

Promoting long-term wealth

Reshaping corporate governance

A report by Tomorrow's Company for the All-Party Parliamentary Corporate Governance Group



The All-Party Parliamentary
Corporate Governance Group

tomorrow's
company

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Foreword



Corporate governance reviews initiated by government are, more often than not, prompted by immediate issues of public concern. Historic worries to stop a UK Enron scenario, bankers' bonuses, distaste over "vulture" capitalists and now executive pay have, in turn, led to demands for a rethink on governance.

Whilst not discounting valid concerns in the Government's current Green Paper, Tomorrow's Company make the important points that; adding layer upon layer of governance regulations can obscure their point, that regulatory reform can be short-termist where a long-term approach is what is needed; and that reforms have become too focussed on avoiding scandals rather than supporting success.

Tomorrow's Company calls for a more holistic approach noting that looking at executive remuneration, in isolation from wider governance issues, is not going to restore public confidence in corporations. A long-term approach demands that companies, their boards and shareholders look beyond immediate share price implications. Where historically, corporate governance and corporate responsibility have been treated as separate objectives, Tomorrow's Company argues that a long-term approach demands viewing these all as part of the same wider aim to assist sustainable wealth creation.

The proposals in this paper form a coherent attempt to encourage long-term investment in and decision making by companies. They recognise and build on the many good examples of excellent governance to be found in many UK companies and, rather than suggesting threats for poor practice, they concentrate on methods to encourage good and long-term practice.

I want to thank Laurie Fitzjohn-Sykes for his authorship and the Officers of the APPCGG, as well as our Facilitator, Jennifer Bryant-Pearson, for their keen interest and involvement in developing this excellent and timely report. We look forward to receiving feedback from our members on the proposals, which will be included in our response to the Government's consultation.

Jonathan Djanogly MP

Chair
All-Party Parliamentary Corporate Governance Group

Executive summary

Since the invention of the joint stock company, there has been continual change in the way our companies are owned and governed to meet the needs of the time. Some of this change has come naturally, and some of it as a result of action by the Government. Today new forces for change are building, and with them come challenges and opportunities. There is a widespread desire to restore public trust in business and to tackle short-termism. There are also great opportunities which come, among other things, from technology, new types of business organisation and a growing movement for purposeful companies. Continually updating how our companies are owned and governed will be critical to creating wealth in these uncertain times.

It is primarily the action of companies themselves – their leaders, their employees, their partners and their owners – which will determine the success of the UK business sector. Nonetheless, government has a crucial role to play in removing some of the obstacles to success, and taking a joined-up view across all policy areas so that there is a conscious focus on the encouragement of long-term wealth creation by companies. This is important, both for the success of UK companies and therefore economy, and in maintaining the UK's position as a global leader in corporate governance and asset management.

Tomorrow's Company has always argued that the key to doing this well is to accentuate the positive: to learn from and to build on the success of the UK's best led, most enduring and fastest growing companies. Government has a crucial role in creating a climate in which more and more entrepreneurs and investors are encouraged to follow their example to the benefit both of the economy and society. The influence of government is felt, in different ways, all along the stewardship value chain that links savings by citizens to investment by institutions, through to the performance and impacts of companies.

It is important that the UK Government concentrates on positively supporting and encouraging the majority of companies in creating sustainable wealth for shareholders and society, rather than only focusing on executive pay and the inevitable few bad apples that make the headlines. The answer to low public trust, productivity and growth is the same – encouraging and supporting companies to deploy capital in pursuit of a purpose that benefits society and shareholders.

This report primarily focuses on how to achieve this for listed companies, while recognising that this is a small, but important, part of a much broader business ecosystem. Many private companies look to best practice set by listed companies. Accordingly, a listed company focus can help develop policies that also support wealth creation in private companies, which make up the majority of the economy.

The proposed reforms take a joined-up approach across how companies are led, governed and owned. They aim to achieve three outcomes – increased influence by patient capital, an enhanced voice for stakeholders and the space in boardrooms to focus on the long term. It is the combination of these three elements that will support and encourage UK companies to invest, and through this improve public trust, productivity and growth.

There is also a need for the policies outlined here to be supported by a broader range of policies outside the scope of this report, including new corporate forms, government procurement, industrial strategy, education and research.

Not all of these reforms can be implemented at once; we see them as a road map for government policy over the next 5–10 years. Some policies are outlined in detail, while others are setting a new direction of travel. As far as possible, cross-party support should be achieved for this road map so that business can plan with confidence.

I. Patient capital and stewardship investors

The UK's capital should be mobilised to support the long-term success of UK companies and economy. We can achieve this by creating large pools of patient capital with the scale to be effective stewards, and then by encouraging these pools of capital, and others, to invest in and support UK companies over the long term. Through improved governance structures shift the balance of influence towards these stewardship shareholders rather than short-term traders.

Policy 1: Long-term capital trusts (LTCTs)

Create a new tax-efficient investment trust structure that has a mandate to support UK economic growth by being an engaged stewardship investor in UK companies. The policy will create funds with the scale to hold large and long-term stakes in UK companies, which is critical to effective stewardship. Rather than the complex process of merging pension funds to create the necessary scale, this policy creates new investment funds with the scale to invest long-term in the UK.

Policy 2: Stewardship stake designation

A new framework providing shareholders in UK companies with the ability to designate a specific stake as a stewardship stake. This would come with a balance of a long-term commitment, increased influence, and a range of financial and non-financial incentives.

Commitment

- A 2-year lock-up, after which a 3-month rolling notice period to unlock, followed by 6 months to sell before the decision to end the stewardship designation is made public.

Incentives

- A requirement for LTCTs to use the stewardship stake designation for 50% of holdings. Use of the designation would also be a powerful signalling device of an asset manager's stewardship credentials and could be rewarded by a superior ranking in the tiers now used for Stewardship Code signatories. This could be enhanced with tax incentives, starting with stamp duty exemption, and if needed, more radical tax incentives could be considered, such as a corporation tax rebate.

Increased influence

- Double votes on remuneration only at the AGM for stewardship designated shareholders. This would provide greater influence to stewardship shareholders without a significant deviation on 'one share, one vote'. It would also help encourage longer-term focused executive remuneration.
- Require companies to disclose how they are engaging and consulting their stewardship designated shareholders. The guidance would be for a meeting 1–2 times a year between the stewardship shareholders and the board to discuss strategy, remuneration and nominations. This could be along the lines of the [Stewardship and Strategy Forum](#) meetings organised by the Investor Forum.

Policy 3: Expanded and strengthened Stewardship Code

Expand the Stewardship Code to cover the roles played by different actors throughout the investment chain – covering asset owners, investment consultants and companies, in addition to asset managers. The Code could also be strengthened by outlining in more detail how the principles translate into action for each actor in the investment chain.

II. Increased voice for stakeholders on long-term value creation

The sources of long-term value are increasingly intangible and are built on key stakeholder relationships. Listening to and consulting these stakeholders is a critical step to making good long-term decisions in boardrooms. This is already a focus for many boardrooms, and a climate of innovation, challenge, and early warning of emerging risks could be enhanced with a stakeholder advisory panel and broadening the remit of the remuneration committee. Stakeholder advisory panels would also create a mechanism to hold boards accountable for honouring the wider duties in Section 172 of the Companies Act 2006.

Policy 4: Stakeholder advisory panel

On a 'comply or explain' basis, require companies above a certain size to introduce a stakeholder advisory panel that has a mandate to provide the board with the stakeholders' view on long-term success, and challenge the board on the wider duties within Section 172. In this role, the panel would be an external source of challenge to the board on its fulfilment of its stated long-term purpose, values and strategy. This would be an informal mechanism by which the board felt accountable for fulfilling its duties under Section 172.

Companies would have flexibility on how to implement the panel. Seven principles are proposed as guidance against which companies would explain how they have been applied. To provide the panel with sufficient influence, this would include the right to make a public statement and the requirement to make a statement in the annual report.

Each company would decide the composition of its panel and process for appointment according to the key stakeholder relationships that are key to the company's long-term success. In most cases this would lead to a majority being employees. The panel should become a key source of information for non-executive directors that has not been sanitised by the executives. For the avoidance of doubt, the panel would not form a formal part of the company's governance and would not in any way dilute the principle of the unitary board, elected by shareholders at the AGM.

Policy 5: Broaden the remit of the remuneration committee

It is people and talent that represent the most important source of value to companies. Therefore, the ability of the board to focus on creating long-term value would be enhanced by broadening the remit of the remuneration committee to include the pay, incentives and conditions of all staff, and the company's wider strategy around talent, culture, diversity and succession, on which an effective and credible remuneration policy needs to be based. This would move remuneration committees away from focusing on the technicalities of executive pay, towards whether the totality of pay and people practices support a company's purpose, values and strategy.

III. Space for effective boardroom decisions

To focus on the long term, boards not only need the support of patient capital and to hear the voice of stakeholders, they also need the space to stand back and reflect. Currently, the Governance Code and regulations are in danger of becoming too prescriptive, adding to the clutter of boardroom agendas. The intent of 'comply or explain' was rightly to enable flexibility and innovation, but as applied in practice it has become too close to 'comply or else'. In the worst cases, this has led to an uncritical 'one-size-fits-all' approach to governance. In contrast, we want to declutter boardrooms, encourage a focus on principles rather than process, and through doing this encourage a greater diversity of approaches.

Policy 6: Clearing the clutter from boardrooms

A new direction of travel is needed that looks to progressively simplify the governance codes and regulations relating to boards. One way to achieve this could be to move away from a long list of provisions in the Governance Code with a 'comply **or** explain' requirement, towards a shorter list of principles with an 'apply **and** explain' requirement. This has recently been adopted in South Africa's King IV Governance Code.

This would encourage boards to actively consider the governance structure that would support their purpose, strategy and business model. This may vary greatly, depending on the complexity and geographical reach of the business.

In time, the combination of active stewardship shareholders and decluttering governance may lead to a change in the role of non-executive directors (NEDs). The role of the NED may shift from being an arms-length monitor towards a more engaged partner of the executives. This could be supported by an increase in the time commitment and resources made available to NEDs.

Challenges and opportunities

The forces for change are increasing. Business faces the challenge of low public trust, low returns, and the potential volatility emerging from climate and geopolitical shifts. This is offset by the opportunities from technology and a growing movement for responsible business.

