# The Business, Innovation, and Skills Committee Inquiry on Corporate Governance

Written evidence submitted by The Modern Corporation Project at Cass Business School and Frank Bold

## Executive summary

Between 2014 and 2016 Frank Bold, a purpose driven law firm, together with the Modern Corporation Project at Cass Business School hosted a global series of roundtables on corporate governance. This submission presents relevant conclusions of this process.

Mainstream corporate governance models have been narrowing since the 1970s in order to put the maximisation of shareholder value at the centre of corporate attention. The resultant focus on short-term share price rises leads to short-termism, undermines companies' ability to invest in their future and diminishes their capacity to anticipate and mitigate systemic risks. To address this situation, we recommend that the Committee consider the following issues.

1. Company law could clarify, for example by revising s. 172 of the Companies Act, that the duty of directors is:
   a. Owed to the corporation as a whole;
   b. To protect the long-term development of the corporation;
   c. To avoid contributing to systemic and specific risks that cause negative impacts on corporate stakeholders and society at large; and
   d. To specify how stakeholders' interests will be taken into account.

2. Company directors should disclose how they evaluate systemic risks, how they take into account stakeholders' interests, and how they reflect both in the company's strategy.

3. The concept of integrated reporting can provide guidance for companies as to how they should take into account and balance interests of different types of shareholders and of other stakeholders.

4. The Parliament can establish an authority with powers to intervene where corporate governance and decision-making contravenes the law (see the example of ASIC in Australia). Such an institution can also have a mandate to oversee board members' adherence to requirements and provide induction and training to directors.

5. Investors can be required to provide fuller and more timely information about their ownership of derivatives, short positions and about their voting and share lending policies.

6. In order to support an overall focus on long-term sustainable value creation, the incentive structures for executives should be:
   a. Based on metrics associated with a firm-specific long-term value creation strategy that integrates financial and non-financial objectives, rather than share price.
   b. Conditional on the achievement and sustainment of long-term goals, including long-term economic performance, fraud prevention and detection, ESG objectives, R&D investment and employee satisfaction.
   c. Transparent regarding the metrics used and the ratio of executive pay to minimum and median salary in the firm.
   d. Limited by reference to average, median or minimum salary within the company.
   e. Limited in terms of bonuses in relation to fixed pay (as the EU's Capital Requirements Directive has done for banks)

7. There are a number of positive effects of increased board diversity, however this strategy will not on its own address the problem of short-termism.

8. Employees and other stakeholders can be engaged in corporate governance in multiple ways:
   a. There is no major legal or economic argument against employee representation on boards as long as the mandate of directors is embedded within the framework of directors' overall responsibility to the company. Indeed, there are strong economic arguments in favour of this change.
   b. Company law can give employees or other stakeholders a right, like shareholders, to bring a statutory derivative action on behalf of the company.
   c. Allowing employees to express a view on the remuneration scheme of top executives can lead to narrowing the gap between top executive pay and median pay in the corporation and to a better alignment of executive compensation schemes with the long-term success of the corporation.
   d. Employees can also be given broader information and consultation rights in bankruptcy or M&A situations.

## Introduction

9. An integral part of City, University of London, Sir John Cass Business School ("Cass") is consistently ranked amongst the best business schools in the UK and the world. Frank Bold is a European purpose-driven law firm committed to helping companies to fulfill and develop their vision, improving the environment for business, and solving the most pressing of society's problems.

10. In 2013, Frank Bold initiated the Purpose of the Corporation Project, a strategic, open-source platform for leading experts and organisations interested in promoting the long-term health and sustainability of publicly listed corporations in the areas of policy-making and business management. The academic basis for the Project is provided by Dr. Jeroen Veldman and Prof. Hugh Willmott, who run the Modern Corporation Project at Cass.

11. Between 2014 and 2016, Cass and Frank Bold hosted a global series of roundtables on corporate governance ("Roundtables") addressing several of the topics raised in this inquiry. The events were held in London (twice) as well as in Breukelen (Netherlands), Brussels, New York, Oslo, Paris, and Zurich.

12. The outcomes of the Roundtables have been summarized in the Corporate Governance for a Changing World report, which is available at http://www.purposeofcorporation.org/corporate-governance-for-a-changing-world_report.pdf (the "Report").[1] The Report was presented on September 28, 2016 at a summit in Brussels with speakers including John Kay, Stefan Stern, and Vera Jourova, European Commissioner for Justice (responsible for corporate governance and company law) (http://summit2016.purposeofcorporation.org).

