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CORPORATE GOVERNANCE IN THE UK: WHAT HAPPENS NEXT?

The House of Commons Business, Energy and Industrial Strategy (BEIS) Committee has published its eagerly anticipated recommendations, following its September 2016 inquiry into the governance of UK companies.

The Committee's report, which can be found here, touches on numerous areas of law and policy that, collectively, have the potential to impact companies of various sizes, both listed and unlisted, public and private, across the gamut of industry sectors.

We have summarised below the Committee's key conclusions and recommendations, along with our own thoughts on how these might develop in practice.

DIRECTORS AND THEIR DUTIES

A key focus of the Committee's inquiry was the extent to which directors of companies generally (but those of listed companies in particular) have been concentrating on their statutory duties. The inquiry placed specific emphasis on the overriding duty of directors in section 172 of the Companies Act 2006 to promote the success of their company for the benefit of its members as a whole, having regard to the interests of certain specific categories of stakeholder.

The inquiry's principal question was whether the duty in section 172 is clear enough, and whether there is a sufficiently developed framework for holding directors to account for complying with that duty.

The Committee has concluded as follows:

- While section 172 currently lacks "clarity and strength", it is not the primary cause of weakness in corporate governance. With Brexit on the horizon, now is not the time to re-frame the law, but directors do need to demonstrate more effectively how they are fulfilling their duties.

- The Committee recommends that **directors be required to report on how they have complied with their duty under section 172** in an "accessible, narrative and bespoke form". The paper suggests modelling this report along the lines of slavery and human trafficking statements required by section 54 of the Modern Slavery Act 2015, rather than through additional narrative in a company's annual report.

- This requirement should be implemented through the UK Corporate Governance Code (the Code), rather than new legislation.

- This new report should address each group of stakeholders in turn and in detail. The Committee suggests, for example, that directors explain their allocation of funds between dividends, pension funds, capital investment and other categories, as well as the time horizon of their decision-making.

- There should also be an **annual exercise of rating the corporate governance of FTSE 350 companies**. This should be based on a "red, yellow and green rating system" developed by the Financial Reporting Council (FRC) and business organisations.

- The Committee recommends that **companies be required to publish their rating in their annual report**. However, it does not state whether this should be a binding obligation enshrined in statute, or a comply-or-explain obligation set out in the Code.

- In relation to non-executive directors, the report suggests that the FRC amend the Code to provide guidance to companies on how to **identify the role and responsibilities of non-executive directors**.

- Finally, the paper recommends **giving the FRC investigatory and enforcement powers** to allow it to assess directors' compliance with section 172 and engage directly with shareholders. If companies do not respond satisfactorily to engagement with the FRC, **the FRC should be able to bring legal action**.

This is a broad and ambitious agenda. Whether it can realise its potential is another matter. Listed companies are already required to report on items covered by section 172, such as employees, the environment, and social, community and human rights issues. Requiring separate and specific reporting on the factors listed in section 172 might prove useful, but it might equally create an additional burden that provides no new information to investors. Much will depend on how the requirement is framed and implemented.

Giving the FRC an expanded enforcement role is a bold proposal which would no doubt require providing it with significant investment and funding. Whether or not it is feasible, the proposal departs significantly from the basis of section 172, which, like the other statutory duties of director, is in essence and origin a private, fiduciary obligation owed to a company, rather than a public duty to be policed by regulators.

EMPLOYEE REPRESENTATION AND STAKEHOLDER ENGAGEMENT

Much time and attention has been devoted to the concept of giving different stakeholder groups a more direct say in the strategy and direction of companies. This has centred particularly around the proposal for employees and workers (and, to a lesser extent, consumers) to enjoy direct representation on company boards, such as those set out in the recent report by Chris Philp MP and the High Pay Centre.

Responses to the original inquiry on this point varied significantly, from scepticism by industry bodies to predictable support by unions. However, despite the political significance and discussion around this theme, the Committee has dedicated surprisingly little space to it in its report.