The UK is a global leader in governance and asset management, due to decades of reforms and business-led initiatives. However, reforms have become too focused on avoiding scandals, rather than supporting success. The cumulative effect of layer upon layer of regulation and codes has been to make it harder for boards to focus on the real drivers of wealth creation – innovation, investment, and consistency of purpose. This is equally true of the recent Government Green Paper on corporate governance (the “*Green Paper*”). Government reforms need to support wealth creation through increasing the influence of patient capital and stakeholder voice, as well as creating the space for these two influences to be incorporated into board decision-making.

The forces of change

How companies are owned and governed has constantly changed to meet the needs of the time. The Company as a separate legal entity originally came into existence to fund and organise overseas trade. Companies then pooled capital for investment in railways and now coordinate the majority of our economy. This has been a story of constant change that we should expect to continue. The confluence of factors pushing for change is now as great as ever. Some are challenges that business needs to address and some are opportunities to be captured. Change is inevitable; the question is, in what direction.

The loss of trust, low returns and short-termism

The main issue driving calls for reform is the growing disconnect between business and society. This was expressed in the EU referendum as a desire to ‘take back control’. Many in government, business and finance recognise that action needs to be taken to improve the public’s trust in business.

The debate often focuses on the emotive issue of executive pay and, while this is an important topic, restoring trust will take more than reducing remuneration. Instead, we need to find ways to empower business leaders and communities to harness the power of business, in order to solve the most pressing problems of society.

Another major force for change is the relatively poor performance of UK business for key stakeholder groups. These trends were highlighted in a recent report by Tomorrow’s Company, [UK Business: What’s Wrong? What’s Next?](#):

- stagnating real wage growth, especially for lower income groups;
- low employee engagement;
- low business investment;
- low productivity;
- poor total long-term returns to shareholders, contributing to rising pension deficits.

There are a range of explanations for these relatively low returns for shareholders and society, from technology to global competition to demographics. These factors have all had a role to play, but in the UK they have been exacerbated by the short-term approach adopted by many investors and companies.

The issue of short-termism is seen most starkly in the rising level of dividends and share buybacks. The UK’s largest companies are forgoing profitable investment opportunities to return cash to shareholders. In 2014, non-financial companies paid dividends of £119bn, leading to net corporate saving of £128bn – 8% of GDP, up from 3–4% in the early 1990s. This might not be a problem on its own, but the financial system reinvests this money in existing financial assets or government bonds, rather than productive business investment.

One cause of this is that companies are using high internal hurdle rates to decide whether to pursue an investment opportunity. Many boards look for a return on capital of 15% or higher from investment projects, leading to the rejection of profitable investment opportunities. For example, a recent survey of the S&P500 found the median hurdle rate was 18%.¹ Anecdotal evidence suggests this is the same in the UK. Furthermore, as interest rates have fallen, hurdle rates have stayed the same. The classic economic assumption that lower interest rates lead to higher business investment does not seem to happen in practice.

The uninvested funds are then returned to shareholders, via dividends and buybacks, who then often reinvest the money in assets providing a lower return than the company could have achieved. This is seen most starkly for pension funds. Surveys of US pension funds have found the average expected nominal return is around 7.5%, which many think is unrealistic given current yields, but is still significantly lower than company investment hurdle rates.² UK pension schemes are likely to have a similar expected nominal return.

Instead of removing capital from our companies, we need investors and companies to deploy capital in tackling the challenges facing society, and through this create wealth for employees, shareholders and society. Housing, renewable energy, infrastructure, new approaches to health and social care, investment in talent and education – all these are areas where both society and the economy would be better served by companies that invest.

An opportunity to support success

Set against the challenges of low trust, low returns and short-termism is a more encouraging picture of successful companies acting responsibly outside the public eye. For each BHS, there are many more success stories. For example, JCB's investment in UK manufacturing, Unipart's culture of innovation and employee ownership, GSK's commitment to tackling antibiotic resistant diseases, Virgin Money's commitment to serving all stakeholders, and Adnams investing in low carbon and water usage facilities.

There is increasing awareness of the importance of being a responsible corporate citizen, and of creating value for all stakeholders. This is being recognised by an increasing number of business leaders and investors, as shown in their actions and numerous opinion surveys. While there is still a tendency for more talk than action, the balance is improving.

The importance of purpose and stakeholders is being incorporated into decisions by many large companies. It is also the driving force behind a group of start-ups that are pioneering new business models and organisational forms that provide individuals with the purpose and autonomy that are crucial to well-being, as highlighted in the Government's [Mission-Led Business Review](#).

There is an increasing body of evidence showing that business success is achieved by pursuing a long-term purpose which aligns with society and creates shared value with stakeholders. This has recently been highlighted by [Tomorrow's Company](#), [The Big Innovation Centre](#) and [Blueprint for Better Business](#).

Overall, there is a lot to be optimistic about. There is a growing body of companies that are pioneering a different approach. There is a generation of business leaders who are trying to adopt a different approach in existing large companies. Supporting this is a mounting body of evidence and organisations that advocate the importance of purpose, values and stakeholders to business success.

Progress made and the opportunity for reform

Since the Cadbury report in 1992, there have been continual improvements to corporate governance in the UK, rightly placing the UK as a global leader in the field. The recent *Green Paper* is a helpful continuation of this. It includes many sensible policies, some of which are expanded on in this paper. The *Green Paper* rightly highlights the strength of UK corporate governance, with high overall standards of corporate behaviour, and scandals being rare. The UK Government certainly should continue to reduce the likelihood of scandals and tackle executive pay, but this is not the answer to productivity, public trust or economic growth.

The *Green Paper* places too much focus on tackling executive pay and reducing scandals, rather than supporting wealth creation through the purposeful deployment of capital in well-led companies. Instead, we need to focus on how to support the majority of companies that are trying to act responsibly, rather than yet again focusing on the inevitable few bad apples that make the headlines.

The need for reform does not mean increasing the regulatory burden. On the contrary, reforms should create the structures that allow companies to be given more freedom. Reforms should support the best examples, rather than only focusing on preventing the failures. In doing this, reforms should aim to catalyse a larger cultural shift, rather than to prescribe the exact nature of the desired change. Achieving this requires a joined-up view of governance, ownership and the investment chain.

Further enhancing reforms would be a broad consensus across Westminster, the City and business. Sufficient time should be taken to develop a consensus that would provide the confidence and consistency business need to plan and invest.

Opportunity for the UK to continue to lead on corporate governance

This is a real opportunity for the UK – reforms to corporate governance are not only important to UK companies, but also in maintaining the UK's position as a leader in governance and asset management. One of the UK's greatest assets is the City and related professional services. This relies on companies choosing to be based here and raise finance here, as well as investors choosing to place money here. The success of this industry long term will depend on UK corporate governance structures delivering long-term value for companies and shareholders, rather than extracting value from the corporate system.

Listed company focus

The policies outlined in this report are focused on the governance and ownership of listed companies. While this is a narrow focus, it is an important one. UK listed companies employ 3.7m people (16% of private sector employment) and account for 47% of domestic investment.³ Beyond direct employment and investment, listed companies have a greater impact by acting as the coordinating hubs for industries with an ecosystem of smaller suppliers.

The ownership and governance of listed companies is in many ways a key export for the UK. The UK is seen as a global leader in corporate governance. This helps attract companies to the UK, supporting the success of the City. The UK has the world's second largest asset management industry, managing £6.9tn, of which £2.9tn is from overseas. With the uncertainty post the EU referendum, it is critical that the UK continues to attract investment, companies and finance.

Listed companies also often set the standards of governance that private companies seek to follow. Improving the governance of listed companies is therefore a key means to improve the governance across all UK companies. Therefore, one test for the policies outlined is whether they would also support wealth creation in private companies.

Nonetheless, it is important to recognise the limitations of focusing on listed companies. To be effective, these policies will need to be part of a wider set of policies supporting innovation, start-ups and the broader business ecosystem.

Some of these wider policies are:

- Private company transparency
- Government procurement
- Encouraging diversity in corporate form, and ownership structures, policies and tax regimes that encourage business at crucial stages of growth and transition to adopt ownership models that are most likely to achieve the objectives described in this paper
- Bank credit creation
- University research
- Training and education
- Scale-up capital for start-ups

Three areas of reform

There have been many attempts to tackle these issues, especially the question of short-termism. To be effective reforms need to tackle the underlying causes, rather than seek to mitigate the symptoms. Too often there is a focus on aligning interests and creating accountability with short-term targets (1–3 years). Instead, reforms need to support the structures, institutions and culture that enable trust.

Underlying many of these barriers to wealth creation is the balance between trust and accountability in each relationship. This balance exists at each step in the investment chain – pension trustee to asset manager, asset manager to board, board to CEO and CEO to employees. This is often described in economics as a principal-agent relationship.

Too often the desire for accountability has led to the introduction of targets and financial incentives. The problem is that targets by their nature are based on short-term outcomes; therefore, in the understandable desire for accountability, short-term distortions are introduced.

The alternative is to apply the principles of stewardship throughout the investment chain, creating structures that encourage and justify greater trust in each relationship. We define stewardship as the responsible management of inherited resources so as to pass them on in better condition. If all those involved see themselves as stewards this decreases the need for short-term accountability and monitoring, and so frees individuals to focus on what will lead to long-term wealth creation, even if this cannot be measured or assessed in the short term. Three areas of reform are required to enhance the focus on long-term wealth creation.

We need to move beyond the classic debate between increasing or decreasing the power of shareholders. Often debates around corporate governance agree on the diagnosis of short-term shareholder pressure, but then disagree if the solution is less shareholder influence, or increasing the number and influence of long-term shareholders.

To support long-term wealth creation, we need to increase the scale and influence of patient capital and so align its representation and engagement more closely with the board's intentions; increase the voice of stakeholders and create the space in boardrooms for effective decisions.

The policies outlined in the following sections could be implemented on their own, but would be far more effective in combination. Creating pools of patient capital has more impact if governance structures provide more influence to long-term owners. Similarly, long-term owners can help support sustainable wealth creation if they, and the companies in which they invest, hear the voice of stakeholders. Lastly, the increased influence of patient capital and stakeholders will have more impact if boardrooms and fund managers have the time and information to take long-term decisions.

