tomorrow's company

Tomorrow's Company response to Corporate Governance reform: green paper

Tomorrow's Company welcomes the focus by the Government on how to reform corporate governance to help create an economy that works for everyone. Our response draws heavily on our recent report for the All-Party Parliamentary Corporate Governance Group, Promoting long-term wealth: reshaping corporate governance. The first part of our submission summarises the six policies put forward in this report, under the three themes of patient capital, stakeholder voice and clearing the clutter from boardrooms. The second part answers the specific questions in the green paper. We would be willing to work with the Government on taking our proposals forward.

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 that 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. See more detail at tomorrowscompany.com.

Our six policy proposals

Before looking at reforms we need to be clear on what problems we are seeking to solve. As Tomorrow's Company highlighted in its report, UK Business: What's Wrong? What's Next?, the picture at a macro level presents cause for concern. 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. Overall, the current business approach is underdelivering for shareholders and society.

Of critical importance is the low level of investment by UK companies. The UK's largest companies are forgoing profitable investment opportunities to return cash to shareholders. This is leading to net corporate saving of £128bn – 8% of GDP, up from 3–4% in the early 1990s, and larger than the budget of NHS England.

We welcome the policies proposed by the government to tackle the issues around executive pay and reduce the probability of corporate scandals. However, we question if this will meaningfully improve public trust or productivity. We believe the answer is to support and encourage the majority of UK companies, which are already acting responsibly, to invest in tackling the problems that society faces and through this inspire their employees, customers and the public. To achieve this companies need stewardship shareholders that support them over the long term, boards that hear the views of stakeholders on long-term value creation, and the space in boardrooms to make effective decisions. We put forward six policies under these three themes.

1. **Long-term capital trusts (LTCTs)** – the creation of a new tax-efficient investment trust structure with a mandate to support UK economic growth by being an engaged stewardship investor in UK companies
2. **Stewardship stake designation** – a new framework providing shareholders in UK companies the ability to designate a specific stake as a stewardship stake with a balance of commitments, incentives and increased influence
3. **Expanded and strengthened Stewardship Code** – the expansion of the Stewardship Code to cover the role played by different actors throughout the investment chain, covering asset owners, investment consultants and companies, in addition to asset managers
4. **Stakeholder advisory panel** – requiring 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 its wider duties under Section 172
5. **Broaden the remit of the remuneration committee** – broadening the remit of the remuneration committee to include the pay, incentives and conditions of all employees
6. **Clearing the clutter from boardrooms** – 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

Detailed responses

Executive pay

1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the green paper would you support? Are there other options that should be considered?

The evidence that executive pay structures are not working for shareholders or society is stark and overwhelming. Real-wage growth has stagnated over the last 20 years[1] while the ratio of executive to average worker pay has tripled.[2] Furthermore, too often pay structures create a distorting incentive to focus on the short term, leading to low investment.

We argue that issues around executive pay are broadly a symptom of other governance failures, rather than the cause of the problem. Accordingly, efforts should be focused on tackling the underlying causes, including, short-termism and a lack of stakeholder voice.

We'd also highlight that currently only 3% of companies lose their advisory vote on pay.[3] As a result, the impact of binding votes may not be that great. We support other changes to encourage and support long-term committed stewardship shareholders, who would then use the increased influence of a binding vote.

Rather than increasing the power of all shareholders on executive pay, we propose providing increased influence to stewardship shareholders, alongside building a base of stewardship shareholders. This is outlined under Policy 2 in our report Promoting long-term wealth. Ultimately, executive pay should incentivise management to create long-term value; it follows that executive pay should be influenced by shareholders who are committed to the company for the long term.

2. Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

2.i) Voting records
Making disclosure of voting at AGMs mandatory is unlikely to change behaviour. Furthermore, it is important to note that voting at AGMs is a poor measure of investor stewardship. Stewardship involves active engagement throughout the year. After carrying out this engagement, a vote for or against may be equally justified, and is often no reflection of the level of stewardship. Furthermore, the greater the focus on voting, the more investors may use impersonal and formulaic methods, outsourcing their thinking to third parties, rather than engaging themselves in the merits of each company's policy.

2.ii) Shareholder committees
We are supportive of the creation of informal and flexible shareholder committees or group meetings, but would not go as far as giving a shareholder committee formal powers over nomination or remuneration. The Governance Code could require boards to meet twice a year with their largest long-term shareholders. This would help create the space where the board could ask for the shareholders' views on remuneration and nominations as well as the company's strategy, culture, succession, and fulfilling its full duties under Section 172. This already happens in one-on-one meetings, but a combined meeting of the board and stewardship shareholders could create a different dynamic. This could build on the work of the Investor Forum's Stewardship and Strategy Forums. One way to achieve this would be to increase funding for the Investor Forum to help coordinate these meetings.