13. The Roundtables confirmed that there is an emerging consensus that the goal of the corporation should be to create long-term sustainable value, while contributing to societal well-being and environmental sustainability; that these objectives can be mutually reinforcing; that there is no objection in company law to this goal in any jurisdiction; and that corporate governance should be developed to a standard where it may contribute to these objectives.

14. However, this consensus has not yet been reflected in mainstream corporate governance models, which since the 1970s have put the maximisation of shareholder value at the centre of corporate attention. The resultant focus on short-term share price rises leads to short-termism, undermines companies' ability to invest in their future and diminishes their capacity to anticipate and mitigate systemic risks.

## Directors Duties

**Is company law sufficiently clear on the roles of directors and non-executive directors, and are those duties the right ones? If not, how should it be amended?**

15. The duty of care contained in s. 174 of the Companies Act is reasonably clear on the duties of executive and non-executive directors. Whether these duties are appropriate requires further research and consultation. There is insufficient guidance to company directors as to what is expected of them (as expanded below in the next question).

## Is the duty to promote the long-term success of the company clear and enforceable?

16. The duty is neither entirely clear nor easily enforceable. Section 170 provides that the duty is owed to the company but s. 172 qualifies that the obligation is to promote "the success of the company for the benefit of its members." This may lead to a short-sighted focus on the interests of shareholders.

17. Directors are under an obligation to proactively and critically evaluate the material financial risks and opportunities to their company. In practice directors often don't exercise their broad discretion to consider what is best for the company and instead identify their duty to promote success of the company with maximising its short-term market value.

18. A revised formulation could clarify that the duty of directors is:

    a. Toward the company as a whole;

    b. To protect the long-term development of the company;

    c. To avoid contributing to systemic and specific risks that cause negative impacts on the company's stakeholders and society at large; and

    d. To specify how stakeholders' interests will be taken into account.

19. A shorter version would emphasise that the duty of directors is to promote the long-term success of the company for the benefit of the company itself, its shareholders and relevant stakeholders (as enumerated in the current ss. 172(1)(a)-(f)).

20. In practice, the current duty is largely unenforceable. This is partly due to the courts' appropriate reluctance to interfere with the exercise of proper business judgment. Additionally, the fact that shareholders are the only stakeholders with an effective ability to enforce this provision through derivative actions results in a tendency to prioritise their interests above those of other stakeholders, such as employees and creditors.

21. Although UK company law entitles directors to take account of a broad range of issues which they consider will further the interests of the corporation, the permissive character of company law does not translate easily into practice. The reason for this is not to be found exclusively in the law, but in the broader institutional setting that focuses boards' attention on short-term shareholder value maximisation. Changes must therefore address this broader institutional framework.

## How are the interests of shareholders, current and former employees best balanced?

22. Currently, the law requires directors to focus on the long-term success of the company for the benefit of its members, meaning all present as well as future shareholders. This creates pressure on directors to disregard the interests of other stakeholders. This problem can be addressed by removing the dominant focus on 'members' from the definition of directors' duties, whilst protecting their interest by keeping the focus on the success of the company (see previous question).

23. There is a lack of guidance on how directors should interpret and apply potentially competing stakeholder interests. There may be instances where the long-term interests of the company are not the same as the short or medium-term interests of shareholders, if we consider their interest to be exclusively measured in terms of financial performance. For example, investment in research and development or in stakeholder relationships may take years to yield financial returns but are important for the well-being of the company into the future. Detailed guidance should not be addressed through a revision of the Companies Act 2006 due to the risk of codifying overly specific, complex or rigid interpretation. However emerging issues could be addressed through non-binding guidance or a revision of the Corporate Governance Code (useful examples to reference are the King Report on Corporate Governance (2009) and draft Dutch Corporate Governance Code (2016)).

24. Proper consideration of diverse stakeholders' interests can be further facilitated by the concept of integrated reporting, which is developed by the International Integrated Reporting Council. It guides companies to account for a range of intangible assets, structured in six "capitals" representing resources and relationships that are key to their value creation strategy but might otherwise be perceived as a waste of shareholder assets.

## How best should the decisions of Boards be scrutinised and open to challenge?

25. The enforceability of directors' duties depends on

their clarity and concreteness. Furthermore, UK can follow the example of other jurisdictions that have established an authority with powers to enforce legal requirements and intervene where corporate governance and decision-making contravenes the law. For example, Australia has instituted a strong regulator for markets and corporations (the Australian Securities & Investment Commission). In the Netherlands, the Enterprise Chamber can provide remedies in case of mismanagement, and can intervene to take provisional measures in takeover situations, for example.