I. Patient capital and stewardship investors

The UK has £10.2tn of net household wealth, £2.1tn of which is in pension funds.⁴ This capital could be more effectively mobilised to support UK companies and long-term wealth creation. UK companies are too often subject to damaging short-term pressure from shareholders. This issue has been highlighted by many people, including in the [Kay Review](#) in 2012. Instead, the UK needs pools of patient capital which have long-term horizons and a willingness to support UK companies as stewardship investors.

II. Increased voice for stakeholders on long-term value creation

The sources of long-term value are increasingly built on the health of stakeholder relationships. Boards are responding with surveys, additional information in management reports and supplementing with site visits. However, there is a limit to what can be achieved given the time constraints NEDs face. Furthermore, there is at present no effective governance mechanism by which boards can be held accountable for their obligation under Section 172 of the Companies Act. This requires them to have regard to the likely consequences of decisions in the long term, and the interests of employees, suppliers, customers, the community and the environment. Without imposing a rigid formula, the UK Government can stimulate boards to innovate in the way they bring these obligations to life, through the way they consult and engage with stakeholders.

III. Space for effective boardroom decisions boards

Despite 25 years of governance improvements since Cadbury, NEDs are still information and time poor. Expectations have increased on NEDs in excess of the time and resources to deliver. If more board time has to be spent on considering the latest guidance note or regulatory change, less time will be spent reviewing strategy, culture and the greatest dilemmas, risks and opportunities faced by the company. This contributes to a risk-averse culture in many boardrooms.

While this was never the intention of ‘comply or explain’, Governance Codes are at risk of being too prescriptive. Company secretaries and general counsels have observed that in practice ‘comply or explain’ has come to be interpreted as ‘comply or else’ and the manner in which the latest Financial Reporting Council (FRC) report highlights non-compliance reinforces this perception. This creates a focus on box-ticking rather than meeting the principles of the Code. Instead, a new direction of travel is needed that simplifies governance and moves to a fully principles-based regime.

I. Patient capital and stewardship investors

The complaint of short-term pressure from shareholders has been voiced for many years. There have been numerous reviews, reforms and initiatives to instil a longer-term focus in UK equity markets, but more needs to be done. The focus of the majority of the investment chain remains relatively short term, which puts pressure on companies not to invest. To tackle this, reforms need to create pools of patient capital, encourage stewardship investors, provide these investors with greater influence, as well as improving the wider workings of the investment chain through an updated UK Stewardship Code.

Barriers to patient capital and stewardship

Asset owners

- Asset owners allocate capital to meet regulations and match liabilities, rather than support UK companies and meet the capital needs of the economy. The majority of pension funds still have a narrow focus on how to deliver financial returns to meet the accrued liabilities of existing scheme members.
- Attempts have been made to broaden the focus of pension fund trustees, most notable with the Law Commission's report on the [Fiduciary Duty of Investment Intermediaries](#). However, there is limited evidence that many pension trustees are taking a wider view. Pension trustees either misinterpret or do not have confidence in the wider implications of fiduciary duty. This often leads to asset owners to issue mandates and monitoring performance over a short-term horizon, despite their own horizons being long term. This was highlighted by a recent study by the UK Government, [Metrics and models used to assess company performance](#).⁵
- This narrow focus has been reinforced by market practice that has been focused on de-risking pension schemes in order to reduce the volatility of deficits. This has resulted in a significant shift away from equities towards debt. This is a perverse notion of de-risking. Pension funds now predominantly hold low-yielding debt, which delivers an insufficient return to meet their obligations, and does not serve the present or long-term interests of the ultimate beneficiaries.
- The asset owner space is quite fragmented and hence lacking in scale. For example, there are over 6,000 separate Defined Benefit (DB) pension schemes. This makes them reliant on investment consultants and the current offering of the asset management industry. Fragmentation is likely be exacerbated by the shift from DB to Defined Contribution schemes (DC), leading to smaller pools of capital.

Asset management

- The asset management industry predominantly focuses on delivering outperformance versus a benchmark through trading shares. This is in contrast to delivering value by supporting the companies they own to achieve long-term success.
- Asset management also incurs and charges high fees to savers. Asset managers charge fees based on the promise of outperformance that in aggregate they cannot deliver. Management fees are used to resource a near zero-sum trading game, rather than supporting long-term value creation. High fees are exacerbated by excessive intermediation that increases costs and disconnects savers from their investments. As highlighted in the Financial Conduct Authority's (FCA) interim report for the [Asset Management Market Study](#), average management fees for active funds are just below 1% per annum, a high cost given the market dividend yield is 4%.
- Shareholders influence companies primarily through their decision to buy or sell, rather than through formal governance structures. Combined with fragmented shareholdings, this leads to a low incentive for asset managers to engage and support companies achieve long-term success.

Policy 1: Long-term capital trusts (LTCTs)

Create a new tax-efficient fund structure designed to encourage long-term investment in the UK. The aim is to create larger pools of patient capital without the difficulty of merging existing pension funds, which is compatible with a DC world and works with the existing reality of significant foreign ownership in the UK. The balance of incentives and obligations would need to be struck to attract capital and to have a meaningful impact on capital allocation.

Why this is needed

As highlighted earlier, there is currently a shortage of patient capital. Many asset owners have long-term horizons, but these are often converted into short-term focused fund selection and mandates to asset managers. In addition, the investment returns to asset owners are currently significantly reduced by high investment fees. For any saver building up a pension pot from the age of 25 and paying 1% fees per annum, at the point of draw-down at age 65, a third of the pension will have been lost as fees.

Worse still, the UK's listed companies are suffering too. The market's short-term focus on 'beating the benchmark' through trading does little to support companies achieve long-term success. Shareholder engagement can be weak, or worse still outright destructive as it encourages businesses to 'gild rather than build'. This policy aims to create a pool of capital that seek to deliver returns by supporting companies achieve long-term success while incurring low fees.

Individuals and asset owners would like to invest long term, but end up investing short term. Similarly, funds would like to have committed capital in order to invest long term, but inevitably end up focusing on short-term performance. The proposed framework would bring both sides together.

Scale is critical in achieving this long-term, low-cost and stewardship-focused investment approach. Scale provides the ability to move investment teams in-house, which reduces fees and enables them to accept greater short-term volatility in the pursuit of long-term performance. Scale also enables funds to buy larger stakes in companies that are critical for stewardship.

There is a global trend towards pension schemes moving investment management in-house in order to reduce costs and carry out long-term investment.⁶ A prominent example is the Ontario Teachers' Pension Plan (OTTP) in Canada, which had \$171bn of assets at the end of 2015. The majority of its investment management is in-house, including a private equity group that invests \$28bn and has played a lead role in many transactions.⁷ More detail on OTTP's move into private equity can be found in this [case study](#).

Similarly, the Canada Pension Plan manages \$210bn of assets on behalf of 19 million savers putting it into the top 10 of pension funds globally. This scale enables it to build investment expertise internally and open regional offices to place investment professionals closer to key markets. In addition, features of the regulatory regime in Canada, including the absence of restrictive investment and solvency regulation, allow the Canada Pension Plan to invest for the long term, with [expected holding periods](#) of over five years for most asset classes and with a focus on infrastructure investment. Indeed, historically, infrastructure investment has been highest globally among the Canadian and Australian large funds.

Further examples are found in the Nordics, where pension funds hold large stakes in domestic companies, and in the Netherlands, where 90% of the labour force is enrolled in a pension plan and the two largest funds (ABP, with €344bn under management, and PFZW, with €162bn under management) are again among the 10 largest funds in the world and manage their investments in-house. Australia has also created pension funds with significant scale through the creation of superannuation funds in the 1980s with a 9% required contribution, due to increase gradually to 12% over the next decade.

The issue is that UK pension funds do not have this scale. The UK is the second largest pension market in the world with \$3.2tn of assets (2015),⁸ and yet the UK's largest pension fund (BT Pension Scheme) is only number 44 globally, with \$68bn of assets.⁹ Relative to other countries, the UK has a relatively even distribution of funds between pension schemes, while other countries often have a few very large funds. This issue was also highlighted by the [PLSA's DB Taskforce Interim Report](#).

This lack of scale is exacerbated by the low investment by UK pension schemes in UK equities. From 1960 to 2000, the average UK pension scheme allocated around 50% of funds to UK equities; this has now fallen to 18% in 2015.¹⁰ Data from the Office for National Statistics (ONS) paints a bleaker picture: beneficial ownership of UK shares by UK pension funds has fallen from 22% in 1998 to 3% in 2014.¹¹ Pension funds are the largest source of capital in the UK, but they invest too little in UK companies to be effective stewards.

The issue of fragmentation could be made worse by the shift from Defined Contribution (DC) schemes to Defined Benefit (DB) schemes. This could lead to individuals investing in a large range of funds, rather than a single company scheme. One positive development is the introduction of Master Trusts, which are multi-employer pension schemes. These have the potential to create much greater scale as they serve multiple employers. In particular, Master Trusts are being set up to serve automatically enrolled members of pension schemes. However, they currently lack scale; the largest Master Trust is NEST which has £1bn in assets.¹² It is growing slowly with auto-enrolment, but it is a long way off having the scale to be an effective stewardship investor in UK companies.

Greater scale is also being achieved by the UK Government's plan to merge 89 local government pension schemes into six wealth funds, each with more than £25bn.¹³ The Government's rationale for this was to increase infrastructure investment, but it could also help create the scale to be stewards of UK companies. However, in general, merging pension funds is too difficult to implement more broadly.

This policy creates the necessary scale for stewardship by forming a small group of funds that pension funds, and other asset owners, can invest in. These funds would have the mandate and scale within UK equity markets to act as effective stewards of UK companies.

Lastly, it is often highlighted as a problem that the UK is one of the most open countries to corporate takeovers. Many see this as a key cause of short-termism as it pressures management to avoid a low share price that could attract a takeover. This policy would help mitigate against this by creating a group of investment funds that had the aim of deploying capital in the UK economy. For these funds, accepting a takeover offer may be unattractive as while it leads to a one-off short-term return, it removes forever the potential to invest in that company going forwards. They might struggle to better deploy the capital elsewhere in the UK.

