

CORPORATE GOVERNANCE UNDER THE SPOTLIGHT



Recent scandals affecting businesses in the UK have put the spotlight on corporate governance and Theresa May has made it clear she intends to crackdown on unacceptable boardroom behaviour. A recent report published by the Business, Energy and Industrial Strategy Committee¹ suggests that the current law does not require revision but a number of measures are being recommended including a voluntary code of corporate governance for large private companies, which have hitherto not been subject to the UK Corporate Governance Code that applies to listed companies.

The UK has long been an established leader in corporate governance, combining high standards with low burden and flexibility – one of a number of reasons why it is considered an attractive destination for business. However, recent major corporate governance failings at BHS and Sports Direct, as well as rising public dissatisfaction with executive pay levels, has prompted the Government to reassess the accountability, control and make-up of those responsible for the performance and management of UK companies.

On 5 April 2017, the Committee published a report considering potential amendments to the corporate governance framework for UK companies. The Business, Energy and Industrial Strategy Committee's (the Committee) wide-ranging inquiry forms a separate exercise from both the Government's narrower green paper consultation on corporate governance and the Financial Reporting Council's (the FRC) review of the UK Corporate Governance Code (the Code).

The outcome of the report is positive, with the Committee concluding that the UK retains a strong system of corporate governance and generally warns against any radical overhaul of the UK's internationally recognised regime. However, it also identifies areas for significant improvement and provides recommendations to address the changing nature of company ownership.

Promoting good corporate governance

The Committee did not consider it necessary to revise the current law under section 172 of the Companies Act 2006 which governs directors' duties, including the duty to promote the success

¹ The Business, Energy and Industrial Strategy Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department of Business, Energy and Industrial Strategy.



of the company for the benefit of its members as a whole - in part due to insufficient legislative time in the wake of Brexit.

The report did however recommend a number of measures designed to ensure that directors demonstrate they take their existing duties to other stakeholders (including employees, customers and suppliers) and the long-term consequences of their decisions seriously, including:

- That the FRC amend the Code to require directors to report on the fulfilment of their duties under s172, in particular explaining how stakeholders' interests are considered and how the company's long-term objectives are pursued. Any failures in this respect should be addressed and explained.
- That the FRC establish an annual rating system for corporate governance using a traffic light system, which companies would be required to reference in their annual reports.
- That the Code provide guidance on the roles and responsibilities of non-executive directors.
- Improving investor engagement through the creation of stakeholder advisory panels, encouraging more imaginative and regular digital communication and pushing back on the use of boiler-plate statements in annual reports.
- Enhancing the FRC's enforcement powers to engage and hold directors accountable in respect of their duties, including legal action for breach of s172 where engagement is unsuccessful.

The report suggests that any corporate governance report be loosely modelled around the slavery and human trafficking statements currently required from companies. The proposed reporting/rating regime is in its formative stage and remains very broad, however

any framework would have to provide investors access to information not previously available in order to be effective. Equally, it is unclear how any additional enforcement powers provided to the FRC would be practically implemented, as the duty under s172 is a fiduciary one owed to the company alone.

Private companies

Under the current corporate governance framework, private companies in the UK are not subject to the Code. In order to address the growing disparity in corporate governance obligations between public and private companies, the report recommends that a voluntary code of corporate governance is established for large private companies (those with more than 2,000 employees). The scheme would be funded by a small levy on members and would implement a flexible, comply-or-explain model to reflect the diverse nature of the companies it could cover.

Executive remuneration

In relation to executive pay, the report notes that the Government does not intend to directly limit executive pay by law. The Committee's recommendations therefore focus on simplifying executive remuneration structures through effective corporate governance. In particular, the report recommends that:

- Long-term incentive plans (LTIPs) be phased out, with no new LTIPs from 2018.
- That preference is given to deferred stock options that are not subject to annual performance targets as a way of incentivising long-term decision making.
- Short-term cash bonuses are used on a limited basis and where offered, should align with wider company objectives or corporate governance responsibilities, rather than performance.

- A 25% vote against a remuneration report in one year should trigger a binding vote on executive pay the following year.

- Any chair of a remuneration committee should resign if proposals do not receive 75% of shareholder backing.

- Pay ratios as between executives and UK employees should be reported.

Board composition

The Committee notes that board diversity continues to be a concern, in the FTSE 100 only 10.4% of executive directors are women and only 8% of board positions are held by non-white directors. The report recommends that:

- From 2020, at least half of the new appointments to management level positions in FTSE 350 and all listed companies are to be women, with any company failing to meet this standard being required to explain the steps it is taking to rectify gender inequality in its annual report.
- The FRC amend the Code so that all references to gender are extended to include ethnicity.
- All FTSE 100 companies and businesses publish their workforce data, broken down by ethnicity and by pay band (similar to the gender pay gap regime).
- The Code should require that each remuneration committee have an employee representative, with companies encouraged to include workers on their boards (though the Committee did not recommend that this be mandatory).

The Committee's report can be found in full [here](#).



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