position to take a leading role. It has a mandate to reflect a broad range of stakeholders and the experience of doing so, notably the providers as well as the consumers of capital. The FRC's long tradition of public consultation is also important. Codes that operate on a comply-or-explain basis need general consensus support because this generates peer pressure to comply.

The FRC could also take on the role of monitoring disclosures by un-listed companies, raising with them the failure to make declarations of compliance and the quality of explanations for non-compliance. This should be done in the context of a general enhancement of the scrutiny of the quality of explanations including those from listed companies. In doing this the FRC should base its judgements on the established definition of what constitutes a proper explanation for non-compliance[10].

One of the benefits of good governance for private companies is the comfort it can give to creditors. Disclosures under the code should be made available to credit-rating agencies and those from whom the company has material borrowing arrangements.

As far as the threshold for disclosure requirements goes, we would apply those suggested above. Disclosure of adherence to the governance code should be obligatory for companies required to publish a strategic report.

[10] See UK Corporate Governance Code, section on Comply or Explain, paragraph 3

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Question 13: 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?

The short answer to this question is: yes. Recent decades have seen a tendency to increase regulatory pressure on listed companies, particularly around disclosure, and this has led to an uneven playing field. It is also important to draw larger unlisted companies into the net.

The Green Paper noted that the British Private Equity and Venture Capital Association has produced some useful guidelines to disclose a range of information comparable to that published by companies in the FTSE 250. However, there is a need for consistency between initiatives.

We believe the FRC should be asked to undertake a broad-ranging review of non-financial reporting to take account of the results of its culture debate as well as the opportunity afforded by Brexit to remove disclosure requirements which are there only to satisfy EU legislation. The objective would be to produce a simpler framework for non-financial reporting which was fit for purpose in all companies. Priority should be given to disclosures that are likely to drive behavioural change rather than those which are simply a clerical recording of fact.

Other issues section

Question 14: Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

The Green Paper refers in a number of places to the role of shareholders, especially with regard to the oversight of remuneration. While it is true that some shareholders have sometimes been guilty of short-termism and of failing to challenge boards of failing companies, there has also been considerable progress in recent years through the development of the FRC's Stewardship Code and the Investor Forum. This needs to be encouraged.

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We believe more could be done to promote the role of asset owners (ie the pension funds and charitable foundations etc who place their money with asset managers). When issuing a mandate to asset managers to manage money on behalf of beneficiaries in the UK, asset owners should be required to state that, in setting the terms of the mandate, they have taken account of the interests of their beneficiaries, including their time horizons. A requirement on pension fund trustees to make such a statement is likely to result in mandates that place more specific stewardship responsibility on asset managers.

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Appendix

Two approaches to remuneration

The following tables set out how the IBE's proposed approach would work compared with a more conventional current approach. Both examples start from a situation where the "on-target" rate for a chief executive position is around £2.5 to £2.6m. The term "on target" means the amount the executive would receive if he or she performs as expected and meets targets with a certain degree of stretch.

The IBE approach consists of a fixed payment out of which the executive would be obliged to buy shares in the company and hold them for the long term plus a modest bonus opportunity. The conventional approach includes a larger bonus opportunity and a performance share scheme under which shares amounting to a multiple of base salary might vest depending on whether performance targets are met.

While the average pay-out under the two approaches is broadly the same, the conventional approach incorporates a much wider range of possible outcomes and a significantly higher maximum. The IBE approach offers greater certainty. Though the on-target rate remains very high by comparison with average earnings, it still includes downside for poor performance affecting the share price. Since there are no artificial performance targets, executives will have no reason to manipulate results in the short term in order for their schemes to vest. At the same time they will have an overarching incentive to run the company to achieve a growing and sustainable generation of cash.

It should be assumed that the greater certainty in the IBE approach would enable Remuneration Committees to negotiate some reduction in "on-target" rates.

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1. **The IBE approach**

On target remuneration £2.5 to £2.6 million

Description	Entitlement	Total paid
Base pay £	2,000,000	2,000,000
Bonus £	Up to 15%(10% paid as on target rate)	200,000
Executive Pension contribution £	Nil	
Long term share incentive £	Nil	
Requirement to purchase shares (say half salary) £		1,100,000

Gross outcome after one year: cash receipts of £1,100,000 and shareholding of £1,100,000

Outcome after five years – return on share portfolio of £1,100,000

Share price change %	-20	0	+20	+50
Value of portfolio £	880,000	1,100,000	1,320,000	1,650,000
Dividends received £ [11]	175,201	175,201	175,201	175,201
Total return £	-44,799	175,201	395,201	725,201
Total income after 5 years £[12]	2,155,201	2,375,201	2,595,201	2,995,201

Notes:

- The negative return from a falling share price eats into the original salary.
- The difference between the upper and lower calculation is £840,000 – sufficient to reward performance but a much smaller variable than on a conventional system. The average payment would be £2,575,201.

[11] Dividend calculation assumes a starting dividend yield of 3% and an annual increase in the dividend of 3%.

[12] Cash remuneration plus portfolio return

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2. **The conventional approach**

On target remuneration £2.5 to £2.6 million

Cash and short-term elements

Description	**Entitlement**	**On target payment**
Base pay £	400,000	400,000
Bonus £[13]	Up to four times salary	960,000
Executive pension contribution £ [14]	30% of salary	120,000

Medium term share-based elements

Description	**Entitlement**	**On target payment**
Long term share scheme £	Up to four times salary, vesting after five years subject to performance conditions.	480,000[15]

Potential share scheme outcomes depending on market return

	No vesting	On target	All vest
Face value £	Nil	480,000	1,600,000
Market value £ at -20%	Nil	384,000	1,280,000
Market value £ at 0%	Nil	480,000	1,600,000
Market value at £ +20%	Nil	576,000	1,920,000
Market value at £ +50%	Nil	900,000	2,400,000

[13] This assumes a 60% payout. Before deferred element. Until recently it was common for part of the bonus to be deferred and then matched with additional funds depending on performance criteria. However, leading shareholders have begun to oppose this option and it is therefore not included in this example. The total reward would be significantly higher than given in the example were matching to be included.
[14] Executive pension contributions are lump sum payments intended to contribute to a defined contribution scheme and are not normally factored into the on-target rate.
[15] Face value of shares vesting, assuming on target rate of 30%

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Note:

- The negative return from a falling share price does not eat into base pay and other cash income. However, these are smaller than under the IBE approach
- With no vesting under the share scheme the minimum outcome is £1,360,000 (excluding the pension contribution), though this does assume an on-target bonus is paid.
- With maximum vesting, and a 50% return on the share element, the total outcome is £3,760,000, again excluding the pension contribution.
- The average payment would be £2,560,000, but the difference between the minimum and the maximum is £2,400,000. While this is a very large range, executives have very little control over where the result ends up.
- Including the pension contribution would increase the amount received by £120,000 even though the disclosed on-target reward would not change.

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