Proposed structure

The proposed structure is to create a new marketplace for multiple long-term focused investment funds with committed capital. This would operate as a subset of the current asset management industry, with a mandated allocation of capital from pension funds and the approval of funds overseen by the FCA according to a set of principles. There would be a combination of commercial and non-profit entities creating these investment funds.

- The Government would set out a framework with a combination of tax incentives and obligations for long-term investment.
- Any individual or entity could invest in them. This could be UK individuals, UK pension funds or foreign investors.
- Any organisation could create one of these funds, but each would have to secure approval from the FCA. The aim would be to only approve a limited number, so that each one had sufficient scale. They would be assessed periodically to check they were fulfilling their mandate and hence entitled to any tax breaks.

- Each fund would be assessed annually against the principles in the framework. The FCA would then issue recommendations for changes or a warning. If issues were not addressed after multiple warnings, then the FCA would have the power to shut the fund down, but with a tender process for other managers to take on the portfolio of assets. This would avoid the damage of creating a forced seller of assets. The administrative burden of this would be limited by only giving approval to a small number of funds.
- These funds would initially start with a focus on UK listed equities, but they could be subsequently expanded to other asset classes. In particular, this could include venture capital and infrastructure projects.
- It is envisaged that these funds would be created by a combination of large UK asset managers and the non-profit entities that have created Master Trusts. The combination of commercial and non-profit providers would help provide effective competition.
- The recently launched [People's Trust](#) could also become one of these funds as it meets many of the principles below – low-cost and long-term focused. It has already attracted significant media attention and its business model could certainly be adapted to deliver asset management in-house.
- Similarly, the Woodford Patient Capital Trust (WPCT) exemplifies the aim of this policy. The WPCT states: “We invest in the true sense of the word, buying stakes in businesses and helping them to fulfil their long-term potential”. The WPCT has low fees, and has already £800m invested – 75% in UK assets and with most in a concentration of early stage or early growth companies. If such funds could be dramatically sized up, there would be a tremendous benefit to the UK economy.

Funds would be assessed against a set of principles. For each principle, there would be some guidelines on the expected implementation, but flexibility if another route was sought. A starting list of principles and guidelines are outlined below. These would need to be refined as experience is gained.

Principle 1: Deliver investment returns while supporting the long-term sustainable success of UK companies and economy.

- 90% of assets must be invested in UK companies, or companies where the majority of operations are in the UK.
- Funds would state if they were investing in listed and or private companies. It is envisaged this would start with listed companies and then expand to private.
- Through investment decisions and stewardship, seek to support business investment in the UK. Hence, encourage companies to invest, rather than return cash to shareholders.

Principle 2: Seek to deliver returns through engaging and supporting companies to achieve long-term success, rather than trading based on changes in market expectations.

- This could include a requirement for at least 50% of assets invested in UK listed equities to be designated as a stewardship stake (see detail below in Policy 2 on stewardship stake designation). This percentage is guidance and could be adjusted through time. Policy 2 is a framework for shareholders to lock-up stakes in companies in exchange for greater influence and some tax incentives.
- For listed equity investments, a minimum average holding period of 5 years. This is compared to an average of 2 years for the entire market.

Principle 3: Gain sufficient scale to act as an effective steward of its investee companies.

- Funds should aim to exceed £10bn within 5 years; this would be larger than the current largest UK-only fund that has £6bn in funds.¹⁴ £10bn would allow a fund to own stakes of sufficient size to act as an effective steward.

Principle 4: Fund manager and analyst pay should be aligned with the long-term performance of the fund.

- For example, pay to be based on 5-year rolling performance or to be locked up in the fund itself. This is slightly longer than some funds that currently have remuneration based on rolling 4-year performance.

Principle 5: Deliver value for money, passing on the benefits of scale to investors.

- Have a fund management fee that falls with the size of the fund. For example, as Equitable Investment has introduced such a structure where the percentage management fee falls as the fund grows. This shares the benefits of scale between the fund manager and the saver.
- Maximum OCF (ongoing charges figure) of 0.7%. For example, the Government introduced a fees cap on Master Trusts used for auto-enrolment of 0.75% per annum. The FCA [review](#) found that the average clean OCF for active funds was 0.9%.

Principle 6: Communicate and engage with the ultimate beneficiaries, rather than through intermediaries.

- Where possible and without incurring prohibitive administration costs, funds should aim to communicate transparently with the ultimate beneficiaries. This could be clear disclosure on a website, a regular newsletter or surveys of beneficiaries.

Fund structure – closed-end investment trust

The funds would be structured as an investment trust, because a closed-end vehicle helps create a long-term approach. Investment trusts are companies with a normal listing that invest in other securities. Hence, once the money is raised in the initial share offering, it is locked up in the fund. This avoids the short-term pressure that arises in unit trusts when underperformance leads to outflows from the fund. This ability to pursue a long-term approach is arguably the reason that investment trusts have consistently outperformed unit trusts.¹⁵

This structure will remove the pressure to deliver short-term performance to secure fund inflows and avoid outflows. It will also avoid the funds having to sell shares due to outflows. In order to grow, the funds would need to carry out consistent share offerings.

Currently, investment trusts must pay out at least 85% of income (i.e. dividends) received. To enable investors in the funds to opt for this to be reinvested, the LTCTs should have a choice between a cash or a scrip dividend. A scrip dividend is additional shares in the fund, and therefore essentially means the cash is reinvested, rather than paid out.

Attracting funds – tax breaks, branding and a mandated allocation

To be effective, these funds would need to attract a significant pool of capital. This can be achieved by a combination of tax incentives and marketing benefits. It can also be kick-started by mandating a small allocation from UK pension funds. By way of context:

- The UK asset management industry manages £6.9tn, of which around £2tn is UK pension funds and £1tn is UK individuals.¹⁶
- UK listed companies have a total market capitalisation of £2.1tn.¹⁷
- The amount of funds currently managed with a UK-only equity mandate is £214bn (£43bn of this is in ISAs), with the largest UK funds at around £6bn.¹⁸

Many individuals and asset owners are already looking to invest long-term and with low fees, therefore the marketing benefits of these funds may be sufficient to attract a significant allocation of capital. The process of assessment against the stated principles by the FCA would make the job of selecting funds easier for the pension trustees.

This could be enhanced with a range of tax incentives for both individuals and institutions. Firstly, the funds will receive tax breaks through a significant proportion of investments being designated as stewardship stakes (see Policy 2).

In addition, there are a range of possible tax incentives for individuals.

- As with a pension, individuals could invest pre-income tax and with no capital gains tax once invested. Then as a further incentive they would pay a lower rate of income tax when income from the fund is drawn down.
- Similar to a Venture Capital Trust (VCT), tax incentives could be provided to individuals as long as they have held shares for 4 years.

- Flexibility could also be allowed on the £1m pension lifetime allowance. More people are hitting this limit; therefore, flexibility could be quite attractive.
- The tax break for stocks and shares ISAs could be restricted to investment in these funds. The total amount of money in ISAs was £518bn in March 2016, of this £250bn is in stocks and shares ISAs. Each year £80bn is subscribed in new ISAs, of this £20bn is in stocks and shares.¹⁹
- Relief on inheritance tax (IHT) could also be provided, similar to the relief for AIM shares.

Fund management is a scale industry. The new funds will need to be of a certain size from the beginning to be effective. The tax incentives should be sufficient to attract funds once at scale, but to kick-start the process it may be useful for the Government to require UK pension funds to allocate 1–5% to these new entities. UK pension funds have £2tn in assets, therefore a 5% required allocation would be £100bn. The 5% requirement could be varied according to the maturity and liquidity requirements of the pension scheme.

Mandating how a portion of pension assets are invested could be considered too high a level of interference by the Government. However, pension fund asset allocation is already heavily regulated. In addition, individuals are mandated to invest a portion of their income; this addition would ensure a small portion of that was invested in a way to support future UK prosperity.

A 5% allocation from UK pension funds, and 5% from UK individuals would total £150bn. If split between 10 funds, then this would be £15bn per fund. If fully invested in the FTSE All-Share, this would be an average 7% ownership.²⁰ This would create a real difference to the provision of patient capital invested in UK listed companies. By investing in smaller UK companies, their holding and therefore positive influence could be very substantial indeed.

Another way to attract funds from pension schemes would be to link allocations to the LTCTs to the Pension Protection Fund (PPF) levy. Pension schemes that invested in the LTCTs could be allowed to pay a lower PPF levy. Investment in LTCTs would support the UK economy and hence reduce the systemic risk to UK pensions; it is therefore natural that the Government should incorporate this into the level of the levy for each pension scheme.

Asset owner fiduciary duty

One barrier to the growth of the new proposed funds could be the narrow interpretation of fiduciary duty by many pension scheme trustees. Despite the work of the Law Commission, in its report on [Fiduciary Duties of Investment Intermediaries](#), most pension trustees narrowly focus on achieving financial returns to meet the accrued liabilities of existing scheme members.²¹

This narrow focus ignores how investment decisions impact on the future success of UK companies and economy, which ultimately is critical to the long-term prosperity of pension scheme members. For example, if a UK pension scheme invests abroad it only receives a financial return. In contrast, if a UK pension scheme supports investment in the UK economy, this will not only deliver a financial return, but also improve the outlook for the entire UK economy. Without successful companies, a strong economy and rising productivity, UK pension schemes will struggle to meet their long-term obligations.

Even though this would be broadly beneficial, trustees do not feel empowered to invest on this basis lest it be held against them by retirees whose vested interest in the future success of the UK economy is less straightforward. This bias towards the single-minded pursuit of short-term profit maximisation, on the basis that it is “safer” for trustees, has been debunked in various forums, including in the UNEP-commissioned [Freshfields Report](#). The bias, however, persists.

The Law Commission provided very clear [guidance](#) that in order to achieve long-term financial returns and hence fulfil their fiduciary duty, trustees may consider environmental, social and governance factors. The guidance clearly states that these factors are often financially material and therefore should be factored into investment decisions. Awareness of this guidance may need to be increased to encourage pension schemes to allocate assets to these new long-term UK investment funds. Alternatively, further clarification may be required to make it clear to UK pension scheme trustees that supporting the UK economy is a key means of delivering investment returns to scheme members.

