ICGN
International Corporate Governance Network

Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
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Via email: corporategovernance@beis.gov.uk

14 February 2017

Dear Corporate Governance Reform Team,

ICGN comment on the UK Green Paper for Corporate Governance Reform

The International Corporate Governance Network (ICGN) welcomes the opportunity to comment on the Department for Business, Energy & Industrial Strategy's Green Paper on Corporate Governance Reform.

ICGN's mission is to promote high standards of governance in companies and responsible investment practices by investors, with a long-term perspective on sustainable value creation. This mission extends systematically to promoting efficient financial markets and economies world-wide. ICGN was established over 20 years ago, and today our membership of governance professionals spans over 45 countries, with over 20% based in the UK, and includes investors representing assets under management in excess of US$26 trillion. Many of our members have significant investment holdings in UK companies.

Our policy positions are guided by the ICGN Global Governance Principles and the ICGN Global Stewardship Principles both of which have been developed in consultation with ICGN Members and as part of a wider peer review. Also of relevance for this consultation is ICGN's Guidance on Executive Director Remuneration.[1] These documents inform the basis of our response to the questions posed in the consultation. They reflect our global perspective as an institutional investor-led body, and we would like to emphasise the important role that investors play as de-facto guardians of good corporate governance to help ensure the health and prosperity of financial markets, and ultimately society as a whole. As such, ICGN plays an important role in serving as a single source of international experience and a platform for balanced and constructive dialogue between investors, companies and policymakers.

We would make the initial observation that in an international context the UK's system of corporate governance is widely respected and well-regarded. The UK Corporate Governance Code and UK Stewardship Code both provide a strong foundation for good corporate governance practices by companies and for responsible investment practices by institutional investors. These codes have

[1] For further background on ICGN, including its core policy documents, please see: https://www.icgn.org/policy

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influenced positively the development of similar governance and stewardship codes in many jurisdictions around the world.

At the same time we understand that there remains scope for improving the corporate governance regime in the UK. In this regard, we welcome the government's recognition of the critical role that governance plays in safeguarding the efficient functioning of an economy and society more broadly. The government's focus with this Green Paper includes both the "traditional" governance topic of executive remuneration. But it is also important to see the government placing a greater focus on less traditional governance topics that have not been as focused upon in the UK Corporate Governance Code, namely the importance of stakeholder relations and the corporate governance of private companies.

Before responding to the questions outlined in the Green Paper we would like to share our overarching view that executive remuneration, while important, is perhaps over-emphasised both in the Green Paper itself and in the overall context of UK corporate governance reform proposals. Many of our UK institutional investor members believe that the subject of remuneration may be disproportionately emphasised in their engagement with companies, relative to other important areas of governance, strategy and finance.

We welcome new options for reform in executive remuneration, but ICGN would suggest that issues which are integral to the long term sustainability of companies such as business ethics and culture, risk management and integrated reporting can be of equal, if not greater, importance. In this regard, we respectfully encourage the government to keep in mind this broader perspective on corporate governance in the development of new reforms.

Executive Remuneration

Executive remuneration is a highly politicised topic, particularly given growing social concerns around income inequality, largely due to instances of questionable pay practices in some UK companies. There is also a widespread perception that ongoing increases in CEO level pay is not commensurate with the increases in the long term value of the companies they lead.

The ICGN published a first statement on executive remuneration in 2005 and today our guidance sets out our perspective on what global investors expect from companies when proposing pay policies and annual remuneration reports. We believe both should be linked to company performance and long term value creation.

Our Guidance is written in the acknowledgement that investors who actively engage and vote on remuneration must act in the context of their fiduciary duty to their end clients and beneficiaries, which include long-term individual savers and pension funds. Investor obligations are primarily to these clients and beneficiaries, not to government policy objectives. In many ways investor and government perspectives on governance are aligned, but it would be inappropriate for investors to serve as agents of government policy in addressing those aspects of executive remuneration that have political sensitivity if these are different from their fiduciary responsibilities.

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Question 1: Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance?

We welcome the government's intention to generally strengthen shareholder influence in ensuring executive pay promotes the long term success of the company. However, while we agree with some of the options in the Green Paper, ICGN believes that shareholders in UK companies already have adequate power to influence executive pay through the reforms introduced in 2013, including the binding vote on pay policy and the advisory vote on the annual remuneration report. We therefore make the following observations regarding the options presented:

Option (i): We do not support the addition of new binding votes that are applied across the board to all companies. We think it most appropriate for investors to make effective use of their existing powers rather than seek new powers.

