



**ICGN**

International Corporate Governance Network

Business, Innovation and Skills Committee  
UK Parliament

By internet submission:

24 October 2016

To Business, Innovation and Skills Committee:

**Re: Corporate Governance Inquiry**

The International Corporate Governance Network (ICGN) welcomes the opportunity to provide some high level observations to the Inquiry on Corporate Governance from the Business Innovation and Skills Committee.

The ICGN is a body which represents the corporate governance professionals of the world, particularly those working within global investment institutions. It was established over 20 years ago and today our members include investors representing assets under management in excess of US\$26 trillion. Over 20% of our membership is based in the UK, with a further 30% based in the USA and the rest from other parts of the world - many of whom have substantial shareholdings in the UK market and are therefore relevant to this Inquiry.

Our policy positions are guided by the ICGN Global Governance Principles and Global Stewardship Principles, both of which have been developed in consultation with ICGN Members and as part of a wider peer review. They inform our response to the questions posed in the Inquiry Terms of Reference regarding director's duties, executive remuneration and board composition. We have addressed each point as broad commentary from the perspective of an investor-led body and we have also taken the liberty of concluding with reference to the important role that shareholders 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.

**Directors Duties**

Section 172 of the Companies Act (2006) clarifies that the duty of a director is to promote the long term success of the company for the benefit its members - the shareholders. The Section also rightly identifies other factors (the long term, employees, customers, other stakeholders) to which directors must "have regard" in the conduct of their duties. While these factors are clearly identified, the specific way in which directors have regard to stakeholder factors in practice is possibly less clear. ICGN recognises that director's duties under this act seek to embrace worker, consumer, environmental and other interests, to promote the long-term success of companies, and thereby to contribute to sustainable economies, safeguarding prosperity for future generations.

We believe that both company directors and investors should think systemically about contributing to stable markets and economies, and that these principles should be imbedded in strategic decision-making and company governance. While there is

no one way for directors to address stakeholder issues, we do encourage companies to consider ways in which to enhance their engagement with a broad range of stakeholders.

One method would be to embrace the practice of 'integrated reporting' which blends traditional financial reporting with narrative around longer term environmental, societal and strategic factors. 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.

## **Executive Pay**

Shareholders can play an important role in influencing company remuneration practices which is exercised by a binding shareholder vote on the remuneration policy, complemented by company engagement. We acknowledge that challenges exist both in pay structures and pay quantum. We also note that, in a global context, executive remuneration in the UK is high, though generally lower than pay packages in the USA.

Coupled with the binding vote on remuneration policy, non-binding shareholder votes on annual pay packages can provide important guidance to boards. UK shareholders are prepared to vote against objectionable pay practices which are inconsistent with the previously agreed remuneration policy. In the event that shareholder concerns are not addressed by companies, the ICGN advocates that the next course of action would be to consider the effectiveness of directors incumbent on the remuneration committee. We believe that this is a more practical approach to remuneration oversight by investors and would urge caution about broadening the scope of binding votes on pay to the current annual vote about remuneration implementation. We believe this annual vote is best left on an advisory basis.

While binding votes provide the potential for shareholders to have a final say in a pay package, this effectively takes an operational decision away from the board and remuneration committee – which is not necessarily a good thing. It could also result in skewed engagement between companies and investors, focusing on remuneration over other strategic, financial and governance matters.

In a systemic context we are aware of growing income inequality around the world and of the related social tensions that can potentially affect economies and markets. In this context we do believe that both investors and company boards should be able to justify both the structure and the quantum of executive pay. But we would urge caution about the merits of calling for a disclosed ratio between highest paid employees and average workers. It would be a very blunt indicator whose results could easily be distorted and would not be comparable across sectors.

To help promote long term thinking and performance, ICGN's own remuneration guidance calls for long term key performance indicators, including environmental, social and governance (ESG) factors, to be considered as performance criteria in remuneration packages. Also, as disincentives or deterrents, malus and claw-back

provisions should be standard features of remuneration structures to discourage inappropriate risk taking.

### **Composition of Boards**

ICGN strongly supports board diversity and has published guidance documents focusing both on diversity in a general context and the specific issue of gender diversity. Diversity is a core attribute of a well-functioning board which supports greater long-term value for shareholders and companies. Diversity promotes directors with experience, social backgrounds and competencies to help enable effective board decision-making and leadership. Moreover, relevant board candidates with the needed skills to promote diversity and board effectiveness should not be discriminated against based on gender, age, nationality, race, sexual orientation or gender identity.