- The Committee urges companies to **establish stakeholder advisory panels**. It also recommends amending the Code to require companies to state in their annual reports how they are engaging with stakeholders.
- It also recommends that the FRC amend its Stewardship Code to provide more explicit guidelines on stakeholder engagement and to require the **disclosure of voting records by asset managers**.
- The report states that the Government should consult on a requirement for large and listed companies to publish **full information on advisers engaged in transactions** above a reasonable threshold, including the amount and basis of those advisers' fees. The report doesn't name specific types of advisers but seems to be referring principally to legal and financial advisers.
- The Committee has rejected the concept of mandatory worker representatives on boards. Although it recognises the achievements of companies that currently adopt this model, it believes a mandatory regime would tend towards tokenism.
- Instead, it recommends having at least one **employee representative on the remuneration committee** in order to scrutinise executive pay. This requirement should be enshrined in the Code.

The goalposts for employee representation have been continually shifting since Theresa May made her initial speech on the subject in July 2016, before becoming Prime Minister. Talk of the German and Swedish models has gradually subsided as a consensus has arisen that mandating worker representatives on unitary company boards is likely to be unworkable.

Employee representation on remuneration committees would appear to be a middle ground, although ultimate decisions as to executive remuneration and stakeholder interests will remain with the board. Although including a requirement to this effect in the Code would no doubt prompt many listed companies to take this step, it would remain to be seen whether AIM companies do the same, and merely swapping the remuneration committee for the board seems to do little to combat concerns of tokenism.

EXECUTIVE PAY

The hot potato of the inquiry revolves around remuneration for executive directors. The Committee's response is that, in a global market based economy where UK companies compete for talent, it would not be helpful for government to directly limit executive pay or to redistribute income for high-earners through the tax system.

However, the Committee does believe that high and unwarranted executive pay is an issue that needs to be addressed for the benefit of society as a whole. It suggests that effective corporate governance, rather than government intervention, is the way to tackle this.

We have produced a separate note on the Committee's detailed recommendations on pay, which can be found here. In summary, the key points are:

- **Long-term incentive plans (LTIPs) should be phased out** as soon as possible. No new LTIPs should be agreed from the start of 2018 and existing agreements should not be renewed.
- **Companies should instead use deferred stock options** to incentivise long-term decision-making. These should be tailored to individual businesses, but the "default" position recommended by the Committee is for vesting to occur in annual 15 – 20 per cent increments over five years.
- Companies should make "limited use" of short-term performance-related cash bonuses. Where used, these should be aligned to wider company objectives or corporate governance responsibilities.
- The Committee has rejected the idea of an annual **binding vote on executive pay in favour of a binding vote only where more than 25 per cent of the votes are cast against** the remuneration report.
- As noted above, there should be **employee representation on remuneration committees**.

- The chair of a remuneration committee should normally have served on the committee for at least one year and should be expected to resign if their proposals do not receive the backing of 75 per cent of voting shareholders.

- The FRC should work with other stakeholders to require the **publication of the pay ratios** between the CEO and senior executives on the one hand and all UK employees on the other.

- A company's people policy should include its overall approach to investing and rewarding employees at all levels, and further details of remuneration levels should be published.

A CODE FOR PRIVATE COMPANIES

The inquiry identified that the increasing prominence of large private companies is creating a gap in the UK's corporate governance framework. Unlike listed companies, the comply-or-explain basis of the Code does not apply to private companies, yet private companies as a group are a significant creator of jobs.

The Committee sought views on whether a new corporate governance code should be developed for large private companies. Although it recognises that the diverse nature of private companies may make it difficult to formulate a single governance code, the Committee has concluded that there is value in formulating such a code for large private companies. In particular, it concludes as follows:

- A code for private companies would raise awareness of good practice and improve standards of governance, but it would not be sensible to apply the existing UK Corporate Governance Code to private companies.