26. Additionally, Dutch employee representatives have a limited right to challenge decisions of the board before the Enterprise Chamber. This power is part of the broader corporate governance framework in the Netherlands, which is characterised by a coordinated market economy and institutionalised stakeholder engagement. This solution may be inappropriate for the quite different context in the UK. A more appropriate solution may be to introduce board level employee representation, as discussed below in the question regarding employee participation.

**Should additional duties be placed on companies to promote greater transparency, e.g. around the roles of advisors. If so, what should be published and why? What would the impact of this be on business behaviour and costs to business?**

27. The Roundtables identified a need for greater transparency in two distinct areas:

    a. Stricter notification of substantial holdings of investors and strategic direction of their engagement in investee corporations. Institutional investors can be mandated to provide fuller and timely information about their ownership of derivatives, short positions and about their voting and share lending policies.

    b. Disclosure by companies and their directors of how they evaluate systemic risks, how they take into account stakeholder's interests, and how they reflect both in long-term strategy.

**Should Government regulate or rely on guidance and professional bodies to ensure that Directors fulfill their duties effectively?**

28. These two strategies are not mutually exclusive. Guidance can be useful to clarify the duty to promote long-term success of the company and consider diverse stakeholders' interests.

29. With respect to regulation, in addition to earlier suggestions, the following requirements could be imposed:

30. Require that board members' qualifications and remuneration be made public.

31. Establish an institution with powers to:

- Intervene where corporate governance and decision-making contravenes the law.

- Oversee the board members' adherence to requirements and to provide induction, training and certification with regard to financial, social and legal affairs, financial reporting, due diligence and compliance systems.

- Maintain a public register of prospective board members, thereby facilitating recruitment along lines of diversity, and a register of training compliance, providing certification and accreditation.

## Executive pay

**What factors have influenced the steep rise in executive pay over the past 30 years relative to salaries of more junior employees?**

32. Since the 1970s, proponents of shareholder primacy have successfully linked incentive plans to share price. There is no clear positive link between increased CEO remuneration and improved performance in terms of creating long-term shareholder value, but adoption of these methods can have a number of adverse impacts, as they lead to pressure to employ strategic means to increase share price in the short term, such as the strategic use of dividend increases, share buyback programmes, M&As and mass layoffs at expense of investments in R&D, innovation, productive capacity, and human capital.

33. Ironically, disclosure of executive salaries has likely contributed to the increase as well.[2] In the past, executives were limited in their ability to compare their salaries across companies. Now they have access to detailed information about salaries over time and across jurisdictions. This suggests that transparency, on its own, is unlikely to exert downward pressure on salaries.

34. This is combined with the increased reliance on executive compensation consultants, which are limited in number and therefore operate in a concentrated market. Companies tend to rely on one consultant and consultants seek 'repeat business', which creates a conflict of interest and a general upward pressure.[3]

**How should executive pay take account of companies' long-term performance?**

35. There are several strategies that companies can use in their incentive structures to support long-term sustainable value creation. These options may be supported by appropriate legal rules and public policy:

a. Ensure that incentive structure metrics are associated with a firm-specific long-term value creation strategy that integrates financial and non-financial objectives.

b. Make executive remuneration, and specifically share-based remuneration, conditional on the achievement and sustainment of long-term goals, including long-term economic performance, fraud prevention and detection, ESG goals, R&D investment and employee satisfaction.

c. Publicly disclose executive remuneration and its ratio to minimum and median salaries.

d. Allow employees to express their view on executive compensation schemes.

e. Cap executive pay by reference to average, median or minimum salary within the company.

f. Cap bonuses in relation to fixed pay (the EU's Capital Requirements Directive has done so for banks).

**Should executive pay reflect the value added by executives to companies relative to more junior employees? If so, how?**

36. To prevent excessive income inequality which does not reflect the difference in relative contribution and which undermines employees loyalty and public trust, companies may set a ratio for executive pay by reference to average, median or minimum salary within the company.

**What evidence is there that executive pay is too high? How, if at all, should Government seek to influence or control executive pay?**

37. The level of executive pay affects a companies' social license. A survey of the members of the UK Institute of Directors (IoD) found that a majority of respondents perceive public "anger over senior levels of executive pay" as the biggest threat to the reputation of business. 54 per cent of IoD members thought that building a successful corporation was the most important motivation for a business executive, compared to just 13 per cent who said they were motivated by financial reward.[4]

38. From a perspective of efficiency, the problem is the design of executive pay schemes which contributed to present high levels whilst encouraging a short-term approach to the company's financial organisation. As explained above, linking incentive plans to share price has caused skyrocketing of executive pay but there is no evidence of a positive correlation between the use of such strategies and long-term value creation.[5]

39. The Government can influence or control executive pay by encouraging or requiring companies to take the actions outlined above.