Many shareholders, even those who vote diligently on advisory and binding remuneration resolutions, are often reluctant to take operational decisions away from the board. Shareholders elect directors to take these decisions on their behalf, and expect boards to develop appropriate remuneration structures to promote the long-term success of the company. While shareholders have an important role to play through engaging and voting on remuneration plans, the first line of defense must lie with the board and the remuneration committee.

An area that might call for additional attention is the introduction of an escalation process. The Green Paper rightly notes that it is rare for companies to "lose" a pay vote, meaning over 50% of votes against. However less uncommon are votes that generate what the Green Paper refers to as "significant minority" opposition, which might be defined as over 20% of shareholders voting against the pay report. In such cases some form of escalation - possibly in the form of an escalated binding vote on pay policy - may be warranted when it is clear that the company may be insensitive to the concerns of a critical mass of its shareholders.

Option (ii): We support the option of introducing stronger consequences for a company losing its annual advisory vote on the remuneration report. This is similar to the current regime in the UK, albeit with the new introduction of a super-majority of shareholders to approve the company's next pay policy vote.

Option (iii): We do not support upper limit thresholds which we believe could result in a diminutive level being set.

Option (iv): We do not support the requirement of the existing binding vote on the executive pay policy to be held more frequently than every three years. The current approval on a three year basis of the policy complemented by an annual vote on the actual awards made to executive directors is adequate.

Option (v): We support scope for further guidance from the Financial Reporting Council (FRC) on how companies engage with shareholders following remuneration votes that encounter significant shareholder opposition. But this need not apply to remuneration alone, and could apply to any resolution at a shareholder meeting where significant opposition may exist.

Question 2: Does more need to be done to encourage more institutional and retail investor to make full use of the existing and any new voting powers on pay?

Option (i): We do not support the introduction of mandatory voting disclosure. The majority of investors already disclose their voting records. Given the important ownership of overseas investors it is unclear how such a provision could be imposed on investors not domiciled in the UK. However, we support the strengthening of the UK Stewardship Code to encourage more transparent disclosure at a company level as well as aggregated level. This would also provide more accountability of asset managers to asset owners in the execution of their stewardship obligations. The ICGN's Global Stewardship Principles, emphasise the importance of investors making effective use of their voting rights, as well as disclosing voting records both to their clients and the public at large.

Option (ii): While some companies may wish to consider establishing a senior shareholder committee, to scrutinise remuneration and other governance issues, we would caution against a mandatory requirement for the creation of such committees in all companies. We believe this would not be scalable given the number of listed UK companies, and that such a requirement would prove burdensome for both companies and investors and lead towards superficial compliance.

Option (iii): We support the encouragement of individual retail shareholders to exercise their right to vote. The presence of nominee accounts, while cost efficient, obstruct underlying holders from being able to exercise their right to vote. Segregated accounts should be the default option for custodians who should provide an identified investor with a holdings certificate upon request with any other documentation to enable the investor to attend a general meeting, speak and vote. As a related issue, we also believe that both retail and institutional shareholders should be able to have confirmation that their votes cast have been received and formally counted by the company.

Question 3: Do steps need to be taken to improve the effectiveness of remuneration committees?

Option (i): We do not support a new requirement for remuneration committees to consult shareholders and the wider workforce in advance of its pay policy. The remuneration committee plays a central role in addressing concerns relating to both the structure and quantum of executive pay. ICGN supports the existing UK Corporate Governance Code recommendations on remuneration committees, and we encourage all remuneration committee members, and indeed all board members, to be accountable for developing appropriate remuneration structures and to be sensitive to the concerns of shareholders and stakeholders regarding pay. This can, and often does, involve consultation with shareholders, both before and after remuneration votes, but a requirement for boards to consult both shareholders and employees on remuneration plans is likely to be unworkable. We believe many boards are already aware of where their executive remuneration plans are susceptible to shareholder or stakeholder concerns.

Option (ii): We support the recommendation from the Executive Remuneration Working Group to require chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role. We think this may be better expressed within the UK Corporate Governance Code than in the form of hard law.

Question 4: Should a new pay ratio reporting requirement be introduced?

Option (i): We support pay ratio reporting as suggested in the Investment Association's Principles of Remuneration, however we are cautious about mandatory requirements which could lead to abuse and misleading distortions.