- Instead, a **new code should be developed, based on the comply-or-explain model.** It should take a "light touch" and be proportionate and flexible to reflect the diversity of companies it would potentially cover.

- The Committee envisages that the code would initially apply to companies with over 2,000 employees, with that threshold potentially reducing over time.

- Although the FRC has offered to develop a code for private companies, the Committee recommends that **a new body be set up to oversee and report on compliance**. However, it suggests that the FRC, the Institute of Directors and the Institute for Family Business work together with private equity and venture capital interests to develop an initial code.

- The scheme would be **funded by a small levy on members**.

- The code would start out as voluntary but, if compliance were poor, a mandatory regime should be introduced.

If this proposal is adopted, it will be interesting to see what kind of code is developed for private companies. There is an obvious risk that the disparate nature, size and structure of private companies will result in a level of necessary departure from the code that denudes it of much of its substance.

The reference to private equity and venture capital interests presumably implies involvement by bodies such as the Private Equity Reporting Group and the British Venture Capital Association, which already take an active role in governance within their own sectors with relative success. There will be those who feel that this sector-by-sector approach to private company governance will yield greater fruit than a one-size-fits-all approach.

BOARD DIVERSITY

The final area of the Committee's inquiry was the concern that there is still insufficient diversity on boards, in terms both of gender and of ethnic and social-economic background. The report notes that currently only 10.4 per cent. of FTSE 100 executive director positions are occupied by women and the number of female CEOs has declined over the past three years. It also notes that only 8 per cent. of FTSE 100 board positions are held by non-white directors.

The Committee recognises the fact that existing legislation requires a degree of reporting on these issues, but suggests that the current framework is not clear enough. It is therefore recommending the following:

- The term "senior manager" (which is the term used in the current regime for company reporting) should be clarified so that more meaningful metrics can be produced. This supports previous recommendations by the Hampton-Alexander Review on FTSE Women Leaders.

- The report also recommends amending the Code to **require listed companies to disclose the gender balance** on their executive committee in their annual report.

- The Committee has also set a mission statement that, from May 2020, at least half of all new appointments to senior and executive management positions in listed companies should be women.

- To tackle the current lack of ethnic diversity, it recommends enacting legislation to ensure that all FTSE 100 companies and businesses **publish their workforce data, broken down by ethnicity** and pay band.

- Finally, to open up access to a more diverse director base, the Committee wants to revise the Code to **require appointments of new directors to be conducted by open advertising.** This would be coupled with a new role of the FRC to oversee the rigour of director evaluation processes.

The Committee's recommendations concentrate on greater transparency and reporting, rather than minimum quota. This means that, to be effective, they will need to rely to a large extent on pressure from and involvement by investors and clients. This would require considered dovetailing with the Committee's proposed changes to the Stewardship Code.

While open advertising may well widen the talent pool from which listed companies can choose, to monitor this effectively the Committee wants to place yet more responsibility on the FRC. Again, this will require significant investment so as to substantially expand the FRC's activities from its current role as the guardian of financial reporting. Whether this can be done in practice, and where the funding will come from, remain open questions.

WHAT NEXT?

The Committee's report provides plenty of food for thought. Some of its proposals are modest and appear feasible, others are bolder and potentially harder to implement in practice.

Perhaps most ambitious is the proposal to transform the FRC into a much more wide-ranging supervisory authority, including renaming it to better describe its proposed new role.

The Government certainly has a lot on its plate at the moment.

Quite apart from the impending negotiations on the future of the UK outside the EU and the possibility of a second referendum on Scottish independence, the Government has yet to set out the detail of its proposals for extending the current PSC regime to other kinds of domestic legal entity; it has only just started consulting on its proposal to require overseas entities to disclose their beneficial ownership; it is in the middle of conducting a wide-ranging review on simplifying UK tax legislation; and we still await its proposals on exceptions to the continually postponed prohibition on corporate directors.

Whether the Committee's recommendations can ultimately be put into practice may depend less on will, and more on wherewithal.

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