ICGN encourages companies to develop and disclose board diversity objectives and for boards to play a role in fostering diversity and inclusiveness within a company's operations through overseeing recruitment and human capital management strategies. The ICGN also encourages shareholders to establish a dialogue with companies and, if necessary, hold the board accountable in instances of company non-compliance with market regulations or deficient disclosure with market protocols. Companies which do not meet such protocols should further expect heightened shareholder interest.

In some cases it may be positive to include worker representation on the board to the extent the individual met the required skills and needs to contribute to the effective decision-making of the board as a whole. Board directors are collectively responsible for pursuing the success of the company and should not act for any self interest or for any one constituent group. We would therefore be cautious about considering a more systematic introduction of workers to the boards of companies, and careful consideration would have to be given to the fiduciary responsibility of the employee director relative to the company and other constituencies, such as trade unions.

### **Role of Investors**

The UK shareholder rights regime is arguably one of the strongest in the world, and the ultimate beneficiaries of those rights should be the many millions of people who save for their pensions. Further, we believe that the Companies Act (2006) adequately provides for clarity around directors duties though there is perhaps scope for additional guidance relating to how directors can show proper "regard" to its stakeholder responsibilities. It is therefore not a matter of inadequate legislation that fails to keep UK companies in check, but rather a lack of truly effective corporate governance monitoring and enforcement on a systemic level.

ICGN believes that shareholders are by far the most influential constituency to hold irresponsible business behaviour and poor corporate governance practices to account by virtue of their share-ownership rights and responsibilities. Over 20 years ago Sir Adrian Cadbury and his Committee on the Financial Aspects of Corporate Governance set in motion the framework for promoting meaningful dialogue between

shareholders and companies with the world's first Combined Code on Corporate Governance implemented through a comply or explain system. Today, we are witnessing the emergence of investor stewardship codes.

The ICGN published its first Statement on Institutional Investor Responsibilities in 2003 and, this year, our Members approved the ICGN Global Stewardship Principles. In similar fashion to the UK Stewardship Code under the auspices of the Financial Reporting Council, the ICGN Principles provide a framework for investors to better understand and implement their fiduciary duties to preserve and enhance long-term value on behalf of their beneficiaries - the investing public.

Investor stewardship codes are not a panacea for mitigating the chances of another BHS and it would be overly ambitious to say we could rule out poor corporate governance practices indefinitely - as Adam Smith taught us in 1776, *"negligence and profusion, more or less, always prevails in the management of the affairs of companies."* But stewardship codes can provide a clear framework for investors to embrace as they exercise their stewardship obligations on behalf of UK pensioners, savers and public at large.

There are a number of challenges which we must address if we are to ensure the effective accountability of board of directors to shareholders and society at large, some of which ICGN is working on:

- Firstly, we must improve and professionalise the practice of corporate governance and investor stewardship. Today there are excellent courses available for directors, company secretaries, auditors, financial analysts and so on. There is, however, no recognised professional qualification for investors responsible for corporate governance oversight on how they discharge their responsibilities.
- Secondly, we must recognise that most institutional investors have hundreds or thousands of companies in their portfolios, and while many are bolstering resources dedicated to company engagement, this is still far from adequate. Encouraging greater shareholder collaboration may be helpful in this regard and working with organisations such as the UK Investor Forum or through global body such as the ICGN can facilitate broader engagement activity on a collective scale.
- Thirdly, mechanisms for registering and confirming votes , particularly cross-border votes, are woefully inadequate and discourage active engagement from foreign shareholders to interact directly with UK companies, or asset owners to engage through their managers. This was well documented by Professor John Kay in his review of UK equity markets and long term decision-making in 2011. We are yet to make progress on many of his recommendations which we might revisit as part of this Inquiry process.

We conclude by referencing the globally respected Organisation for Economic Co-operation and Development (OECD) when they referred to the important role that investors play in preserving and enhancing long-term value: *"The effectiveness and*

*credibility of the entire corporate governance system and company oversight depend on institutional investors that can make informed use of their shareholder rights and effectively exercise their ownership functions in their investee companies”* (2015 OECD Corporate Governance Fact-book). It is the purpose of the ICGN to improve investor stewardship. Much has been achieved. But there remains much to be done.

We would welcome the opportunity to meet directly with the Inquiry Committee 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 Committee for launching this very important enquiry and we remain at your disposal should you have any questions.

Yours faithfully,



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