# Tomorrow's Company submission to the BIS Select Committee Inquiry

Written evidence submitted by Tomorrow's Company in response to the Business, Innovation and Skills Committee Corporate Governance inquiry.

## 1 About Tomorrow's Company

1.1 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 and was a major influence on the development of the 'inclusive' definition of directors' duties in section 172 of the companies Act. Tomorrow's Company was also influential and involved in the development of early BIS plans for narrative and strategic reporting. Issues of corporate governance and corporate behaviour are also closely related to the pressures brought to bear by institutional shareholders and capital markets, and Tomorrow's Company has been influential here too, helping to stimulate the interest in investor stewardship. See more detail at tomorrowscompany.com.

## 2 Introduction

2.1 Tomorrow's Company welcomes the BIS Select Committee inquiry. Despite many improvements in corporate governance over the last few decades there are some increasingly pressing issues that need to be addressed. This submission mainly draws on our recent report UK Business: What's Wrong? What's Next?, see this report for more detail on any of the issues mentioned.

## 3 Context – What's Wrong?

3.1 Before looking at reforms we need to be clear on what is currently not working. At a macro level there is quite a negative picture - the UK has low levels of business investment, low productivity, low employee engagement, stagnating real-wage growth and recurring corporate scandals. It is therefore no surprise that public trust in business remains low. The irony is that shareholder returns have also been poor. The 20 year real-return on UK equities is now the same as government bonds, not seen since the Great Depression. Overall, the current business approach is not working for shareholders or society.

3.2 Of critical importance is the low level of investment by UK companies. This is contributing to UK companies now in aggregate being net savers in the economy to the tune of £144bn in 2014, 9% of GDP, before dividends and buybacks. This saving has to be offset by other sectors of the economy borrowing, principally the government. A significant driver of this is rising dividends that reached £119bn in 2014, of which £88bn were from listed companies. The lack of spending and investment by companies is becoming a critical issue that needs addressing.

3.3 There are numerous examples of this at a company level. GSK in 2015 paid £3.9bn in dividends, while investing £3.1bn in R&D and achieving a 13% internal rate of return on R&D. An individual saving for a pension would most likely prefer that their money was invested at a 13% return researching new drugs than at 2% in government bonds. GSK is a successful and responsible company, but it is forgoing profitable investment opportunities in order to pay higher dividends, which are then ultimately reinvested in government bonds. This is to the detriment of shareholders and society. Across the UK economy the desire to pay high dividends is creating a significant misallocation of capital.

3.4 This is part of a broader picture of risk-aversion in many companies which has been building over the last few decades. Too much focus is placed on meeting short-term targets, mitigating risks and complying with regulations. There is too little focus on entrepreneurial leadership and the appropriate risk taking that we know is the foundation of success in many family and founder led companies.

3.5 There are numerous factors contributing to this risk-averse approach, from economic uncertainty to shareholder pressure and disruptive technology. Amongst these, governance structures also play their role. 25 years on from Cadbury there have been many technical improvements to corporate governance from director independence to the audit process. But as we would expect, governance reforms typically follow scandals and therefore naturally focus on preventing more scandals. A key challenge for this inquiry, therefore, is finding the right balance: are our governance structures working if they prevent one Enron, but in the process impede the creation of five Googles? Is the key problem facing governance reducing the number of scandals, or encouraging our companies to invest?

3.6 Contributing to the risk averse approach has been the overburdening of expectations placed on boardrooms. Non-executive directors (NEDs) have faced rising expectations from increased regulation, business complexity and society's ethical demands. Against this has been only a modest increase in the time and resources available to NEDs. NEDs remain time- and information- poor. This leaves too little time to discuss long-term issues and can cause NEDs to recede into discharging their regulatory duties, rather than pursuing long-term value creation.

3.7 Any discussion of directors' duties, executive pay and board composition, needs to be based upon a clear understanding of what is the most important current failure within governance structures. Radical change is needed, but this does not mean adding to the regulatory or governance burden.

## 4 Directors Duties

4.1 Directors owe their duty to the company, rather than any one stakeholder. This was clear before 2006, and the 2006 Companies Act sought to clarify this, but opinions vary on how far this has helped.

4.2 More importantly, law alone does not shape behaviour. The main influences are incentives, market structures and culture. In the listed company world too often boards and commentators think they are doing a good job if the share price is rising, rather than if they are supporting the long-term success of the company. This culture is reinforced by various market structures. For example, NEDs are elected by shareholders and accountable to shareholders and it is understandable if they then go on to believe that they owe their duty to shareholders. Remuneration is usually linked to the share price and this too makes it harder for executives to put the long term success of the company ahead of its short term reception by the stock market. We believe that these structures and incentives are far more powerful than the wording of directors' duties and much of our work with boards and investors is designed to redress this imbalance in the long term interests of shareholders and stakeholders alike.

4.3 Debates on directors' duties too often seem to start from the premise that there is a trade-off between stakeholders that needs to be re-balanced. Tomorrow's Company has always found in its research that companies succeed when all their stakeholders succeed, including shareholders. Companies achieve success then they have happy employees, satisfied customers and stable suppliers. Shareholder returns are then the by-product, not the starting aim. The problem with the current business approach is not the focus on shareholder value, but is its misinterpretation as short-term profit.

4.4 The issue is that while there is alignment between stakeholders is in the long-term, in the short-term there are difficult trade-offs. Therefore, the value in the 2006 clarification of directors' duties is not to change the long-term commitment to the creation of long term shareholder value, but rather to make explicit that achieving the right balance in the short and medium term is critical to achieving long-term success.