We are sympathetic to the concerns expressed in the Green Paper about the quantum of executive pay, though we do note that the FTSE 100 CEO pay to average pay ratio, while high, appears to have stabilized since 2013. While it is difficult, if not impossible, to define maximum pay ratios of this nature that are relevant to all companies in all sectors, we do believe that boards and remuneration committees should be aware of and be sensitive to the quantum of pay awarded to executives, even if the absolute level of pay of an executive director may be small relative to a company's earnings or cash flow. We believe that boards should be able to justify the quantum of pay awarded to executives, without making exclusive reference to pay levels in peer companies.

As the Green Paper notes, sectoral differences between companies and remuneration patterns make difficult meaningful comparisons of CEO pay to the pay of average workers. While that may be a relevant comparison within sectors, a more relevant comparison across the universe of listed companies in the UK might be to compare CEO pay to the medium household income level in the UK. This approach would provide for a common denominator, and would be less flattering for companies in some sectors, such in financial services, where average employee wages may be higher than in other sectors.

Question 5: Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened?

Option (ii): We support transparency of bonus targets and performance metrics, including a discussion of how such targets and metrics relate to company strategy and long-term success. We believe that companies should disclose the performance metrics and target ranges that are used to govern the size of awards granted.

At the same time we are sympathetic to company concerns that some truly strategic performance metrics may be commercially sensitive if placed in the public domain. We are therefore cautious about the merits of a mandatory requirement calling for retrospective disclosure of all bonus targets for all companies. We think this could result in companies not adopting relevant performance metrics in some cases due to legitimate concerns about commercial sensitivity.

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Question 6: How could long-term incentive plans be better aligned with the long term interests of quoted companies and shareholders?

We agree with the Green Paper's intent to align long-term incentive plans with the long-term interests of the company and its shareholders. While we favour longer term vesting and holding periods in this context, we think these should be consistent with the company's own capital allocation and investment horizon, and that a fixed holding period that is the same for all companies in all sectors would be problematic.

Having said that we encourage longer term holding periods, and note that some companies have introduced a "career shares" holding period that can extend well beyond the five years articulated in the Green Paper. As the Green Paper notes, the advantage of longer term holding periods of this nature is that there may be a lesser requirement to define specific performance metrics that may be very complex – and not always directly relevant to company long-term performance.

<u>Strengthening the employee, customer and wider stakeholder voice</u>

ICGN believes that a company's key stakeholders, including its employees and customers, are fundamental to its long-term performance and success, and that it is relevant for both company boards and their shareholders to recognise the importance of stakeholders. The description of directors' duties under Section 172 of the Companies Act appropriately calls for directors to "have regard" for stakeholders interests, though this dimension to the Companies Act has not been actively tested in a legal context.

Question 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?

ICGN encourages companies and their boards to recognise and build awareness of their obligations to have regard for stakeholders interests, reflecting not only the directors' duties under Section 172, but also to appreciate ways in which stakeholder relations can promote long-term success for the company and its shareholders. This requires awareness of how the company impacts its stakeholders and society at large. Robust and objective self-assessment of this nature, perhaps incorporated as part of board effectiveness evaluations, should enable both executive management and the company's board to build a shared understanding of its stakeholder relations. This should feature in board discussion and debate, including discussions of strategy, risk management and reporting.

The Green Paper outlines a number of possible ways to formalise this stakeholder awareness including having stakeholder advisory panels or appointing stakeholder representatives to company boards. These approaches could be appropriate in individual company settings, but we do not believe a specific approach should be mandated in this context, either by legislation or code. We believe it is better for companies to choose their own path for determining an appropriate board and committee structure.

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We do support the suggestion that strengthening reporting requirements related to stakeholder engagement would be advantageous. In this regard we encourage companies to consider the practice of 'integrated reporting' which blends traditional financial reporting with narrative around longer term environmental, societal and strategic factors including the multi-capital framework expressed in the International Integrated Reporting Framework. This is important both as a management tool for companies and boards and as a way for investors to better understand how a company balances its commercial and stakeholder interests. The government or the FRC may wish to develop greater disclosure guidance for companies in this area.

Question 8: Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice?

Stakeholders are relevant and important for all companies, and all boards should be sensitive to stakeholder interests. We do not believe that there are a number of employees or other size threshold that should trigger specific requirements in terms of enhancing stakeholder understanding and relations.

