Institute of Business Ethics

24th October 2016

Submission of the Institute of Business Ethics to the Corporate Governance Enquiry of the Parliamentary Business, Innovation and Skills Committee

Who we are

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 from 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 to us being invited by the Financial Reporting Council to be a supporting partner and major contributor to their new Culture Coalition. We offer the following submission to the Committee.

The IBE's philosophy

The IBE believes that businesses which 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 will be more sustainable because their franchise – or the licence to operate which is conferred on them by society – will be more secure. Profit is perfectly 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 will drive a sustainable business. Some values are ethical, for example openness,

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honesty and respect. 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 takes governance well beyond its traditional pre-occupation with processes and structures, designed to deliver accountability and enhance strategic decision-making and risk oversight and centres it on the purpose of the organisation. Such tasks remain critically important but boards must do more. Thus we welcome the debate on governance which has been launched by the Prime Minister and followed up by the Committee.

Our principal conclusions

Governance and board effectiveness

- All boards of larger companies, both listed and unlisted, should be required to issue an annual public statement describing how they have taken account of Section 172 of the Companies' Act 2006 in assessing their own skills requirement, in setting their priorities and in taking decisions. It is important to note that the Act applies to all companies and the directors' duties it contains to all directors.
- We do not believe that the UK's governance arrangements would be enhanced by a requirement to have a designated board position either for a representative of the workforce or with responsibility for relations with broader society. Relations with employees and with society are important issues which are the responsibility of the full board.
- Instead the UK governance code should be amended to enjoin larger companies to have a board committee responsible for assisting the board in systematic oversight of the way in which the company's values are delivered both with regards to employees and other stakeholders.

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- The Governance Code should also be amended to enjoin larger companies to state whether they have an internal code of ethics and behaviour and to describe how the board monitors its implementation.
- The FRC should revise its board effectiveness guidance to take closer account of Section 172.
- Unlisted companies should be required to demonstrate the public nature of their annual Section 172 statement both by displaying it prominently on their website and by direct circulation to employee representatives, major suppliers and customers.
- The FRC should redouble its efforts to make relevant parts of the Governance Code apply to unlisted companies. The larger ones should be required to state how they apply the Governance Code. The FRC should monitor the statements and name and shame companies that fail to make one. Failure to make a statement could make directors of such companies liable to sanctions and be considered as a factor in any private litigation.

<u>Remuneration</u>

- The executive remuneration system is seriously discredited and needs substantial reform. This will not be achieved simply by the introduction of another binding vote.
- Legislation and regulation around executive pay should be repealed and replaced with new rules based around a simple principle that the only permissible form of remuneration is one which can be objectively valued at the time of delivery. This means restoring cash as the essential currency. However executive directors should be required to spend an agreed portion of this cash on shares held for the long term even for a period after they have left the company.
- One simple binding vote could then be held at each annual meeting under which the shareholders would agree the size of any salary increase and bonus. These would only become effective after the annual meeting.

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- Where the bonuses paid to executive directors exceed a given proportion, say 25% of salary, then all employees should automatically be eligible for a bonus in the same proportion of salary as that paid to the chief executive.
- We do not agree with the suggestions made by some that companies should have specially constituted committees involving shareholders and employee representatives in deciding remuneration schemes. This would create severe practical difficulties in terms of operation and tend to undermine the concept of the unitary board.

Pensions

- The problem highlighted by the BHS pension deficit can best be dealt with by a simple change in the regulation requiring the Pensions Regulator to certify at the time of a takeover that it is satisfied with the viability of the pension scheme and of any programme aimed at closing the deficit.
- Where there is a pension deficit, bonuses and salary increases to those executives covered by the current Directors Remuneration Regulations should not be permitted unless there is an agreement in place with the Pensions Regulator on how the deficit will be closed.

Supporting analysis and response to the Committee's questions

1. BHS pensioners were severely let down by both the management which presided over its bankruptcy and its previous owner. **This problem can best be dealt with by a simple change in the regulation requiring the Pensions Regulator to certify at the time of a takeover that it is satisfied with the viability of the pension scheme and of any programme aimed at closing the deficit**.

