UK Corporate Governance Reform

Green Paper Response

Submitted by Cass Business School, Frank Bold and Sheffield Institute of Corporate and Commercial Law

Introduction

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.

The Sheffield Institute of Corporate and Commercial Law (SICCL) is a research centre based at the University of Sheffield which focuses on corporate, commercial and financial law, combining practical and theoretical insights. Professor Andrew Johnston is the director of SICCL, and has been researching corporate governance in the UK, EU and Australia since 2000.

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.

Between 2014 and 2016, Frank Bold and the Modern Corporation Project at Cass Business School hosted a global series of roundtables on corporate governance. The academic basis for the roundtables was provided by Dr. Jeroen Veldman and Prof. Hugh Willmott, who lead the Modern Corporation Project at Cass. Prof. Andrew Johnston contributed his expertise to the roundtables. Events addressing many of the issues raised in the consultation were held in London (twice) as well as in Breukelen (Netherlands), Brussels, New York, Oslo, Paris, and Zurich.

The outcomes of the Roundtables are 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"). 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).

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. These objectives can be mutually reinforcing and there is no objection in company law to this goal in any jurisdiction. There was further agreement that corporate governance should be developed to a standard where it may contribute to these objectives. 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.

Executive pay

> 1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

The level of executive pay affects a company's social licence to operate. 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.[1]

However, executive pay is also relevant to efficiency. The current design of executive pay schemes contributes to observed high levels of pay whilst encouraging a short-term approach to the company's financial organisation. Linking incentive pay to the current share price has caused a skyrocketing of executive pay but there is no evidence of a positive correlation between the use of such strategies and long-term value creation.[2]

Evidence as to the positive long-term impact of shareholder interventions both on pay and more generally remains inconclusive. However, we would suggest that granting further powers

[1] Performance-Related Pay: What Does Business Think. High Pay Centre. Available at: http://highpaycentre.org/blog/excessive-executive-pay-a-threat-to-business-say-institute-of-directors-me
[2] Lazonick, W. (2013). The Financialization of the U.S. Corporation : What Has Been Lost, and How It Can Be Regained. *Seattle University Law Review, 36*, 857–909.

to shareholders to control executive pay is unlikely to have the intended effect of dampening the current trend toward rapidly increasing remuneration.

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 anticipate 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.[3]

In the US, where it is mandatory to hold a shareholder advisory vote on executive compensation at least every three years,[4] 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.”[5]

The evidence suggests that shareholder intervention in executive pay is the exception rather than the rule.[6] This is confirmed by the Green Paper which shows that, to date, shareholders have only rejected one remuneration policy in a FTSE 350 company. Reinforcing shareholder voice in the expectation that specific types of shareholders (those with a ‘long term’ approach) will have greater influence over pay and steer it in a more sustainable direction may ultimately be counterproductive and exacerbate the focus on short-term share price. We suggest that, if the aim is to use pay to support a company's long-term success, it would be more effective to encourage or require companies to give employees the opportunity to express their opinion on pay, or, better, to be represented on remuneration committees.

> 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? Do you support any of the options mentioned? Are there other ideas that should be considered?

[3] BIS (2012) Executive Pay: Shareholder Voting Rights Consultation, London, Department for Business, Innovation & Skills (March 2012).
[4] §951 Dodd-Frank Act
[5] ProxyPulse 2014 at p.6
[6] Tsagas, G. (2014). A long-term vision for UK firms? Revisiting the target director’s advisory role since the takeover of Cadbury’s PLC. Journal of Corporate Law Studies, 14(1), 241-275

Whilst institutional investors frequently threaten to take action to rein in executive pay (see for example 'Investors plan tougher action to tackle excessive corporate pay' *Financial Times*, 13th February 2017), the evidence in the Green Paper is that levels of shareholder dissent have been very low, despite their enhanced powers. Whilst some shareholders certainly take a long-term view, we are sceptical that further empowerment of shareholders will result in executive pay practices which support the long-term development of the company. More specifically, many pension funds and insurance companies have divested their equity positions since 2008, investing instead in overseas equities and alternative investments, removing an important potential counterweight to the short-term orientation of hedge funds and other speculative vehicles. Those that remain are under pressure from short-term liabilities which have become extremely onerous under long-term zero interest rates and quantitative easing, reducing their capacity to consider issues of long-term alignment between executive incentives and the long-term interests of the business. More generally, we do not view continued reliance on shareholder action as an adequate solution to the issue of executive pay.