The German model, including its model of co-determination (mandating employee representatives on the Supervisory Board) is often referenced as a governance system that incorporates stakeholder influence into board composition. While this may prove effective in Germany (and we note that the co-determination system also has a number of critics within Germany) we do not believe this system of governance, which also involves a two tier board structure, is directly relevant for the UK.

Question 9: How should reform be taken forward?

ICGN believes that voluntary or code-based approaches should be mainly employed to improve company understanding and relations with stakeholders. To the extent there were to be a legislative approach, it should focus on primarily on disclosure standards relating to stakeholder relations. We also believe as part of good stewardship, investors should also monitor how investee companies manage their stakeholder relations and be prepared to engage with companies to the extent stakeholder relations are poorly or incompletely managed.

As another consideration, ICGN was a recent co-signatory with other company and stakeholder groups in a letter to Prime Minister May, which proposed consideration of creating a "mechanism" to monitor how companies adhere to the stakeholder requirements under Section 172.[2] There may be benefits for such a mechanism to serve an ombudsman role to look after the broad interests of shareholders and stakeholders. We note that as a practical matter investors may be less likely to make actual use of such a mechanism than other stakeholders, in part because shareholders might generally prefer direct engagement with companies through their

[2] Other signatories include the Institute of Corporate Secretaries and Administrators, the Institute of Directors and the Trade Unions Council. Please see: https://www.icgn.org/sites/default/files/170124_Letter%20to%20PM.pdf

own ownership rights rather than rely on a third-party body. However, an ombudsman capability could have merit in promoting a greater stakeholder voice - as long as its ultimate focus would be on promoting the long-term success of the company, and not the specific interests of individual stakeholders in ways that are not related to company performance and success.

We also would note that for private companies with limited, if any, institutional shareholder monitoring and engagement on stakeholder relations, a monitoring mechanism of this nature could possibly fill the gap that institutional investors currently fill with regard to public company stewardship activities.

Corporate governance in large privately-held companies

Questions 10-12: What is your view for strengthening the corporate governance framework for the UK's largest privately held businesses? If you think the corporate governance should be strengthened, which business should be in scope and how would this be achieved?

It is fair to say that most of the focus of UK governance and reporting standards is on public companies. Yet large private companies play a critical role in the UK economy in terms of wealth creation, employment and impact on stakeholders, including their customers, local communities and environmental interests. Many ICGN members are investors in private equity, as well as public equity. Accordingly, we believe there is scope for greater consideration of corporate governance standards for private companies, particularly as some private companies may at some point in their life cycle consider public listing and ownership.

The concentrated ownership of private companies means that their controlling owners typically monitor closely company financial and operations, and this can be a very positive form of control and oversight. But even though the provisions of Section 172 also apply to private company directors, it less clear whether private equity owners and directors devote the same attention to stakeholder interests as compared institutional shareholders in public markets, given their public stewardship commitments. This is one reason, as noted above, why the proposed monitoring mechanism might have greater relevance for private companies than public companies. Even if a company is not publicly listed, we believe it may be positive to strengthen stakeholder reporting for large private companies where stakeholder impacts may be more substantive.

There may be merit in introducing another formal corporate governance code in the UK to cover large private companies exclusively, and we agree with the Green Paper's observation that the standards of governance for Premium Listed Companies may be disproportionate and may not all be relevant for private companies. At the same time we believe that the UK Corporate Governance Code should remain a primary point of reference for both public and private companies, and would note that there exist other established governance standards in the UK market, such as the Quoted Company Alliance (QCA) governance principles for small companies, primarily listed on the main market. The FRC also offers guidance for smaller company governance for AIM listed companies.

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In this context a new corporate governance code for private companies could possibly muddy the waters, particularly if broad principles of governance were to be significantly different for such a code. Given that ownership structures can be fluid, large private companies could at some point become public companies – and vice versa. On that basis any new private company code should be in broad alignment with the UK Corporate Governance Code. As another possibility, rather than create a wholly new governance code for the private market, it might be sensible for a body like the QCA or FRC to issue guidance on private company governance and how it differs from public company governance.

We hope our comments are useful and we would welcome the opportunity to meet directly with the Department for Business, Energy and Industrial Strategy to elaborate on our observations or to provide a view on the questions expressed in your consultation. Once again we would like to congratulate the Department for leading this very important consultation and please to contact ICGN Policy Director George Dallas (george.dallas@icgn.org) if you have any questions or comments.

Yours faithfully,

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Erik Breen, Chairman, ICGN Board of Governors

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