We believe there is merit in considering shareholder attendance on nomination committees in time, but this should follow measures to increase the base of long-term stewardship shareholders. For further discussion of shareholder nomination committees see our previous report, Bridging the UK engagement gap through Swedish-style nomination committees.

2.ii) Retail shareholders
Improving the way retail investors engage with companies has many merits. Retail investors may bring a different perspective to institutional investors. However, it is unlikely to meaningfully improve public trust, productivity or growth. Retail investors only own 12% of UK shares[4], with each individual holding a very small stake. This means they are unlikely to have the time and resources to act as stewards. Furthermore, these individuals are, in general, towards the top of the distribution of wealth, so may not meaningfully increase the voice of the average person.

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

We are supportive of measures to increase stakeholder voice within governance structures overall, rather than only on executive pay. In our report, Promoting long-term wealth, we propose the flexible introduction of stakeholder advisory panels.

We also support broadening the remit of the remuneration committee, with the aim of shifting the focus of the remuneration committee away from looking at the technicalities of executive pay in isolation, towards considering the pay of all employees and whether this is supportive of the company's values, culture, purpose and strategy. For example, a report by CIPD found that excessive executive pay was demotivating for many workers.[5]

Requiring remuneration committee chairs to have served for at least 12 months on a remuneration committee is good practice, but this should not require regulation, and on its own it would make little difference. We would encourage the government to focus on the reforms that would have a meaningful impact.

4. Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

Pay ratios can be crude and can also be 'gamed' by business decisions. However, these criticisms can be levelled at almost all forms of disclosure. We would therefore be supportive of requiring pay ratio disclosure as it would prompt an explanation for why it is high or low. It would then be for commentators and analysts to judge if this was a credible explanation.

In addition, we would support any changes that helped move remuneration disclosure away from the technicalities of 'how' executives are paid, towards 'why' a certain pay structure and level was chosen, and whether this was consistent with the purpose, values and strategy of the company. This would be supported by broadening the remit of the remuneration committee.

5. Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

We would favour increasing pressure through non-legislative means, such as the FRC's remuneration principles. As the Green Paper says, freedom should exist not to disclose incentives that are commercially sensitive.

6. How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of 3 to a minimum of 5 years for share options awarded to executives? Please give reasons for your answers.

We strongly agree with the Green Paper that LTIPs have become too complex, are too short-term and often focus on the wrong metrics.

LTIPs have now become so complex that few understand all their details, reducing accountability and alignment with business performance.

The average 3 year LTIP does not provide a long-term incentive. A 3-year plan quickly becomes a two then one year plan as it matures. This is especially true now that average CEO tenure for the FTSE100 is 5 years,[6] as this means the average CEO will only complete three full LTIPs. The average business cycle and investment horizon for a company is longer than this. Furthermore, LTIPs should provide an incentive for executives to plan their succession.

We also emphasise the need for the metrics within LTIPs to not act as a disincentive for executives to take investment decisions that are judged to promote the success of the company in the long term. The trend towards cash-flow targets in LTIPs has created a significant incentive to reduce investment. Similarly, LTIPs linked to measures of return on capital (ROIC, ROCE) create an incentive to cut business investment and focus only on those business activities that deliver a high short-term return. We believe LTIPs should be simplified by focusing on long-term total shareholder returns.

We are therefore supportive of any changes to simplify and lengthen LTIPs. We are also supportive of requirements for executives to build a stake in the company.

Strengthening the employee, customer and wider stakeholder voice

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

We are supportive of increasing stakeholder voice in governance structures, as outlined in our report Bringing employee voice into the boardroom, and under Policy 4 in Promoting long-term wealth. In the latter paper, we propose the flexible introduction of stakeholder advisory panels, combined with a designated NED and the corresponding reporting requirements.

The argument for this is about more than taking the interests of employees, customers and wider stakeholders into account. It is also about innovation and reputation and opening the boardroom up to a greater diversity of voices and signals.

There is of course a distinction between the narrower argument about employee directors and arrangements that might strengthen the voice of employees specifically, and the wider argument about opening the boardroom up to stakeholder voices. On the first question, we argue that some companies would benefit from considering employee representation on the board, but this should not be mandated. We suggested that there were two routes to enhanced employee representation – an insider route where an employee director was appointed who owed their duty fully to the company, and an 'outsider' route where employee representatives on a panel or forum were free to speak out and express an employee view without having the duties of a director.

We consulted board members with experience of these arrangements in continental European companies. They emphasised the importance of having the union infrastructure. It helped prepare individuals for being an employee director, and provided the communication infrastructure between an employee director and the organisation. Introducing an employee director without this supporting infrastructure may be less effective than it is elsewhere. Given that union membership for private sector employees in the UK is now 2.7m, or 10% of total private sector employment, this supporting infrastructure is not present in most companies.[7]

Turning to the second question, in Promoting long-term wealth we suggest that wider stakeholder panels may prove to be a useful way of holding boards informally to account for their fulfilment of their 'inclusive' duties under Section 172 of the Companies Act. From our discussion with our members and other businesses, we are hearing of an increasing number of cases where companies are now experimenting with these and this should be welcomed and observed by government over at least the next two years.

