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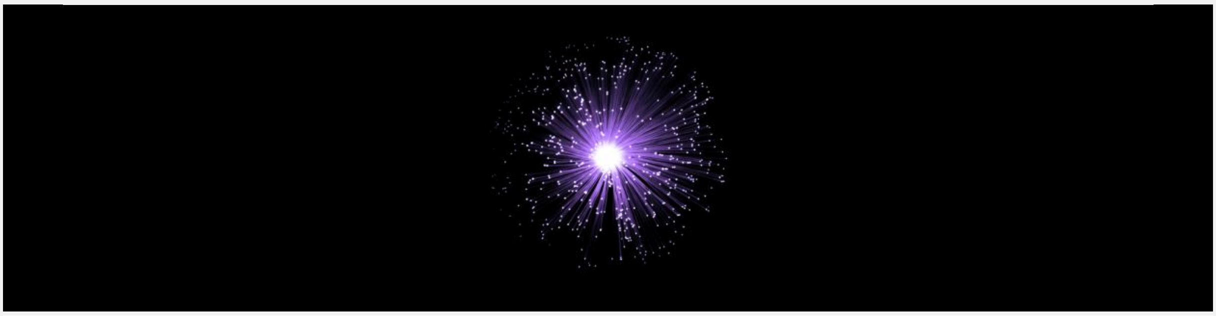

BEIS Select Committee

Corporate Governance Inquiry

5th April 2017

The Business, Energy and Industrial Strategy (BEIS) Select Committee has published its report on corporate governance following the consultation process undertaken over the last six months. Whilst the findings of the Select Committee are not binding on the Government, the proposals laid out in this report may be taken into consideration in any subsequent White Paper on Corporate Governance Reform.

Context and background

The Committee advocates significant improvements to, rather than a radical overhaul of, the existing UK corporate governance regime.

The Committee finds that the corporate governance regime in the UK is 'strong and remains an asset to the country's reputation for doing business.' However, the Committee believes it is important for the Government to keep improving standards in order to minimise the risks of future high-profile corporate scandals and to reflect both changes to the business environment and the rising expectations of society and stakeholders.

In addition, the Committee stresses that 'a small number of highly damaging examples of corporate governance failure should not lead to a hasty and disproportionate response' and cautions against taking any steps that risk adversely affecting the UK's attractiveness as a place to invest.

The majority of the proposals relate to increasing the powers of the Financial Reporting Council (FRC) and the scope of the UK Corporate Governance Code (the Code).

Promoting good corporate governance

The report sets out a series of proposed reforms which are described as being designed to require directors to take more seriously their duties to comply with the law and the Code.

Recommendation 1: *The FRC should amend the Code to require informative narrative reporting on the fulfilment of s.172 duties. Boards must be required to explain precisely how they have considered each of the different stakeholder interests, including employees, customers and suppliers and how this has been reflected in financial decisions. They should also explain how they have pursued the objectives of the company and had regard to the consequences of their decisions for the long term, however they choose to define this. Failures to have due regard to any one of these interest should be directly addressed and explained.*

Recommendation 2: *The FRC, alongside business organisations, should work to develop appropriate metrics to inform an annual rating exercise. This should publicise examples of good and bad practice in an easy to digest, red, yellow and green assessment. There should be a requirement for companies to include a reference to this rating in their annual reports.*

The Committee believes the FRC should encourage companies to 'be more imaginative and agile in communicating digitally with stakeholders throughout the year' and should actively push back on the use of boiler-plate statements in annual reports, using wider powers (as described below).

Recommendation 3: *The Government should bring forward legislation to give the FRC the additional powers it needs to engage and hold to account company directors in respect of the full range of their duties. Where engagement is unsuccessful, the FRC should report publicly to shareholders on any failings of the Board collectively or individual members of it. If companies do not respond satisfactorily, the FRC should be given authority to initiate legal action for breach of s.172 duties. The Government should consider re-stablishing, renaming and resourcing appropriately the FRC to better reflect its expanded remit and powers.*

The Committee urges the Secretary of State for Business, Energy and Industrial Strategy to be more prepared to use existing powers where there is suspicion of serious wrongdoing that may be in breach of the law. The Committee believes that a public statement by Ministers suggesting that they intend to be more proactive in this area would have a deterrent effect.