We would favour regulatory restrictions on variable pay, as well as a limit on the proportion of pay which is linked to creation of shareholder value (whether in the form of stock options or long-term incentive plans linked to total shareholder return). We would also favour, as we discuss below, a legal requirement that stakeholders should have greater input into remuneration decisions in order to create a better long-term alignment with the interests of the business. We consider that regulation is necessary here because shareholders will not bring about these changes. We are sympathetic to the suggestions made to require asset managers to disclose voting records, to establish a senior shareholder committee to engage with the company on key issues such as pay and appointments and to encourage greater engagement by retail investors. However, all of these suggestions rest on the assumption that shareholders are currently dissatisfied with the way in which executives are remunerated, but are, for some reason, failing to express this. The low levels of dissent identified in the Green Paper suggest that this is not the case. Executives are very well remunerated for maximising returns to shareholders in the short to medium term, and shareholders see no reason to question this.

3. Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

Disclosure of pay and the increasing reliance on remuneration consultants is widely recognized to have produced a 'ratcheting' effect, as no executive wants to be paid below the average for the sector.[7] Executive compensation consultants 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.[8]

The use of share options and bonuses linked to the performance of the company's share price or other measures of shareholder return has transformed the incentives of executives, and shifted their focus from running a successful productive business by making investments in innovation and firm-specific human capital to managing the company's share price. As a result, executives concentrate on increasing short-term returns to shareholders by cutting investment, increasing dividends, buying back shares and increasing leverage. The result has been rapidly rising share prices, and higher executive pay, but a decline in high quality jobs and innovation, an increase in the riskiness of companies and increasing public disquiet about the ways in which UK businesses are run.

We agree with option (i) that remuneration committees should give the company's employees an opportunity to express their views on the company's pay policy. The underlying idea is that such a consultation would lead to a narrowing of 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.

This consultation could occur through existing representation channels, such as trade unions representation where it exists, or through a bespoke body to which employee representatives are appointed. If a body is set up to strengthen employee voice (question 7 below), then that body would be ideally placed to give views on the executive pay policy to the remuneration committee. Ideally, given the importance of executive pay to future outcomes for employees,

[7] Financial Reporting Council, Executive Remuneration Working Group, Final Report, July 2016
[8] Murphy, K. J., & Sandino, T. (2010). Executive pay and "independent" compensation consultants. *Journal of Accounting and Economics*, *49*(3), 247-262.

one member of the employee representative body would sit on the remuneration committee, ensuring that executive pay is aligned with the long-term interests of the company and does not simply give incentives to maximise short-term financial performance. Even if no such body is established, we would suggest that an employee representative should be included on the remuneration committee, bringing a broader perspective to bear on issues of pay and constructively challenging the 'received wisdom' of remuneration consultants and non-executive directors.

More generally, we question the current composition of executive pay, which tends to rely heavily on variable compensation. We suggest that this practice has negative repercussions, including incentivising diversion of corporate resources away from investments that could pay off in long-term value creation and innovation to short-term strategies that seek to influence share price. We make a number of concrete recommendations in response to question 6, below.

> 4. Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

Ironically, disclosure of executive salaries appears to have made matters worse, driving the constant increases in executive pay. Before the Greenbury Report (1995), 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.

As an alternative or complement to increased transparency, we suggest that further efforts should be made to reduce the gap between executive and average/lowest paid workers. 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.

We agree that companies should be required to disclose the ratio of executive pay to that of the average (or median) employee. Some difficult definitional issues arise as incentive pay extends below board level, and in addition, large companies may have employees in multiple jurisdictions, as well as large numbers of independent contractors who, in the past, would have been employees. However, in the first instance, we would recommend publishing the ratios of the pay of executives on the board to average and/or median employee pay.

There are also difficulties in calculating the precise quantum of executive pay where they are paid with stock options. Lazonick and Hopkins have drawn attention to the difficulties in calculating executive pay, and in particular the value of stock options.[9] Following their approach, we would suggest that, for the purposes of producing the ratio, executive pay should be calculated on the basis of actually realised gains in a particular year. In other words, it should not rely upon valuation of stock options at the time of award, but value them at the date of their exercise. This would make the disclosure of the ratio retrospective, but would allow more meaningful comparisons to be made.

Disclosing the ratio of executive to average or median pay would help to avoid the pitfall of adverse consequences potentially caused by disclosing other ratios, for example the ratio of executive to lowest employee pay, which could potentially incentivise outsourcing or other forms of externalisation to avoid disclosing high intra-firm inequality.

> 5. Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

In response to question 6, we make a number of suggestions about better alignment of executive pay with the interests of the company. We would suggest here that the broad terms of the incentive plan could be publicly disclosed without compromising commercial confidentiality. For example, the targets to which executive pay is linked could be disclosed (e.g. R&D investment, employee satisfaction) without giving precise details of the target. In addition, the percentage of total pay linked to each of these should be disclosed. Given the difficulty of prospectively valuing share options, referred to above, this disclosure should be based on the total gains made by the executive in a given year.