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

Reforms should begin with listed companies as this provides a space to test reforms and prompt innovation. It is also easier to introduce new requirements by means of the Listing Rules, rather than introducing legislation for all companies.

However, UK listed companies only employ 3.7m people in the UK, or 14% of private sector employment.[8] Consequently, to have an impact on a significant proportion of UK workers, the requirements would need to be expanded to private companies above a certain size. We propose expanding to all companies that employ over 500 employees in the UK. This is 3,380 companies, which employ 9.0m people, 35% of total private sector employment.[9]

A further complication is multinational companies with significant overseas operations and foreign multinationals with significant UK operations. For example, companies in the FTSE100 employ 6.5m people globally, [10] but only 2.2m in the UK.[11] We propose that for UK companies with significant operations abroad these requirements would be introduced for the UK subsidiary. Similarly, for foreign multinationals, the UK only has the ability to place requirements on the UK subsidiary.

9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

We propose a flexible approach is adopted that starts with a period of testing and innovation, which could then be followed by more onerous requirements. For listed companies the requirement for increased stakeholder voice could be introduced through the Listing Rules without the need for primary legislation. When this was suitably refined, this could be expanded for private companies.

Corporate governance in large privately-held businesses

10. What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

Much of the pressure for extending the framework to large privately held businesses has come as a result of the actions of one private company – BHS. Whatever the merits of that case, it is exceptional and it is not on its own an argument for widespread reform. Accountability to shareholders is stronger in most private companies because the ownership is more concentrated and great care needs to be taken not to impose inappropriate rigidity.

Moreover, we argue there are problems with the current listed company governance framework that should be resolved before expanding it to private companies. While the intent of the UK governance regime is flexibility, the way it has become applied in practice has become quite prescriptive, being closer to 'comply or else', rather than 'comply or explain'. This is pushing companies towards a one-size-fits-all governance approach, despite their significantly different business models, industries and strategies. The need for different approaches to governance structures is even more important in private companies, where they have a natural higher degree of variation on many aspects.

One way to achieve this could be to learn 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. We would encourage the Government to set a direction of travel away from 'comply or else' for listed companies before contemplating imposing current arrangements in other sectors.

11. If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

As argued earlier, we do not believe the current corporate governance framework should be extended for private companies. To be extended for private companies the framework needs to be made less prescriptive. On the issue of stakeholder voice there is a case for expanding beyond listed companies. On this question, see our answer to question 8.

12. If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

See our answer to question 11.

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

Where reporting is concerned, the criterion should be the potential impact of the company, rather than its legal form. In our view, therefore, there is merit in moving towards more reporting requirements that are common across different legal forms. This is most relevant to disclosure produced for a wider audience of stakeholders and civil society groups, such as ESG metrics.

Other issues

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

As mentioned previously, while the intent of the UK governance framework is flexibility, the way it has become applied in practice has often become too prescriptive. Furthermore, the regulatory and governance burden on boards has continued to increase, which distracts boards from focusing on the long-term drivers of value. We believe that going forwards the key issue that governance needs to tackle is how boards can gain the courage to invest in tackling the problems facing society, rather than how to further reduce the occurrence of scandals. And there should be a government policy objective of contributing to a process of 'clearing the clutter' for those in the boardroom, building on the example of the King Committee in South Africa.

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[1] Real wage growth averaged 2.9% in the 1970s and 1980s, 1.5% in the 1990s, 1.2% in the 2000s, and -0.1% so far in the 2010s. For data to 2000s – ONS, An Examination of Falling Real Wages, 2010-13, January 2014. For 2010s – ONS, Labour Market Statistics, February 2016.
[2] The ratio of executive to average worker pay has increased from 47 to 148 times between 1998 and 2014 – High Pay Centre, "The State of Pay: High Pay Centre briefing on executive pay".
[3] The Big Innovation Centre, The Purposeful Company – Interim Executive Remuneration Report, November 2016.
[4] ONS, Ownership of UK Quoted Shares: 2014
[5] CIPD, The view from below: What employees really think about their CEO's pay packet, 2015.
[6] City AM, FTSE 100 CEOs: These are the men (and a few women) who run Britain's biggest companies, 20 March 2015.
[7] ONS, Trade Union Membership 2015.
[8] Pattani, A. and Vera, G. (2011) Going Public: UK Companies' Use of Capital Markets, Bank of England Quarterly Bulletin 4, 322.
[9] ONS, Business population estimates for the UK and regions 2015, published 14 October 2015.
[10] Business in the Community, FTSE 100 public reporting – Employee engagement and wellbeing, 2014.
[11] The 100 Group, 2014 Total Tax Contribution survey of the 100 Group, November 2014.