



Governance *in brief*

Government issues Green Paper on corporate governance reform

Headlines

- The UK is recognised as having a world-leading corporate governance framework. Key strengths include a unitary board system which makes directors collectively responsible for the decisions of the board and a Corporate Governance Code operating on a 'comply or explain' basis which continues to evolve in line with emerging good practice.
- The aim of this Green Paper is to consider what changes might be appropriate in the corporate governance regime to help ensure that we have an economy that works for everyone. The paper focuses on three areas:
 - Ensuring that **executive pay is properly aligned** to long-term performance
 - Giving **greater voice to employees and consumers** in the boardroom
 - Raising the bar for **governance standards in large privately-held companies**

Introduction from the Prime Minister

- For people to retain faith in capitalism and free markets, big business must earn and keep the trust and confidence of their customers, employees and the wider public. Where this social contract breaks down and individual businesses decide to play by their own rules, faith in the business community as a whole diminishes. It is clear that something has to change.
- Good corporate governance is about having the right checks and balances within big business to strengthen decision-making and accountability.
- The Government has put forward a range of options to improve the situation. The Prime Minister wants Government to have an open discussion with business, investors and the public about what needs to be done.

Executive pay

The Government is committed to ensuring that companies retain flexibility to set remuneration policy and pay appropriate to their business needs and strategy, whilst giving proper consideration to the views and concerns of shareholders and having appropriate regard to the interests of employees and other stakeholders.

A number of options have been put forward.

A – Shareholder voting and other rights

Introduce a binding vote on all or some elements of the executive pay package. A binding vote could apply to the full remuneration report or only to variable pay awards. A vote could be applied to all companies on an annual basis or only to companies that have encountered significant shareholder opposition to the remuneration report.

Introduce stronger consequences for a company losing the advisory vote on the remuneration report. For example, where a company loses an annual advisory vote, the company could be required to win the backing of a 'supermajority' of shareholders to approve the next pay policy. Alternatively there could be a requirement to hold a binding vote on pay in the following year.

Require or encourage pay policies in quoted companies to (a) set an upper threshold for total annual pay and (b) require a binding vote at the AGM where actual executive pay in that year exceeds the threshold.

Require the existing binding policy vote to be held more frequently. The remuneration policy could be subject to an annual vote or, alternatively, allow shareholders to bring forward a binding vote on a new policy earlier than the three year deadline.

Strengthen the Corporate Governance Code on how companies should engage with shareholders on pay. Options might include setting out a process for remuneration committee engagement with shareholders and employees before the annual remuneration report is presented to the AGM. Stronger guidance could also be included on how companies should engage with shareholders following significant opposition to a remuneration report.

B – Shareholder engagement on pay

Mandatory disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting. Existing guidance could also be strengthened to encourage institutional investors to publish more detail on the rationale for their voting decisions.

Establish a senior 'shareholder' committee to engage with executive remuneration arrangements. This refers to the model laid out by Chris Philp MP and the High Pay Centre in their report entitled *Restoring Responsible Ownership*.

Consider ways to facilitate individual retail shareholders to exercise their rights to vote on pay and other corporate decisions. More could be done to clarify and publicise existing options for individual investors to vote. The Companies Act could be amended to require brokers to offer underlying investors the option to opt-in to voting and wider information rights.

C – The role of the remuneration committee

Require the remuneration committee to consult shareholders and the wider company workforce in advance of preparing its pay policy. This could be achieved through more specific guidance in the Corporate Governance Code. If companies designate a NED to be responsible for representing the interests of the workforce (see below), this individual could also sit on the remuneration committee.

Require chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role.

D – Transparency in executive pay**Introduce disclosure of the ratio comparing the pay of the chief executive to pay in the wider company workforce.**

Boards could be required to explain to shareholders and wider stakeholders why the ratio is appropriate in the context of the performance of the business and rewards for the general workforce.

Disclosure of bonus targets. Retrospective disclosure of all bonus targets within a specified timeframe could be a reporting requirement. Non-legislative pressure could be increased by shareholders and the remuneration guidance in the Corporate Governance Code could be strengthened.

E – Long-term executive pay incentives

Restricted share awards as an alternative to LTIPs. These would not involve complicated performance criteria. The paper notes the criticism that these are a form of guaranteed reward but also the suggestion that the level of these awards would be set much lower (around 50%) than current LTIP awards.

Extension of holding periods to a five year minimum. The requirement in the Corporate Governance Code could be revised from the current minimum of three years to five years. This option could be combined with increased shareholding requirements (the paper notes 2 x gross salary) to help encourage a focus on long term value creation.

Strengthening the employee, customer and wider stakeholder voice

The aim of the proposals in this section is to build confidence that Section 172 (the duty of a director to promote the success of the company – see appendix), introduced by the Companies Act 2006, is properly understood and applied.

Create stakeholder advisory panels. Directors (executive or non-executive) could use the panel to seek views on particular issues, e.g. remuneration policy, and/or panel members could be invited to board meetings to offer views. Panel members could also initiate discussions on topics that they feel are important. While not giving a direct input into board decisions, a stakeholder panel could create more transparency and introduce a dialogue between the board and its stakeholders.