Policy 2: Stewardship stake designation

This policy is for a new framework that lets shareholders choose to designate their stake in a company as a stewardship stake. This would come with the obligation of making a long-term commitment, offset by a range of financial and non-financial incentives, including increased influence. This is to encourage investors to own large stakes held for a long period of time and to positively engage with the company.

Why this is needed

The UK has relatively fragmented share ownership. This means most shareholders have stakes that are too small to influence management, and are easy to sell, which reduces their commitment and allows a short-term focus. This policy would encourage investors to own larger stakes for longer periods of time.

Many fund managers focus on trading based on changes in market expectations, rather than supporting companies achieve long-term success. This is even true for many long-only funds which hold long-term stakes in companies, but are still focused on actively trading this stake in the short term. This policy aims to catalyse a shift in focus, so that fund managers devote resources to supporting the long-term success of companies they own, rather than trying to profit from trading.

The issue of fragmentation and trading focus is compounded by the weak ability of shareholders to influence companies via governance structures. Instead, the main channel of influence is by the decision to buy or sell (i.e. through the effect this will have on the share price), rather than how to vote at the AGM. The policy includes a collection of mechanisms to increase the influence of stewardship shareholders relative to short-term traders.

Alongside this, there needs to be a shift in mind-set that acknowledges the trade-off between liquidity and stewardship. In reality, liquidity makes exit easier and so reduces an investor's commitment to a company. We need to acknowledge that lower liquidity may be required to increase the engagement and commitment of shareholders.

The policy would encourage more in-depth conversations between investors and management about the long-term drivers of value. These conversations already happen, but are currently too rare compared with the conversations that focus on short-term trading.

Proposed structure

The policy would put in place a framework under which investors could designate a shareholding in a company as a 'stewardship stake'. The framework would have a balance of commitment obligations, incentives and increased influence. The balance of these three elements could be adjusted to ensure it was attractive enough for shareholders to use, and strict enough to elicit a shift in focus.

i) Commitment obligations

- Shareholdings would need to be at least 3% of company ownership to ensure that the investor had sufficient size to be an effective steward. This 3% is also the level of holding at which ownership must be publicly disclosed, as it is deemed meaningful by the financial markets.
- There would be a 2-year initial lock-up period in which the stake could not be sold. A public statement would be made when an investor opted into the stewardship designation.
- After the initial lock-up, the investor would need to provide 3 months' notice to exit the designation. This notification would be provided in private to the company and the FCA. When the 3-month period had passed, then the investor would be able to sell. There would then be a 6-month period before it was made public that the investor had exited the designation. This is so to avoid an adverse share price move when a stewardship designated investor chose to exit.
- Groups of funds, either within an asset manager or between asset managers, could group together and lock-up their stake. This could include index funds.
- An allowance could be made for funds that need to trade due to inflows or outflows from their own fund, provided sufficient disclosure was made – the key is that they could not actively trade down their stake once committed.

- Investors would also need to provide evidence that they were dedicating resources to stewardship, so as to avoid index funds using the designation without carrying out any stewardship.

A key question for this policy is the length of time for the lock-up period. Average holding periods for UK shares have fallen significantly. For the FTSE All-Share in 2016, the total value of traded shares was around 50% of the market capitalisation. This implies an average 2-year holding period.²² However, this excludes trading by derivatives so may understate the amount of total trading.

The Investment Association (IA) rightly points out that within this there is a high degree of variation of holding periods between hedge funds and long-only funds. The IA found that funds in the UK All Companies sector (this sector has £158bn under management) had an average holding period of 40-70 months (3.3 to 5.8 years), and that 42% of holdings in this sector are held for more than 5 years.²³ Therefore, despite the average short holdings periods in UK equity markets there is a significant minority that already hold long-term stakes, many for over 5 years. A 2-year lock-up should not be that onerous.

ii) Incentives to encourage adoption

Strong incentives would be needed to encourage investors to lock-up their shares for a period of time. This would include financial and non-financial incentives. The key non-financial incentives are:

- The long-term investment funds (Policy 1) would be required to have a certain percentage of funds designated as stewardship stakes.
- As regulatory pressure on asset management increases, funds will increasingly look for ways to show their stewardship credentials. Having a certain proportion of stakes under the stewardship designation would be one way to achieve this.
- Asset owners will also increasingly look for active stewardship in their fund selection. Using the new stewardship designation would be beneficial to the marketing of the fund.
- Stewardship designation should in time lead to preferential access to company management as companies will prefer to meet those shareholders who have shown a long-term commitment. Management access is critical for fund managers; therefore, this could become a meaningful incentive.
- Investors that self-designate as a stewardship investor would gain increased influence, as outlined below.

The policy could also be supported by some tax incentives. The easiest tax incentive would be a rebate on stamp duty. Currently investors pay 0.5% on share transactions, which raises £3bn per annum for the UK Government.²⁴ There has been pressure to cut this tax as it is high by international standards. Instead, a rebate could be offered to stewardship investors. 0.5% may sound like a small incentive, but small margins often determine fund outperformance or underperformance. This policy could be strengthened by not only offering stewardship-designated shareholders an exemption from stamp duty, but also distributing to them the remaining stamp duty collected.

Additional tax incentives are difficult because funds do not, in general, pay income tax or capital gains tax. These taxes are paid by individuals when they receive income or capital gains from funds. To encourage change in the system, we may need a new means of tax incentive. One suggestion is a rebate on corporation tax for stewardship investors. A company would calculate its UK corporation tax paid per share. Stewardship investors would be entitled to a percentage of this as an incentive. The headline rate of corporation tax could be increased to leave the total amount of tax raised unchanged. As context, UK corporation tax paid is forecast to be £43.5bn by the Institute For Fiscal Studies (IFS) from a tax rate of 20%.²⁵ In 2014 the FTSE100 paid corporation tax of £5.5bn.²⁶ We estimate the UK corporation tax paid for the 1,300 UK listed companies is around £12bn. There is the potential for meaningful incentive, but we recognise the complexities of corporation tax reform. There may be more effective ways to introduce a financial incentive. One further option could be to reintroduce a dividend withholding tax – then offer an exemption to stewardship shareholders. The UK is one of the only countries not to have a dividend withholding tax.

iii) Increased influence for stewardship-designated shareholders

The influence of stewardship-designated shareholders could be enhanced in two ways. Firstly, by increased votes on a binding vote on remuneration. Secondly, through requiring the company to disclose how it is engaging and consulting stewardship shareholders.

By definition, stewardship-designated shareholders will believe in the long-term success of the company and its chosen strategy. They will want to support the execution of this strategy to maximise long-term returns. Engagement on strategy is most effective with the executive, hence why it is currently the executives (CEO and CFO) who conduct the majority of investor meetings. Given this, increased influence will be most effective where it increases the influence stewardship shareholders have on the executives, rather than on the board.

This influence could be achieved by providing stewardship shareholders with a greater say on remuneration. This could also help shift remuneration to a longer-term focus. The Government is already considering introducing binding votes on pay at the AGM. These could be introduced, but with double votes for stewardship-designated shareholders. The average turnout for votes on remuneration at the AGM of FTSE 100 companies is 72%, reducing to 60% for FTSE small cap.²⁷ If stewardship-designated shareholders held 10% of a company, then they would constitute around a third of the votes cast on remuneration at the average FTSE100 AGM. This means that managers of UK companies will be keen to speak to them, enabling stewardship investors to have better access than others.

An additional way to increase the influence of stewardship shareholders is to require companies to consult them and disclose how this has been done. It is envisaged that this would be a meeting once or twice a year between the board and the stewardship-designated shareholders. This could let the board consult the stewardship shareholders on board nominations, strategy and remuneration.

Companies already regularly meet their largest shareholders, but this is usually one-on-one and usually conducted by the executives. A meeting with all stewardship shareholders and the board would help to create a more cohesive conversation. This requirement could also prompt companies to provide preferential access to their largest and most committed shareholders.

The process by which a company formulates its strategy is normally quite long, often taking over 6 months. It starts with business unit budgeting, a board strategy away day and further iterations, before it is approved by the board. Within this there is plenty of time to consult and incorporate the views of stewardship shareholders. Long-term investors can bring a useful perspective to strategy as they have often followed a company through multiple CEOs and have a broader view of the industry. This could be along the lines of the [Stewardship and Strategy Forum](#) meetings organised by the Investor Forum.

This could be further enhanced by an annual meeting between the stewardship-designated shareholders and the stakeholder advisory panel (outlined in Policy 4). This would provide the stewardship shareholders with the stakeholders' view on the long-term drivers of value, to better understand the company, and thus debate strategy. To avoid legal or regulatory concerns regarding 'the creation of concert parties', such discussions could be subject to those terms of collective engagement specified by the Investor Forum.

Background of differential votes and dividends

There have been numerous reforms and ideas to build a long-term shareholder base and increase the commitment of shareholders. These include loyalty dividends and additional votes for long-term shareholders. Some are outlined below.

- The UK [Kay Review](#) (2012) suggested looking at providing additional voting rights to long-term shareholders. This received strong opposition as a departure from the principle of 'one share, one vote'.
- In France, some companies have secured shareholder approval to pay loyalty dividends to shareholders who have held their shares for 2 years or more. Regulations limit this loyalty dividend to be up to 10% of the regular dividend.
- France has also introduced the so-called Florange law in 2014 that requires companies to grant double voting rights to shareholders who have been registered for 2 years.

- Some have suggested loyalty warrants (L-shares) are issued to all shareholders with a time period before they can be exercised and are lost if the shares are sold. However, these have not been implemented.²⁸
- In 2013 the Generation Foundation conducted a consultation on loyalty-driven securities. It found agreement on the need to build a long-term shareholder base, but strong opposition to loyalty securities for the following reasons: it breaks ‘one share, one vote’; unintended consequences; administrative complexities; incentives may be too weak to change behaviour; and it may not tackle short-termism.²⁹
- In 2014 the EU proposed to amend the Shareholder Rights Directive to promote long-term shareholder engagement. Early versions looked at additional voting rights and tax incentives to encourage long-term shareholding, but these were removed from the final version.

This proposal is different to the above proposals and reforms because it does not involve companies paying higher dividends to a select group of shareholders. The financial incentives are provided through the tax system. There would also be significant non-financial incentives from marketing benefits, management access and influence. The proposed policy only flexes ‘one share, one vote’ for an additional binding vote on remuneration, leaving current AGM votes unchanged.