2. Board directors should be fully aware of their duties as set out in Section 172 of the companies act (see Appendix 1). This requires directors to take account of the long term consequences of their

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decisions, the impact on employees, suppliers, customers, community and the environment. Collectively directors are further enjoined to recognise the advantages of a reputation for high standards of business conduct and act fairly between shareholders. We interpret this to mean that boards are not supposed to direct the company's activities to reward only those shareholders with a short term investment perspective.

Our experience is that most directors/boards are not sufficiently aware of these duties. **All boards of larger companies, both listed and unlisted, should be required to issue an annual public statement describing how they have taken account of Section 172 in assessing their own skills requirement, in setting their priorities and in taking decisions.** We believe that the requirement to issue such a statement will lead to a significant change of behaviour. Sanctions should be applied to both boards and directors who fail to issue such a statement. Such a change should be possible through regulation or secondary legislation rather than fresh primary legislation.

There is evidence that the requirement to make statements of this nature can have a significant impact on behaviour. For instance a provision, without sanction, of the Modern Slavery Act requires companies to publish a statement about how they are addressing the issue in their supply chain. This is has had an international effect on companies from New Zealand to the USA as civil society is proactively monitoring these statements which in turn is driving better behaviour and concentrating business minds on the business principles of their supply chain.

3. To strengthen the response of boards, we recommend that **the UK governance code should be amended to enjoin larger companies to have a board committee responsible for assisting the board in systematic oversight of the way in which the company's values are delivered both with regards to employees and stakeholders.**

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The New Zealand authorities are in the process of introducing such a provision and similar requirements exist elsewhere, for example in Italy. **The Governance Code should also be amended to enjoin larger companies to state whether they have an internal code of ethics and behaviour and to describe how the board monitors its implementation.** Both the proposals in this paragraph should be on a comply-or-explain basis. Code revisions do not require a change in the law, but the Financial Reporting Council is obliged to consult on them and this means they would take some time to become effective.

4. **In addition the FRC should revise its board effectiveness guidance to take closer account of Section 172.**

5. **We do not believe that the UK's governance arrangements would be enhanced by a requirement to have a designated board position either for a representative of the workforce or with responsibility for relations with broader society**. Relations with employees and with society are important issues which are the responsibility of the full board. The appointment of a single designated director who might well be ignored by the rest of the board could end up downgrading their importance and undermining the concept of the unitary board. It is also very difficult to see how a single employee could represent the workforce in large companies with a multinational and diverse workforce.

   We believe that compliance with Section 172 will lead boards to address these issues properly. We would emphasise our proposal that board statements on Section 172 would require boards to report on whether they have the right skills to deliver. This is a driver to diversity.

6. Enforcement of good governance in privately listed companies is difficult because directors are not normally accountable to outside shareholders. We recommend that **for unlisted companies there**

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should therefore be a requirement to demonstrate the public nature of the Section 172 statement both by displaying it prominently on their website and by direct circulation to employee representatives, their largest suppliers and customers. Some additional discipline may be required, however, and **the FRC should redouble its efforts to make relevant parts of the Governance Code apply to them. For instance, larger unlisted companies should be required to state how they apply the Governance Code. The FRC should monitor the statements and name and shame companies that fail to make a statement.**

Failure to make a statement could make directors of such companies liable to sanctions and be considered as a factor in any private litigation. We believe that such an approach would considerably increase the discipline applied to unlisted companies, and go some way to redressing the balance vis-à-vis listed companies who have hitherto been more heavily regulated.

7. We believe **the executive remuneration system is seriously discredited and needs substantial reform. This will not be achieved simply by the introduction of another binding vote**. Such votes already exist with regard to policy, to the introduction of dilutive share schemes and the annual re-election of directors, including the remuneration committee. There is no evidence that shareholders have used these binding votes in such a way as to impose real discipline, although they have at times successfully imposed some modest change at the margins. Nor have shareholders and companies been able to design performance conditions which properly align reward to delivery.

   We therefore propose that the law should be changed to outlaw payment that cannot be properly valued at the time is awarded. Currently much executive remuneration takes the form of options or performance share awards as well as deferred bonuses which cannot

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be valued. The outcomes of such schemes are highly erratic and can produce wide swings in results over a relatively short period.