**Do recent high-profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have a greater role?**

40. The impact of shareholder interventions (and more specifically say-on-pay) is still inconclusive. However granting further powers to shareholders to control executive pay is unlikely to have the intended effect of dampening the current trend toward rapidly increasing remuneration.

41. Studies on the effectiveness of "say on pay" requirements in the UK and the US suggest that few shareholders vote against pay policies. It is too early to tell the effects of the new shareholders' right to a binding "say on pay" in the UK, since this only came into force on October 1, 2013. Before 2013, few shareholders used the advisory vote to vote against the remuneration report. In FTSE 100 companies, around 3% of shareholders dissented in 2008, and levels of dissent have been slowly rising higher since the financial crisis, with around one fifth of FTSE 100 companies having more than 20% of their shareholders dissent in 2009.[6] In the US, where it is mandatory to hold a shareholder advisory vote on executive compensation at least every three years,[7] a survey across all publicly listed companies found that only 2% of pay plans (123 out of 4,113) considered in 2014 failed to receive majority shareholder support. On average, pay plans received

89% support from shareholders in the advisory vote, with small- and mid-cap companies more likely to see their play plans rejected. The same survey reports that "two thirds of directors don't believe that 'say-on-pay' has effected a 'right-sizing' of CEO compensation." [8]

42. The evidence suggests that shareholder intervention in executive pay is the exception.[9] Furthermore, counting on the expression of voice by specific types of shareholders may be counterproductive and exacerbate the focus on short-term share price. To support a company's long-term success it may be more efficient to encourage or require companies to follow the recommendations we listed above and provide employees an opportunity to express their opinion or to be represented on remuneration committees.

## Composition of Boards

### What evidence is there that more diverse company boards perform better?

43. The academic research underpinning our report has confirmed a number of positive effects of increased board diversity including: improved access to relevant expertise and specialised knowledge, more effective problem-solving, reduced group think, better understanding of (global) markets, suppliers and customers, improved reputation by conforming to public expectations and better employee relations.

44. However, board diversity is not a panacea to the problems associated with the current corporate governance model. As long as the broader institutional setting remains focused on shareholder value maximisation, no significant change in the actions of board directors is to be expected. Furthermore, board diversity is important for reasons related to equality and fairness, and may not translate into improved financial performance in every company at all times.

### How should greater diversity of board membership be achieved?

45. In addition to transparency requirements and mandatory quotas, Government may establish or encourage the establishment of an institution with a mandate to maintain a public register of prospective board members in order to facilitate recruitment along lines of diversity (as well as a register of training compliance, providing certification and accreditation). Such an institution can also have powers to intervene where corporate governance and decision-making contravene the law as noted above.

### What should diversity include, e.g. gender, ethnicity, age, sexuality, disability, experience, socio-economic background?

46. The diversity of the board should reflect company operational environment and its plans, taking into account factors such as age, experience, expertise, gender, nationality and qualifications.

### Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

47. There is no major legal or economic argument that would prevent workers' representation on boards as long as their mandate as directors is embedded within the framework of directors' overall responsibility to the company. On the contrary, bringing employees onto boards has been linked to better dialogue and closer alignment between management and employees. It has also been connected to better safeguarding of the long-term interests of corporations.[10]

48. Worker representation is possible on unitary boards and occurs in single-level boards in continental Europe.[11] More generally, employees have a right to board-level representation of some form in 13 European countries.

49. In addition to board level representation, employees and other stakeholders can be engaged in corporate governance in the following ways:

a. In some jurisdictions, stakeholder interest groups are granted standing to sue to obtain an oppression remedy or statutory derivative action. In South Africa, for example, the Companies Act 61 of 2008 gives trade unions and employees a right, like shareholders, to bring a statutory derivative action on behalf of the company.[12]

b. Employees should be allowed to express a view on the remuneration scheme for top executives. The underlying idea is that such a consultation would lead to narrowing the gap between top executive pay and median pay in the corporation and to a better alignment of executive compensation schemes with the long-term success of the corporation.

c. Employees can also be given broader information and consultation rights in bankruptcy or M&A situations.

**What more should be done to increase the number of women in Executive positions on boards?**

50. See diversity of board response.

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