Recommendation 4: *The Investor Forum should seek to become a more pro-active facilitator of a dialogue between boards and investors by engaging in regular routine dialogue in order to pick up on any widespread concerns, for example those identified by the new FRC rating system.*

Recommendation 5: *Companies are urged to consider establishing stakeholder advisory panels, as these can be a useful forum in which meaningful collaboration, consultation and dialogue with all stakeholders can take place. The Code should be revised to require a section in annual reports detailing how companies are conducting engagement with stakeholders.*

Recommendation 6: *The Stewardship Code should be reviewed with the view to including:*

- *More explicit guidelines on what high quality engagement would entail; a greater level of detail in terms of requirements; and an undertaking to call out poor performance on an annual basis.*
- *Provisions to require the disclosure of voting records by asset managers. The FRC should undertake to name those that those that subsequently do not vote.*

Recommendation 7: *The Government should consult on new requirements for listed and large private companies to provide full information on advisors engaged in transactions above a reasonable threshold, including the amount and basis of payments and their method of engagement.*

Recommendation 8: *The revised Code should include best practice guidance on professional support for non-executive directors and should require companies to include training of board members as a part of reporting on their people or human resources policy.*

Recommendation 9: *The revised Code should include guidance on how companies should identify clearly and transparently the roles of non-executive directors where they have particular responsibilities and how they should be held to account for their performance. NEDs should be required to demonstrate more convincingly that they are able to devote sufficient time to each company when they serve on multiple boards.*

Private companies

The report recommends that a new governance Code for the largest private companies should be developed in order to improve transparency and drive up standards of corporate governance. The new regime for private companies should be consistent with the existing comply-or-explain approach for listed companies. A light touch approach is suggested, potentially covering revenues, compliance with s172 of the Companies Act, company structure, executive pay, numbers of employees and pension scheme contributions.

Recommendation 10: *The FRC should work together with the Institute of Directors and with the Institute for Family Business to develop a new Code for the largest privately held companies. A new body should be established to oversee the Code for private companies and report on compliance, with a complaints mechanism to raise concerns with the companies concerned. The body would be funded by a levy on companies subject to the scheme.*

Recognising that this "voluntary regime" requires teeth, the Report contemplates a mandatory regulatory regime if standards remain low or there is a significant level of non-compliance in a three year timeframe.

Pay

The Committee agrees with the Prime Minister that high and unwarranted executive pay is an issue that needs to be addressed for the benefit of society as a whole. Whilst recognising that the job of leading a major company is 'extremely taxing and requires great skill and commitment', the Committee reports that overall levels have now been ratcheted up to levels so high 'that it is impossible to observe a credible link between pay and performance, thus undermining public trust in business.' It is acknowledged that there is a tension between 'competitive businesses making rational business decisions in their own interests and the wider societal impacts of these awards.'

With respect to bonus awards, the report supports the use of broader non-financial objectives to assess performance, provided these are genuinely stretching, noting that the use of targets related to s.172 duties or metrics relating to safety or customer service would send a clear signal to investors and employees that a company takes its corporate governance responsibilities seriously.

Recommendation 11: *Companies should make it their policy to align bonuses with broader corporate responsibilities and company objectives and take steps to ensure that they are genuinely stretching. Policy in this respect would be considered by the FRC in their corporate governance rating system.*

The Committee has concluded that LTIPs should be phased out as soon as possible. The Committee suggests that no new LTIPs should be agreed from the start of 2018 and existing agreements should not be renewed.