8. **Legislation and regulation around executive pay should be repealed and replaced with new rules based around a simple principle that the only permissible form of remuneration is one which can be objectively valued at the time of delivery. This means restoring cash as the essential currency. However executive directors should be required to spend an agreed portion of this cash on shares held for the long term even for a period after they have left the company.**

   Subject to agreement with shareholders on dividend cover executives should be allowed to receive dividends on their holdings. This would reduce the need for annual bonuses and create an incentive to run the company with a view to generating sustainable and growing cash flow over the longer term. The requirement to hold the shares after leaving the company would focus more attention on succession-planning which has been a major recent weakness in UK corporate governance.

9. Greater certainty around value should create far more simplicity and reduce overall quantums, even though there would be an increase in salary to compensate for the loss of options, performance shares and bonus opportunity. Anecdotal evidence suggests that executives currently undervalue the remuneration they receive, which leads them to demand more. Besides, a reliance on cash would impose a limit on what could be paid, and might, for example, have prevented the explosion of pay in the financial sector in the run-up to the crisis. This simpler system means there would be no need for long remuneration reports. **One simple binding vote could be held at each annual meeting under which the shareholders would agree the size of any salary increase and bonus. These would only become effective after the annual meeting.** One criteria for salary

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increases and bonuses should be the performance of the executive in delivering the values of the company as set out by the board.

10. It is important to note that a simpler approach to remuneration as described above would make publication of ratios between the earnings of the chief executive and other employees meaningful. This would not be the case at present because chief executive pay generally cannot be accurately valued at present. A requirement to publish ratios should only be introduced after the system has been simplified to make them meaningful.

11. In situations where senior executives were steadily building up a large shareholding and receiving dividends on them, it would be reasonable to restrict the availability of bonuses, which have done so much to discredit the present system in the eyes of the public. **Where the bonuses paid to executive directors exceed a given proportion, say 25% of salary, then all employees should automatically be eligible for a bonus in the same proportion of salary as that paid to the chief executive.**

12. In a remuneration system which was more heavily based on cash, it should be possible to link remuneration to employees' pension arrangements. **Where there is a pension deficit, bonuses and salary increases should not be permitted unless there is an agreement in place with the Pensions Regulator on how the deficit will be closed.**

13. **Finally we do not agree with the suggestions made by some that companies should have specially constituted committees involving shareholders and employee representatives in deciding remuneration schemes**. First, this would run contrary to the unitary board concept. Second, it is not clear that shareholders, who already have substantial voting powers,

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would become more assertive. Third, we consider these committees impractical, especially when the majority of UK shares are held by overseas funds.

In Sweden, where a similar approach exists for nominations committees it has proved difficult to involve international holders meaningfully in the committee process. If applied in the UK, such an approach would place an undue burden on a limited number of large passive funds. Given the size of its holding, for example, Legal & General would be expected to sit on the remuneration committee of virtually every listed company.

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Conclusions

The proposals set out above are in two main parts. Those around the operation of the board and its role in setting and embedding values require little or no change in primary legislation. In contrast, we identify a need for radical reform of the system around executive remuneration which would probably require legislative change. There also needs to be some tightening of the rules around pensions.

One of the merits of our proposals on remuneration, however, is that they are built around a simple principle and simple rules and structures which should eliminate the need for complex reporting. We believe this is consistent with a growing desire to simplify, reduce regulation and increase openness. It would eliminate many complex rules and reporting requirements. This should open up space for more discursive reporting on how companies are delivering value to their shareholders and stakeholders.

We believe that the analysis presented above substantially answers the specific questions raised by the Committee, but would be very happy to discuss our proposals further

For and on behalf of the Institute of Business Ethics
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Appendix 1

Companies Act 2006

Section 172 - Duty to promote the success of the company

(1)A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a)the likely consequences of any decision in the long term,

(b)the interests of the company's employees,

(c)the need to foster the company's business relationships with suppliers, customers and others,

(d)the impact of the company's operations on the community and the environment,

(e)the desirability of the company maintaining a reputation for high standards of business conduct, and

(f)the need to act fairly as between members of the company.

(2)Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3)The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

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