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[9] W. Lazonick and M. Hopkins, 'Corporate Executives Are Making Way More Money Than Anybody Reports', The Atlantic, 15th September 2016.

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? Please give reasons for your answers.

The rise of agency theory, and the associated shareholder primacy argument that executives' incentives should be aligned with the interests of shareholders, has played an important part in ratcheting up executive pay and driving the short-term orientation of corporate governance in the UK. Agency theorists believe that an 'optimal contract' can be found which will align the incentives of executives with the long-term interests of shareholders. Much effort has been spent in pursuit of this contract, but it has not yet been found, and a number of companies have been destroyed in the process.

A number of different approaches are available to companies that want to use their incentive structures to support long-term sustainable value creation. These options could be supported by appropriate legal rules and public policy:

a) Incentive structure metrics should be associated with a firm-specific long-term value creation strategy that integrates financial and non-financial objectives.
b) Executive remuneration, and specifically share-based remuneration, should be conditional on the sustained achievement of long-term goals, including long-term economic performance; fraud prevention and detection; environmental, social and governance (ESG) goals; R&D investment; and employee and customer satisfaction.
c) Executive remuneration and its ratio to average and median salaries should be publicly disclosed.
d) The holding period for shares should be increased from the three years recommended in the UK Corporate Governance Code to at least five years. It would also be possible to create a mandatory rule, contained in the Companies Act, that in relation to listed companies and large private companies, the holding period must be at least five years unless approved by special resolution of the shareholders, as well as approved by the remuneration committee and any stakeholder representative bodies. The law could also imply default clawback provisions into contracts, which would apply where a remuneration committee failed - in breach of its duty of care and fiduciary duty to the company - to include appropriate provisions in the pay scheme. Going further, the law might mandate the inclusion of clawback provisions in pay schemes which would be triggered where performance is not sustained as a result of fraud or negligence.

e) As we suggested in response to question 3, the law should allow employees to express their views on executive compensation schemes through an appropriate consultative body, and, ideally, through representation on the remuneration committee.

f) It would also be possible, as was done in relation to financial institutions by the Capital Requirements Directive to cap executive pay in some way. For example this could be done by reference to a multiple of the average, median or minimum salary within the company, or by reference to fixed pay. The rationale for doing this would be to enhance the social and economic sustainability of the company. Whilst incentives are important for all employees, there is little justification for paying executives in a way which has unlimited upside in relation to short- or medium-term performance. Moreover, this practice produces perverse incentives to engage in financial engineering aimed at enhancing the metrics to which remuneration is linked, whilst undermining investment and productivity within the company.

Strengthening the employee, customer and wider stakeholder voice

> 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? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

Below we outline three options for integrating stakeholder input into board decision-making:

(A) Direct employee/stakeholder representation

We would favour employee representation on boards, subject to giving employee representatives a clear mandate, equivalent to that of the other directors, that they are required to act in the interests of the company. 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] Just as non-executives were introduced onto the unitary board in order to bring 'external perspectives to bear' (2.4), but

[10] Deakin, S. (2012). The corporation as Commons: Rethinking property rights, governance and sustainability in the business enterprise. The. Queen's LJ, (September), 339–381

without apparently reducing its unity, so, we would suggest, the same can be done in relation to employee directors, provided an adequate legal framework is in place.

The UK's reliance on a unitary board structure is not a barrier to worker representation, which occurs on single-level boards in some continental European jurisdictions.[11] Whilst the Green Paper is correct to emphasise (2.12) that companies in those other jurisdictions operate in a slightly different manner and in a slightly different shareholding context, every national corporate governance system is different, and this is not a reason to reject solutions which appear to work elsewhere. Rather, what is required is a careful institutional analysis to design a legal and governance framework within which employee directors may be situated, and which is likely to ensure that employee directors add value to the company rather than bringing conflict onto the unitary board.

In addition, employees, through their representative body, should be given broader information and consultation rights in bankruptcy, takeover and merger situations.

(B) Advisory panel of stakeholders with designated NED

If mandatory employee representation on the board is indeed ruled out (para 2.29), despite earlier indications that it was under consideration[12] we would recommend a combination of the options canvassed in the Green Paper. In any event, this option should be taken in relation to other stakeholders, who, as the Green Paper recognises, are much harder to represent directly on the board.

The largest companies should be required to set up stakeholder advisory panels, extending at least to employees, customers, suppliers, affected communities and the environment. There are, of course, difficulties in defining these groups, particularly the last two, and identifying appropriate representatives.