Designate specific non-executive directors to ensure that the voices of interested groups, particularly employees, are being heard at board level. Each designated NED could chair a board-level committee with the status to ensure that executive decision-making takes appropriate account of employee, supplier or consumer issues. The designated NED could set out their objectives each year and report on how they have tackled issues identified and generally taken forward their responsibilities.

Appoint individual stakeholder representatives to company boards. This can bring a new perspective to board discussions but may also lead to greater conflict and delayed decision making, or potentially shifting the decision making away from the boardroom. There are additional challenges in choosing the representative(s). The Government is not proposing to make this option mandatory but considers that companies should determine whether this model would suit their business.

Strengthening reporting requirements relating to stakeholder engagement. Companies, other than small companies, already have to prepare an annual Strategic Report which provides shareholders with information on how the directors have performed their duties under Section 172 but there are no details as to how this should be done and disclosures are often unclear. Stronger reporting requirements could be designed to provide greater confidence that boardroom decisions take wider stakeholder interests into account. The Government is looking for suggestions on how additional requirements could be introduced.

Corporate governance in large privately-held businesses

The UK's strongest corporate governance and reporting standards are focused on public companies where the owners or shareholders are more distant from the executives running the company. Large privately-held businesses are not expected or required to meet the same formal standards as public companies. There are a number of reasons being recognised now for exploring whether similar standards should apply to at least some of these privately-held businesses:

- 1) Good governance is about more than the relationship between owners and management – there are other stakeholders with a strong interest in whether a business is well run, including employees, customers, supply chains and pension fund beneficiaries;
- 2) Society has a legitimate expectation that companies will be run responsibly in return for the privilege of limited liability;
- 3) Since 1999 there has been a steady decline in the number of public companies and an increase in privately-held businesses; and
- 4) Good corporate governance provides confidence to key stakeholders, such as banks and suppliers, that a company is being well-run.

A number of options for reform have been put forward for consideration.

Extending the scope of the existing UK Corporate Governance Code. The drawback to extending the UK Corporate Governance Code to encompass privately-held businesses is that the Code has been designed for premium listed companies and some of the provisions are not appropriate for privately-held companies. The 'comply or explain' principle could overcome this, as companies could choose not to comply with those provisions which are not appropriate. However if too much of the Code is explained away this could lead to a loss of credibility.

Development of a separate governance code for large privately-held companies. This could be tailored specifically to the needs and challenges faced by privately-held businesses. Adoption of the principles of such a Code could be voluntary, or it could be a more formal 'comply or explain' approach. Different approaches could apply to companies of different sizes, the paper calls for views on where and how any size threshold should be set. The paper notes that some companies have adopted the Institute of Directors' Corporate Governance Guidance and Principles for Unlisted Companies in the UK which was issued in 2010 and sets out a number of voluntary principles.

Applying reporting standards more consistently on the basis of size rather than legal form. At present, companies meeting the definition of a "quoted company" per the Companies Act have to meet stronger corporate governance and reporting standards than privately-held businesses. Recent new reporting requirements, such as the Modern Slavery Statement, have been applied to companies or businesses above a certain size criteria irrespective of their legal form or status.

For further information

The Green Paper and online submission form can be found [here](#).

Responses to the consultation must be received by **17 February 2017**.

Deloitte View

The Government's Green Paper draws together a number of current societal concerns.

- **On executive pay** – we agree that it is important to ensure that executive pay is properly aligned to long-term performance and is fair and transparent.
- **On strengthening the employee, customer and wider stakeholder voice** – we welcome the opportunity to discuss ways in which the voice of employees, customers and other interested parties can be strengthened at boardroom level and support a high-level principles approach allowing companies to choose the most appropriate way to meet it.
- **On corporate governance in large privately-held businesses** – we agree that businesses (and their stakeholders), whatever their legal form, benefit from strong and effective standards of management and governance but would stress the importance of a proportionate, practical and principles-based approach which will not stifle entrepreneurial, innovative and inclusive development.

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Appendix

S172 Companies Act 2006

A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to:

- a) the likely consequences of any decision in the long term;
- b) the interests of the company's employees;
- c) the need to foster the company's business relationships with suppliers, customers and others;
- d) the impact of the company's operations on the community and the environment;
- e) the desirability of the company maintaining a reputation for high standards of business conduct; and
- f) the need to act fairly as between the members of the company.

The Green Paper Questions

Executive pay

1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance?
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?
3. Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, particularly to encourage them to engage more effectively with shareholders and employee views before developing pay policies?
4. Should a new pay ratio reporting requirement be introduced?
5. Should the existing requirements to disclose performance targets for the annual bonus be strengthened? How can this be done without compromising commercial confidentiality?
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 three to a minimum of five years for share options awarded to executives?

Strengthening the employee, customer and wider stakeholder voice

7. How can we strengthen the way in which the interests of employees, customers and wider stakeholders are taken into account at board level?
8. Which type of company should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee or other size threshold?
9. Should any reforms be introduced by a legislative, code-based or voluntary approach?

Corporate governance in large, privately-held businesses

10. Should the corporate governance framework be strengthened for the UK's largest, privately held businesses? What would be the benefits and what are the risks?
11. What businesses should be in scope? Where should any size threshold be set?
12. How should any strengthening be achieved – should this be legislative or voluntary? How should compliance be monitored?
13. Should non-financial reporting requirements be applied on the basis of a size threshold rather than the legal form of a business?
14. Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Are there any other improvements which could be considered?



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