Timeline and feasibility

The policy is designed on an opt-in basis. If the incentives are too weak relative to the obligations, then no investors would choose this structure. In this case, the Government could adjust the balance of incentives and obligations.

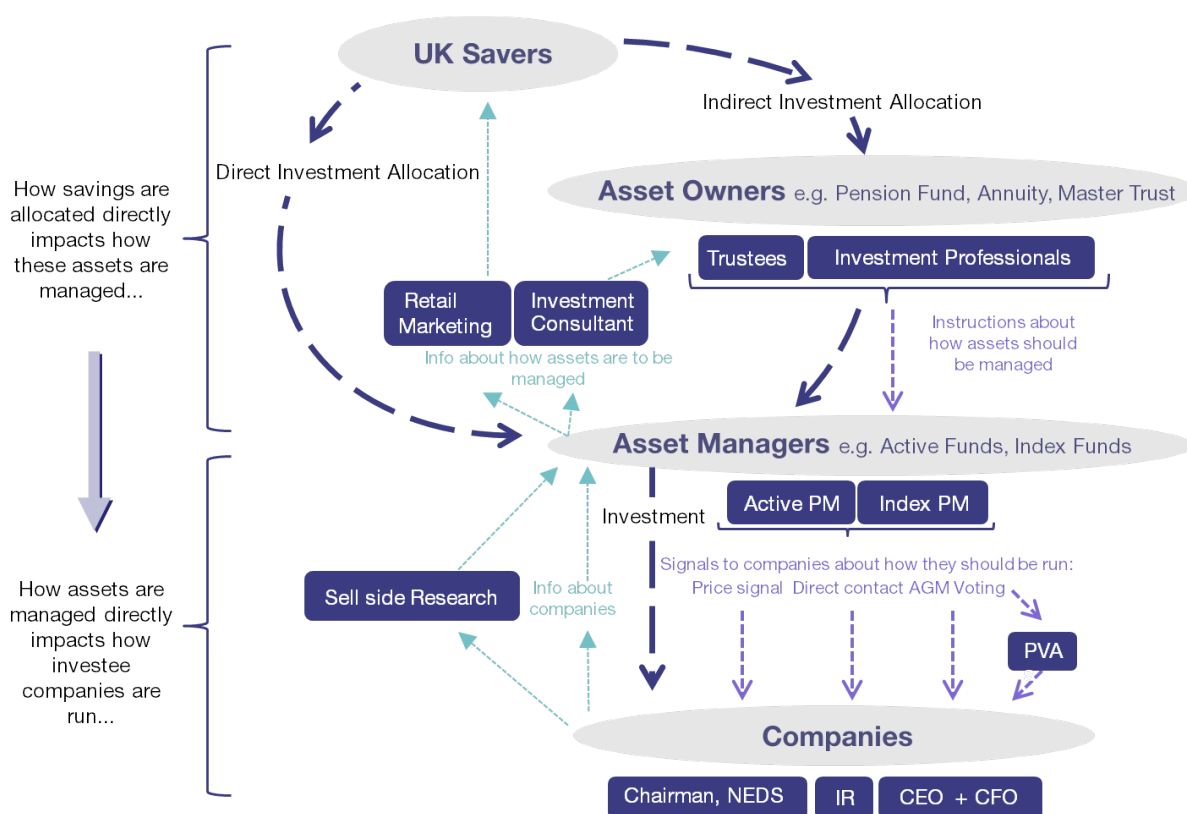
Policy 3: Expanded and strengthened Stewardship Code

This policy aims to strengthen the 2010 UK [Stewardship Code](#). Overseen by the Financial Reporting Council (FRC). To be effective the Code must differentiate the responsibilities of each separate part of the investment chain, and move us beyond improved disclosure towards encouraging better actions. While our previous two policies in this section are designed to empower the hands of a few long-term focused shareholders, this policy aims to improve the workings of the system as a whole.

Why this is needed

The investment chain does not simply allocate savers' funds, it also helps determine how the assets owned on their behalf are run. It is the industry's responsibility to achieve the best possible financial return for customers, but it can only achieve this if it collectively sends the right signals to underlying assets to maximise their sustainable value.

A map of the investment chain as a signalling system:



Each and every part of the investment chain will affect the signals that make it through to our listed companies – ranging from price signals, to direct contact or AGM voting – and so impact upon how they are run. But too often, these signals are not the ones needed to maximise sustainable value creation.

For example, when asset managers concentrate on quarterly earnings performance such short-termism can infect the decisions of the companies they own. Nowhere is the adverse effect of this felt more than in the UK's record of declining corporate investment. As long-term opportunities are being ignored, earnings growth has suffered and so too have UK savers. Similarly, unless sufficient attention is placed by investors on ESG issues (environmental, social and corporate governance), companies may cut corners. Not only does this place the confidence we have in UK business at risk, but all the academic evidence suggests that in the long run this will put saver returns at risk.³⁰

Better stewardship will benefit UK companies, savers and the wider economy, but it is being held back by blockages of incentives and information across the UK investment chain. The 2010 UK Stewardship Code was designed as a first step to help address this. Today, 288 investment institutions have signed up to it, but only a very small minority have actually modified their practices or devoted extra resources to the area of stewardship. The FRC has since responded to pressure to give the Code more teeth by introducing three tiers and threatening de-listing to those in the bottom tier if they do not improve their reporting of their stewardship. Also, because of the Code's current narrow wording, it is barely relevant to either investment consultants or asset owners such as pension schemes.

It is therefore time to make the UK Stewardship Code truly fit for purpose – by clarifying the separate responsibilities for each part of the chain, together with the clear recommended actions they might take to improve the workings of the system as a whole.

Proposed Structure

- The FRC can build upon the existing UK Stewardship Code with reference to Tomorrow's Company's forthcoming document '*Signatories for Stewardship Action*' (available upon request).
- This work has been produced through discussion with a group of forward-thinking asset owners and managers as well as extensive engagement with pension trustees, investment consultants and UK companies. These proposals are borne out of consultation, and motivated by the growing acceptance that the overall state of UK stewardship must be improved.

An improved UK Stewardship Code, as envisioned by '*Signatories for Stewardship Action*':

- Must outline from the outset a framework for thinking about the investment chain as a system to deliver signals to owned assets to optimise their sustainable value; only if it is clear what we are trying to achieve by stewardship can every part of the chain do their part.
- Incorporate the most recent legal advice (e.g. Law Commission and IORPS II) to inform responsibilities at the level of asset owners and investment consultants, and use existing reporting frameworks (UN PRI, PLSA, FRC) to improve disclosure of asset managers.
- Identify different responsibilities for all parts of the chain – asset owners, investment consultants, asset managers and companies. Define clear and specific actions for each that may improve the investment industry's ability to deliver effective stewardship. Under the 'comply or explain' model, institutions can evidence how they have achieved these goals.

II. Increased voice for stakeholders on long-term value creation

The ability of boards to focus on the long-term can be further enhanced by increasing the voice from, and engagement with, those stakeholders that are critical to long-term value creation. Innovation is highly correlated with diversity of input – that is part of the case for greater diversity within the boardroom. However, there are clear limits to how much diversity of voice can be achieved while meeting all the knowledge and experience criteria for boardroom appointments.

If large companies are to be more in touch with the changing expectations of their employees, their current and future customers, and the society in which they operate, then the best thing the Government could do would be to offer them a spur to find new ways of doing this, and require them to report on what they have done. This is becoming more important as the drivers of long-term value are increasingly intangible and built on a company's key relationships with customers, people, suppliers and society.

Many boards are already focused on this, but boards would still benefit from an unvarnished view on the health of stakeholder relationships. This would enhance the effectiveness of board members and help them fulfil their wider duties under Section 172. The Government could encourage this by, on a 'comply or explain' basis, requiring companies to introduce stakeholder advisory panels and broaden the remit of the remuneration committee, while doing both in a way that leaves undiluted the duty of all directors.

In our consultation on this area, we have found considerable resistance from companies who feel that this could simply become another bureaucratic imposition. The Government should be very careful about what it imposes, and we therefore suggest two mechanisms for introducing such a policy in the most flexible and unbureaucratic way.

First, the Government should declare an intention and equip itself with powers that it does not immediately implement. Large companies would have a 2-year period of grace for experimentation with no statutory obligation at all.

Secondly, the Government would at the start of this period add a modest reporting requirement: just as annual reports will now be expected to cover the gender pay ratio, so they would also be expected to include a statement from companies on how they interpreted their responsibilities under Section 172, and what action they took in different ways to empower their people and other stakeholders to contribute to innovation. This already falls within the scope of the mandatory 'strategic report', but this clarification and minor expansion of the reporting requirement would go a long way towards ensuring that responsibilities under Section 172 are being discharged. Those companies which already engage stakeholders and empower employees could take advantage of this provision to demonstrate their leadership; those companies with little or nothing to report would be stimulated to start taking effective action.

What follows is the policy that the Government would then, additionally impose at the end of the grace period.

Policy 4: Stakeholder advisory panel

On a ‘comply or explain’ basis, require companies above a certain size to create a stakeholder advisory panel that gives voice to the stakeholders that are crucial to the long-term success of the company. In addition, have one NED designated to consult with this panel and communicate back to the board.

Why this is needed

The sources of long-term value are increasingly intangible assets. Stakeholder relationships have always offered the vital source of long-term success. This includes especially – a stable ecosystem of suppliers, a base of loyal customers who act as advocates, an engaged workforce, a sustainable environment and the public’s trust, without which regulator pressures intensify. Engaging, consulting and listening to these stakeholder groups is critical to long-term value creation. See the Tomorrow’s Company report [Bringing employee voice into the boardroom](#) for more discussion of the benefits of increasing employee voice in governance structures, and the earlier report on [Tomorrow’s Relationships](#).

Many boards recognise this and actively consult and engage key stakeholder groups. This is often through surveys or other forms of management reporting, supplemented with site visits. But there is a limit to how much time a NED can spend meeting employees and wider stakeholders. Despite much progress, many boards receive an inadequate view on the strength and health of key stakeholder relationships.

In general, NEDs are still over-reliant on the information provided by executive directors. Too often the information that reaches the board has been sanitised by management and is overly focused on financial information. Many NEDs struggle to gain a well-rounded and independent view on the health of stakeholder relationships.