4.5 Nonetheless, there remains a lack of awareness of Section 172 and what it really means for the duties of directors to promote the success of the company. Tomorrow's company is working to raise awareness among board members and institutional investors and we would welcome any recommendation from the Committee that would help turn the legal obligation to have regard to the interest of other stakeholders into a lived reality.

4.6 To reinforce this there is a need for governance and market structures that hold boards and executives to account for their duty to promote the long-term success of the company having regard to the interests of its stakeholders. Changes to governance and ownership structures could help support this longer-term and broader focus.

4.7 The introduction of stakeholder advisory panels is one way that may help boards balance stakeholder interests in the short-term in order to maximise the value of the company in the long-term. In this line, advisory panels could be introduced that would assess a board and company against the wider duties in section 172. This may go some way to counter balance the short-term pressure exerted by shareholders.

4.8 We should also not ignore the important role for investor stewardship in holding companies to account and supporting them in pursuing long-term value. Institutional investors have a crucial role in this – The Stewardship Code introduced in 2010 has become a low bar that most investors have signed up to, and therefore has had limited impact. This should not detract from the important role that investors can play in challenging and supporting executives. See 2020 Stewardship and Building Stewardship Momentum for more detail on the role investor stewardship will need to perform to change the balance of priorities in the minds of directors, and the focus of companies on the long term.

## 5 Boardrooms in general

5.1 Rather than change directors' duties, governance structures could be improved to strengthen the board's exposure to stakeholder voices to support the long-term success of the company. One step is to increase employee voice within governance structures by offering companies the choice between incorporating employees on the board as insiders, or increasing their voice and power as outsiders. Please see a forthcoming Tomorrow's Company report for more detail.

5.2 Another step would be to reform the director nomination process. Currently this is a relatively closed process, creating little connection between directors and the shareholders who elect them. Lessons could be learned from the Swedish nomination committee structure where major shareholders are brought together to have a greater say in the nomination of directors. See a previously Tomorrow's Company report, Bridging the UK engagement gap through Swedish-style nomination committees, and a recent report by Chris Philp MP, Restoring Responsible Ownership.

## 6 Executive pay

6.1 Executive pay is a key issue that needs addressing. Executive pay has risen far more than wages to employees or returns to shareholders. There is increasing evidence that the link between pay and performance is weak if non-existent. The level of pay is one of the most widely cited issues reducing public trust in business.

6.2 This has been caused by many factors: one worth highlighting is increased complexity. Executive pay has developed into its own industry, creating structures that can only be understood by the advisors who design them. This complexity has removed a common-sense reality check as to whether an amount is appropriate and if the structure supports long-term value.

6.3 The introduction of votes and, in time, binding votes should help, but more is needed. Tomorrow's Company recommends that the remit of the remuneration committee is broadened to review remuneration arrangements across the company in the light of the values and behaviours the company stands for, and the talent that it needs to attract and develop.

While not getting into the detail of how all employees are paid, the committee should consider if executive pay is helping create the culture the board seeks to foster. Does executive pay send a signal to all employees that ‘we’re all in this together’?

6.4 The committee would then publish an annual statement with a focus on the rationale behind the remuneration arrangements and relativities both inside and outside the company, rather than simply on the mechanics of the scheme, as is currently the case. This statement should make a clear link to the company’s strategy, values and culture.

6.5 To further encourage a change in executive pay structures, onerous tax rates on short-term pay could be considered. Pay above £300,000 could have a 60% tax rate if not locked up for a 5-year period and linked to the long-term performance of the organisation.

## 7 Composition of boards

7.1 Tomorrow’s Company has been a consistent advocate of diversity on boards. Good progress has been made, but more needs to be done. However, it is important to remember that the ultimate aim is to achieve a diversity of viewpoints that effectively challenges the executive. Diversity should not be about box-ticking in order that directors reflect society. Instead, diversity is a key means to overcome the group-think that too often captures boards. Our report Tomorrow’s Global Leaders – how to create a culture that ensures women reach the top goes more deeply into the long term steps companies need to take to encourage this diversity of thinking.

7.2 As highlighted above, Tomorrow’s Company is in favour of increasing employee voice within governance structures. However, this does not have to mean employees on the board. In Bringing employee voice into the boardroom (November 2016), Tomorrow’s Company advocates a flexible approach where companies can choose between two options, either they can put employees on the board as insiders, or increase their voice as outsiders with an employee advisory panel. In the first of these two options, the encouragement of employee share ownership would provide a natural constituency from which to draw representation.

## 8 Other relevant Tomorrow's Company reports

8.1 Governing Culture: Risk & Opportunity? (September 2016) – In partnership with the City Values Forum this is a practical guide for how boards can govern their culture.

8.2 The need and opportunity for business to lead post Brexit (August 2016) – The result of the referendum was a wake-up call for business and political elites. Business lost its voice in the debate because people sensed that the system is not working for them. Many of these concerns are justified. Tt is critical that businesses do not retreat into cost cutting, but instead invest and tackle issues that have been ignored for too long. This is not only vital for our economy, but also presents an opportunity for business to show leadership and regain the public’s trust. This report sets out some simple actions that companies could take to provide this leadership.

8.3 Tomorrow’s Capital Markets: Investing in what we value (October 2015) – This report concludes the formal part of the Tomorrow's Capital Markets programme. It sets out a vision for capital markets if they were effectively performing their role in supporting companies as they tackle the challenges facing the world. It describes welcome positive signs of change and suggests how these may be built upon.

**Contacts:**
Laurie Fitzjohn-Sykes (Director of Research) laurie@tomorrowscompany.com
Mark Goyder (Chief Executive and Founder) mark@tomorrowscompany.com