Recommendation 12: *Following consultation with stakeholders, the FRC should amend the Code to establish deferred stock rather than LTIPs as a best practice in terms of incentivising long-term decision making. The consultation should develop guidelines for the structure of executive pay with the following features:*

- *A simpler structure based primarily on salary plus long-term equity, to divest over a genuinely 'long-term' period, normally at least five years, without large steps;*
- *Limited use of short-term performance-related cash bonuses, which should be aligned, where possible, to wider company objectives or corporate governance responsibilities;*
- *Clear criteria for bonuses: they should be genuinely stretching and be aimed to provide incentives rather than just reward.*

The Committee believes that 'the current scale of opposition to remuneration reports and policies' does not justify annual binding votes on pay levels. However, they do suggest that the threshold for triggering a binding vote should be low and that the Remuneration Committee Chairman should be held to account where insufficient support is received.

Recommendation 13: *The FRC should revise the Code to include a requirement for a binding vote on executive pay awards the following year in the event of there being a vote against of more than 25%. This requirement should be included in legislation at the next opportunity.*

Recommendation 14: *Any Chair of a Remuneration Committee should normally have served on the committee for at least one year previously. To further incentivise strong engagement, the Chair of a Remuneration Committee should be expected to resign if* *their proposals do not receive the backing of 75% of voting shareholders.*

Recommendation 15: *Companies should set out clearly their people policy, including the rationale for the employment model used, their overall approach to investing in and rewarding employees at all levels throughout the company, as well as reporting clearly on remuneration levels on a consistent basis. The FRC should produce guidance on implementing this recommendation for inclusion in the Code.*

Recommendation 16: *The FRC should amend the Code to require the publication of pay ratios between the CEO and both senior executives and all UK employees. The Government should require public sector and third sector bodies above a specified size to publish equivalent pay ratios.*

The Committee has considered the idea of employee representation on remuneration committees and believes this would represent a powerful signal in relation to company culture and a commitment to fair pay (see below for the Committee's views on worker representation on boards more generally). However, accepting that this would not work for all companies, it is not recommended that this be made mandatory. The Committee suggests that this option should be included in the Code and expects leading companies to adopt this approach.

Composition of boards

Diversity

The report also makes a number of recommendations on improving the diversity of boards.

Recommendation 17: *The aims and targets of the Hampton Alexander Review should go further and from May 2020 at least half of all new appointments to senior and executive management level positions in all listed companies should be women. Companies should explain in the annual report the reasons why they have not achieved this target and what steps are being taken to rectify gender inequalities on executive committees.*

Recommendation 18: *The FRC should embed the promotion of ethnic diversity of boards within the revised Code. At the very least, wherever there is reference to gender, the FRC should include a reference to ethnicity, so that the issue of ethnic diversity on boards is made explicit in the revised Code, and is given as much prominence as gender diversity.*

Recommendation 19: *The Government should legislate to ensure that all FTSE 100 companies disclose workforce data broken down by ethnicity and pay band, in the spirit of the McGregor Smith review published recently.*

The report also notes that cognitive diversity should also be a consideration. Diversity is also about differences in approach and experience which promotes more effective challenge and more informed decision making.

Recommendation 20: *The FRC should work with others to provide improved guidance on cognitive diversity in the context of board membership.*

Recommendation 21: *The revised Code should have the issue of board diversity as a key priority and there should be a public explanation of the reasons why members are part of the board. The Code should require annual reports to contain information on diversity on the board and in the workforce covering gender, ethnicity, social mobility and diversity of perspective. This narrative should include agreed targets and report on how accurately the board mirrors the diversity of the workforce and the customer base.*

Worker representatives on boards

The Report supports the inclusion of workers on boards in the form of an employee being appointed as a director in their own right with full responsibilities. The Committee believes the insight and challenge brought by worker directors would benefit many boards. The report does not recommend that this should be a compulsory requirement but companies are encouraged to consider this as something that should become the norm.

Nomination committees

The nomination committee is responsible for finding and appointing board directors based on merit and against objective criteria. It has a crucial role in ensuring board diversity.

Recommendation 22: *the FRC should update the Code to explicitly state that the procedure for the appointment of new directors should be by open advertising and external search consultancy, with explanations provided if this is not the case.*

Recommendation 23: *the FRC should be given new powers to oversee the three-yearly board evaluation process to ensure it is "genuinely independent, thorough and consistent across companies."*

The full report of the BEIS Committee can be found here.

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