Concern is also expressed that too little attention is often given to the wider duties in Section 172 of the 2006 Companies Act. The legal wording is clear that directors owe their duty to the company and should have regard to the wider implications for stakeholders. However, there are insufficient mechanisms to hold boards accountable against these wider duties. Interviewees mentioned that the majority of board minutes have no mention of Section 172 or wider stakeholders, while a minority have one line stating the board ‘had regard for the impact on stakeholders’, and only a small number reference a meaningful discussion.

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.*

Stakeholder advisory panels could help provide the NEDs with an additional source of information on the health of stakeholder relationships. This would help NEDs focus on role of stakeholder relationships in long-term value creation and in fulfilling their duties under Section 172.

Importantly, the aim would be for advisory panels to help reduce regulation and a box-ticking approach to compliance. As the *King III* report from South Africa says: “*The ultimate compliance officer is the company's stakeholders who will let the board know by their continued support of the company if they accept the departure from a recommended practice and the reasons furnished for doing so.*”

If boards successfully introduced advisory panels that gave voice to stakeholders, there may then be less need for regulation to protect stakeholder interests. This should help boards spend more time discussing the long-term drivers of value, rather than governance and compliance.

Given the potential value of a stakeholder advisory panel, why have more boards not introduced one? Many of the best boards are moving towards this. However, one barrier is that if NEDs were to request a stakeholder advisory panel that was independent of the executives, this would be viewed as quite challenging to the executives. Furthermore, as outlined in the next chapter, the application of the Governance Code has become too prescriptive, limiting the prospect for innovation which could include stakeholder advisory panels.

Lastly, stakeholder advisory panels could help restore public trust in business by introducing an independent voice for stakeholders within governance structures. The annual statement from the advisory panel would be a credible statement on how the board was seeking to create long-term shared value for all stakeholders.

Structure

There is concern that stakeholder advisory panels would add unnecessarily to the governance burden on boards. There is also an understandable desire to protect the principle of the unitary board, in which all directors share responsibility for stewardship of the enterprise. To allay these concerns, advisory panels should be introduced in a flexible manner, on a 'comply or explain' basis and with only a set of principles on how they should be structured. And it should be made clear that none of the proposals are intended to undermine the unitary board.

If a shift to a fully principles-based governance regime was introduced, as per Policy 6, then stakeholder advisory panels could be introduced with a view to effectively engage and stakeholders, with the recommended practice of using an advisory panel.

- The remit would be to challenge the board on its commitment to the long-term success of the company, and the impact of their decisions on wider stakeholders.
- The aim would be to form a constructive dialogue between the board, advisory panel and stewardship investors. The right to express disagreement in a public statement would be used as a last resort.
- Regulation would outline a set of principles against which companies would have flexibility in how they meet them. Companies would then disclose how they had met each principle.
- The first question for the panel would be whether the company has introduced the panel in accordance with the principles.
- This could initially be introduced on a 'comply or explain' basis for large companies to allow a period of innovation and testing. The panels will involve additional cost and therefore should not be imposed on smaller companies where this may be an unnecessary burden.

Principles

The policy could be implemented by requiring companies to introduce a stakeholder advisory panel, but providing flexibility within certain principles. The introduction of such a panel would not be expected to interfere in any way with the unitary board principle: the panel would not be a board subcommittee and no board member would sit on it. It would, quite intentionally, provide an external and constructively critical voice to enrich the perspective of the board.

Companies would then disclose how their chosen structure for the panel was in accordance with the principles. For each principle, there would be some guidelines setting out best practice.

Principle 1: Independent nomination and a composition representing all key stakeholder groups

The company would decide which stakeholders were key to its long-term success and how to select individuals to represent each group. The company could choose whether this was by nomination or election. For employees, this may be elections similar to pension trustees. For supply chains, it may be a specialist organization with knowledge of human rights and sustainability. For consumers, it could be a relevant consumer body.

Principle 2: Independent chair

The advisory panel should have an independent chair, appointed by the board nomination committee.

Principle 3: Panel members should be paid in order to justify a sufficient time commitment

To ensure that members can dedicate sufficient time and are invested in the role, panel members should be paid and this amount disclosed. Similarly, the company should disclose how often the panel meets.

Principle 4: The panel should have access to sufficient information to challenge the board's decisions

The stakeholder advisory panel should, as far as possible, have access to the same information as is available to the board. The board may limit the information provided only where issues of confidentiality are particularly sensitive. In this case, the board should discuss this decision and make a written record of the reason.

Principle 5: The panel should have access to resources and support

To ensure that the advisory panel can fulfil its role and purpose effectively, adequate resources should be made available. This could involve:

- The panel could be supported by the office of the chairman or a new office of the NEDs, as some companies have introduced.
- The use of external organisations, as exist for many current advisory panels.
- The panel could be provided with a budget from which it could commission external research or consultancy.

Principle 6: Effective channels of communication to the board

Structures should be put in place to ensure a constructive dialogue between the board and stakeholder advisory panel.

- This could include a NED attending each advisory panel meeting and reporting back to the board. This could either be the senior independent director (SID) or the new role of a NED designated with stakeholder engagement (as suggested in the *Green Paper*).
- Another option would be regular meetings between the chair of the company and the chair of the advisory panel.
- There could be an annual private meeting where the advisory panel can question the executive team. This system is already in place in some companies where the advisory panel have the opportunity to question senior management and make recommendations.

Principle 7: The panel should have the right to make public statements and a statement in the annual report

Existing advisory panels have only weak mechanisms to ensure that their contributions have a tangible impact. In some cases, panels are able to make a statement in the sustainability report.

To give the panel power, it should have the ability to make public statements, and should be required to publish a statement in the annual report on its activities for the year. This would need to be approved by legal to avoid any breach of confidentiality. The panel chair could have a section in the governance report within the annual report, which would be approved by the advisory panel and the board. This would be similar to other board committees.

The advisory panel could meet once a year without any board members in attendance to discuss its public statement.

Where there are significant differences of opinion among the panel members, the public statement should reflect this difference.

Policy 5: Broaden the remit of the remuneration committee

Broaden the remit of the remuneration committee so that it considers whether the totality of pay and people practices support a company's purpose, values and strategy, rather than only the technical aspects of executive pay.

Why this is needed

Executive pay remains the most difficult issue for corporate governance. It is widely cited as the main cause of low public trust. Board members and investors also complain it takes up a disproportionate amount of time, distracting from the key issues of long-term wealth creation.

Tomorrow's Company believes that the issue of executive pay is broadly a symptom of other governance failures, rather than the cause of the problem. Therefore, the other policies outlined in this paper should ultimately result in changes to executive pay policies that are longer-term focused and are aligned with an organisation's culture and values.

That being said, this could be further enhanced by broadening the remit of the remuneration committee to include the pay, incentives and culture of all employees, rather than just the pay of executives. This would help shift the focus from the technical aspects of executive pay, towards how incentives for all employees can support the company's values, culture and strategy. This shift in focus is echoed by a letter BlackRock recently sent to all FTSE350 chairman. The letter says BlackRock would look critically where executives received a pay increase out of line with the rest of the workforce.³¹

Some elements of this idea were mentioned by the Financial Reporting Council (FRC) in its submission to the BEIS Select Committee inquiry on corporate governance:

"A future review of the UK Corporate Governance Code should consider the role of the remuneration committee in having responsibility for a wider remit including the pay and conditions of the company workforce and reporting on the link between remuneration structure and strategy. The role of the committee in exercising discretion in relation to awards and the terms in which it would do so should also be strengthened."

Structure

The simplest formulation of the policy would be to ask remuneration committees to put greater emphasis on the relationship between executive pay and the pay of all employees. This could be achieved through greater guidance or changes to the Governance Code. However, more impactful would be to broaden the remit of the remuneration committee to the totality of people-related issues.

Importantly, this does not mean the board is excused of its responsibilities. All board sub-committees exist to conduct more detailed work, while leaving ultimate responsibility for the main board.

The mandate for the remuneration committee would need to be broadened to consider the pay, succession, talent management across the organisation. Executive pay would be one part of this. With a wider remit, there would need to be some presence from HR on the committee.

It would also need to be clear that the committee's role was not to interfere with the executives role in running the organisation, but to provide oversight of all matters relating to people, and report back to the board on the main issues that required board-level discussion.

III. Space for effective boardroom decisions

For the increased influence of patient capital and stakeholders to be effective, reforms also need to provide the space for boardrooms to consider and act on this influence. Currently the burden of regulation too often leads to a homogenous box-ticking focus on process and compliance, rather than a diversity of governance structures focused on long-term wealth creation. With the increased influence of patient capital and stakeholders, boards should be given more trust and freedom to take long-term decisions.

Policy 6: Clearing the clutter from boardrooms

Reduce the complexity of governance by moving from a long list of codes with a ‘comply or explain’ requirement, to a shorter list of principles with an ‘apply and explain’ requirement. This may in time lead to the role of the NED moving from arms-length monitor to engaged advisor.

Why this is needed

Twenty-five years on from Cadbury, there have been significant improvements in the corporate governance of UK companies. The UK’s focus on flexibility with the ‘comply or explain’ approach has been a success, and has been adopted in many countries around the world. However, there is a danger that the way the Governance Code has been applied in practice has increasingly become too prescriptive. The concern was captured in some of the essays from a [report](#) the FRC produced to mark the twentieth anniversary of Cadbury.³²

The principle of ‘comply or explain’ is meant to promote innovation by providing the flexibility for companies to adopt different structures that support their business model and strategy. The issue is that market practice has led to the majority of companies simply seeking to comply and then offering little explanation. Grant Thornton’s annual survey found 90% of companies in the FTSE350 were complying with at least 52 of the 53 provisions in the Code, while 62% complied with all provisions.³³ The danger is that companies are complying with the letter of the Governance Code, rather than a mindful application of the principles.

In addition to the pressure to comply rather than explain, there has been an increasing regulatory and compliance burden on boards. Many well-intentioned regulations, clarifications and initiatives have contributed to an increasingly complex boardroom environment. The amount a NED is expected to know about governance has continued to increase. This problem can be seen in the length of the corporate governance updates that are sent to boards, company secretaries and general counsels.

This leads to many NEDs complaining about being over-burdened with compliance and regulation. Boardroom agendas inevitably become filled with these items, rather than issues of long-term success. The average board pack is now 288 pages long.³⁴ A survey of NEDs in 2014 found 92% expect the time in board meetings dedicated to discussing company governance and risk to increase over the next 3-5 years.³⁵ Board-level recruiters say it is hard to find individuals who will be a NED on a listed company because of the compliance and regulatory burden.

The increasing burden on NEDs is leading to an increase in their time commitment, but there is a limit to what a part-time independent director can achieve. In 1991, the average time a NED dedicated to a company each year was 17 days, barely more than attending board meetings.³⁶ This increased to 30 days in the early 2000s and has remained relatively constant.³⁷

The danger is that the practice of ‘comply or explain’ has become narrow, and in addition, the regulatory and compliance burden has become too high. In the worst case, this has led to a box-ticking approach to governance and has taken away boardroom time from the long-term issues of value creation. Instead, we need to help clear the clutter from board agendas and encourage a mindful application of the principles of the Code, which will hopefully lead to a greater diversity in approaches.

The ability to pursue this approach is enhanced by the other policies in this paper. If boards are having more meaningful engagement with stewardship investors and stakeholders, then it should be possible to provide more freedom within regulations and governance codes.

Move towards a principle-based Governance Code

The UK could look to learn lessons from South Africa. There the corporate governance code is now on its fourth iteration under the guidance of the same chair, Judge Mervyn King. Over each revision, the King Code has moved away from a long list of detailed requirements to 16 principles with an ‘apply **and** explain’ requirement. The aim of this is to move away from mindless box-ticking, towards mindful application of the principles. All companies are required to offer an explanation for how they have applied the principles of the Code, rather than only providing an explanation if they have not complied.

The UK Governance Code already starts with a set of principles, but the key difference is asking companies to explain how they have applied each principle, rather than whether they have complied with a subset of Codes.

This should both free and prompt companies to actively consider the governance structure that is most appropriate for their business, rather than emulating a ‘one-size-fits-all’ approach. This should also start a new direction of travel that is designed to reduce the governance burden on boards.

Future evolving role of the NED

This new direction of travel may in time raise the question of what role we want NEDs to perform. Are they advisors who help lead a company in partnership with management, or are they monitors who hold management to account?

For some companies that have attracted a stable base of stewardship investors, it may be appropriate to shift the role of the NEDs towards being engaged advisors, rather than arms-length monitors. This could be supported by some of the following changes:

- Create an office of the NEDs, or expand the chairman’s office to support the NEDs. This would provide NEDs with a channel of information and set of resources that are independent of the executives. Some companies already have this in place and it works effectively. This could also encourage NEDs to become more engaged with a company.
- Encourage NEDs to commission third-party reports. NEDs currently have this power but rarely use it, as it is seen to be challenging management.
- Increase the time allocation towards 40 days, but not beyond as this would compromise independence.

This shift in role may also prompt a re-examination of NED remuneration. Currently NEDs receive a relatively low annual fee and have almost no share ownership. Boards have guidelines that encourage NEDs to buy shares, but this is not actively enforced, especially given the relatively low pay. This risks creating a lack of alignment with the executives. It also creates asymmetric incentives for NEDs, where their reputation is at risk if the company fails, but they do not participate in its success. Further research could investigate if NEDs should be given shares that are locked up for a long period of time to increase alignment with the executives and long-term shareholders.

The level of remuneration may also need to increase in the instances where NEDs become more engaged as close advisors to the executives.

Implications for private company governance

While the focus of these policy proposals has been on listed companies, there are significant implications and potential applications for private companies. Some of these applications address the Government's question in the *Green Paper* on whether large private companies should be subject to more stringent corporate governance requirements. Others tackle the pressing issue of funding growth companies. The implications for private companies of each of the six specific policy proposals are considered below.

The UK enjoys a rich diversity of corporate forms. Outside the listed company sector there are employee-owned businesses, family businesses, businesses owned by private equity, mutuals, social enterprises and many organisations with hybrids. As Tomorrow's Company argued in its [Tomorrow's Business Forms](#) report, one important part of corporate governance policy should be to continue to encourage this diversity of form, and ensure that there are minimal obstacles for businesses wishing to make the transition. The same report also recommended that it should be part of the practice of boards to review from time to time whether they had the right corporate form in the light of the purpose, values and strategy of the business. The recent Cabinet Office [Mission-Led Business Review](#) also touched on a part of this range of businesses.

Many leading private companies use the UK Corporate Governance Code as a minimum benchmark for their own best practice. Additionally, as the Government *Green Paper* acknowledges, there is already a governance code for unlisted companies. This was published in 2010 by the Institute of Directors in collaboration with the European Association of Director Organisations (ECODA). While it is less exacting than the UK Governance Code, it sets out some basic governance principles and also takes a phased approach, acknowledging that different levels of sophistication are required for different stages in the development of a private company.

The *Green Paper* also acknowledges that scandals are rare. It would be illogical for the Government to introduce a stringent new requirement for unlisted companies based on the experience of a few outliers. The recommendations for listed companies under Policy 6 are that the Government should start to clear away the clutter from boardrooms, and follow the South African example in moving from a process-based 'comply or explain' regime towards further emphasis on flexibility with an 'apply and explain' regime.

The more logical approach is for the Government to focus initially on encouraging patient capital, stakeholder voice, and de-cluttering the boardroom in the listed sector. Only when the direction of travel is established here should it then consider what further intervention may be necessary in private companies of all kinds.

Turning to each specific policy, here is a summary of the potential impact and implications of each policy for private companies.

Policy 1: Long-term capital trusts (LTCTs)

It is envisaged that initially LTCTs would focus on listed equities, and that in time this would expand to private companies from venture to mid-market and large private equity. Through this LTCTs would provide a vital source of capital to mid-sized growth companies.

For decades, the UK economy has suffered from a lack of funding for mid-sized growth companies. This problem was exacerbated after the financial crisis with the focus on de-risking banks, which has led to bank lending to non-financial companies falling by nearly £150bn.³⁸ This issue has been highlighted in numerous reports, such as The [Scale-Up Report](#) by Sherry Coutu.

LTCTs could become a vital source of capital for mid-sized growth companies. LTCTs would also have an incentive to retain ownership as investee companies grow, as they will wish to deploy capital in UK companies rather than simply make a quick return by selling the company.

Policy 2: Stewardship stake designation

Policy 2 is purely focused on listed company ownership structures, seeking to encourage long-term stewardship focused shareholders, despite currently fragmented ownership structures. Private companies already tend to have long-term committed shareholders.

Policy 3: Expanded and strengthened Stewardship Code

The current Stewardship Code is focused on listed companies, with little to say on the stewardship role of asset owners investing in private companies. While the focus will remain predominantly on listed companies, the proposed policy would provide greater clarity on the stewardship role for asset owners when investing in private companies.

Policy 4: Stakeholder advisory panel

The benefits of increasing stakeholder voice in governance structures are as relevant in large private companies as they are in listed companies. The proposal suggests starting with listed companies, and then later expanding to large private companies.

For context, there are 1,300 listed companies in the UK that employ 3.7m people. 14% of private sector employment.³⁹ There are 3,380 companies (including the 1,300 listed companies) in the UK that employ more than 500 employees – in total, these employ 9.0m people, 35% of total private sector employment.⁴⁰

Policy 5: Broaden the remit of the remuneration committee

The broader remit for the remuneration committee should be incorporated into any private company corporate governance code, if this were to be introduced in some form.

Policy 6: Clearing the clutter from boardrooms

The aim of Policy 6 is to encourage a greater diversity of governance approaches while reducing the regulatory burden on boards. If the Government were to set in motion changes that moved in this direction, then over time it would be easier to extend the coverage of the UK Governance Code to the largest private companies. The additional flexibility would allow and encourage private companies to articulate why their chosen governance structures support their purpose, strategy and business model. This approach not only encourages flexibility and innovation, it also avoids the creation of two separate governance codes.

This flexibility is important because the role of the NED changes as a company grows and matures. This diversity in role should be encouraged, not constrained by a prescriptive governance code. In private equity, NEDs are close partners of management, spending on average 50 days a year engaging with the business. In contrast, in large listed companies, NEDs have a more detached monitoring role. A fully principles-based approach would encourage companies to decide what type of role was most appropriate for their business.

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The report has also benefited from dialogue with our community which spans business leaders, investors, policymakers and civil society. They have offered valuable challenge, insight and practical experience. We will not list the names, but to those who have given their time we are very grateful. While these conversations have shaped the proposed policies, final responsibility for what we say lies with Tomorrow's Company.

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This report is intended to lay a foundation for future agenda setting and practical action. We look forward to working with all those who support the overall direction, and continue to engage with those who disagree with some of our recommendations.

We hope this report will be a constructive addition to the debate on how business can be a force for good in society, and the role government can play in supporting and encouraging this.

Laurie Fitzjohn-Sykes
Director of Research

Mark Goyder
Founder Director and CEO

About Tomorrow's Company

Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good in society. It believes business can create more value for shareholders and society by adopting an approach that focuses on purpose, values, relationships and the long term. It succeeds in its goal by convening business leaders, investors, policymakers and NGOs to develop practical solutions. Tomorrow's Company was founded in 1995 following the RSA inquiry into the role of business in a changing world.

Tomorrow's Company has had impact across a number of areas. Its work on investor stewardship and capital markets stimulated the emergence of the UN Principles of Responsible Investment and the UK's Stewardship Code. It has influenced the direction of corporate governance, including defining the inclusive duties of directors for the UK's Companies Act 2006 and influencing the King III report in South Africa.

About the All-Party Parliamentary Corporate Governance Group

The All-Party Parliamentary Corporate Governance Group was formed in 2004 to develop and enhance the understanding of corporate governance at Westminster and to influence future policy making in this area. The focus is on promoting responsible leadership of business, so that the interests of shareholders and other stakeholders are properly protected. Committed to supporting, rather than impeding, business growth, the Group's aim is the promotion of best practice in corporate governance. The Group acknowledges that there is no cast-iron template applicable to every business; it promotes the recognition that there are many ways for companies to create prosperity for their employees and shareholders.

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The All-Party Parliamentary
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