[11] Conchon, A. (2013). *Workers' Voice in Corporate Governance: A European Perspective*. TUC.
[12] See the statement of Theresa May at the G20 summit promising to tackle corporate irresponsibility, "cracking down on excessive corporate pay and poor corporate governance, and giving employees and customers representation on company boards". G20 Summit: PM Commons statement – 7 September 2016, available at https://www.gov.uk/government/speeches/g20-summit-pm-commons-statement-7-september-2016. See also the Corporate Governance Inquiry of the Business, Innovation and Skills House of Commons Select Committee, and Mrs May's request to RSA Chief Executive Matthew Taylor to lead an independent review into how employment practices need to change in order to keep pace with modern business models, which included a question on representation.

Johnston has argued that the law could require 'hybrid forums' to be set up to identify the extent to which groups are affected and suggest appropriate solutions to these externalities.[13] In any event, the conclusions of the forum as to effects on stakeholders and recommended solutions would not be binding on the company. Rather, they would form the starting point of discussions at board level. The board could call on the panel where further information is required. If combined with a transparency requirement (2.18), this would considerably strengthen public trust in the largest companies.

The stakeholder panel could be combined with the suggestion to designate a non-executive with responsibility for inputting concerns from stakeholder groups. That non-executive could chair the stakeholder forum, and report its conclusions to the board. The non-executive could then be required to report back to the stakeholder forum after the board has considered its recommendations. Alternatively, the law could simply require companies to include in their Strategic Report a statement about the activities of their stakeholder panels, their key conclusions, and the extent to which their recommendations were taken into account by the board.

The use of a designated non-executive combined with public reporting would rule out the possibility of bringing conflict onto the board, which is one of the most common objections to direct board-level representation of stakeholders. It would also considerably enhance the information available to the board, as well as the salience of stakeholder issues, which ultimately determine the success of the business over the long-term, as s. 172 of the Companies Act 2006 recognises.

(C) Strengthening accountability to stakeholders

Going beyond the suggestions in the Green Paper we would make two further suggestions. Employees could be given a right to sue to obtain a remedy for unfair prejudice or to bring a statutory derivative action to enforce directors' duties. 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.[14] The rationale for this is that it would allow employees to insist that directors fulfil their duties to the company and act fairly in relation to stakeholders. Of course, certain changes would be required to the framing of the unfair prejudice remedy to extend it beyond the interests of members. The statutory derivative

[13] See A. Johnston, 'Governing Externalities: The Potential of Reflexive Corporate Social Responsibility', Centre for Business Research, University of Cambridge, Working Paper No 436 (September 2012) (available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2165616)
[14] Du Plessis, J. J. (2012). Company law developments in South Africa : modernisation and some salient features of the Companies Act 71 of 2008. *Australian Journal of Corporate Law, 27*(1), 46–72.

action already includes detailed provisions which seek to filter out vexatious litigation which is not in the interests of the company.

8. Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

All companies which have significant effects on stakeholders should be the focus for enhanced stakeholder voice. This would include all listed companies, but should also include all public and private companies of sufficient size (with size acting as a proxy for stakeholder impact). We would suggest using the existing definitions included in the Companies Act 2006, so that all companies which are not classified as 'small' or 'medium' sized would come under an obligation to involve their stakeholders. This would mean that all companies which satisfy two or more of the following criteria (drawn from s. 465 of the Companies Act 2006) would be caught by the obligation: more than 250 employees (including those employed by subsidiaries); turnover more than £36m; balance sheet total more than £18m.

9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

A legislative approach, relying on procedural norms, would be the most appropriate approach to stakeholder panels. Companies could be required to publicise and hold consultations with their stakeholders with a view to setting up appropriate structures, defining their remit and procedures and so on. Procedural norms of this type have frequently been used in European labour law directives, such as the Works Council[15] and Employee Information and Consultation directives[16]. The process and outcome of those consultations should then be disclosed.

The benefit of this approach - discussed widely in the academic literature as 'reflexive law'[17] - is that it allows companies and stakeholders to put in place arrangements which suit their

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[15] Directive 2009/38/EC of the European Parliament and of the Council of 6 May 2009 on the establishment of a European Works Council or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of informing and consulting employees (Recast) implemented in the UK by the Transnational Information and Consultation of Employees Regulations 1999 (SI 1999/3323) as amended by The Transnational Information and Consultation of Employees (Amendment) Regulations 2010 (SI 2010/1088).

[16] Directive 2002/14/EC establishing a general framework for informing and consulting employees in the European Community implemented in the UK by The Information and Consultation of Employees Regulations 2004 (SI 2004/3426).

[17] For detailed discussion of the use of reflexive law in European corporate governance regulation, see Johnston, A. *EC Regulation of Corporate Governance* (Cambridge University Press, 2009). For a general account of the possibilities of reflexive law, see Teubner, Gunther. "Substantive and reflexive elements in modern law." *Law and Society Review* (1983): 239-285.

needs and reflect the particular impacts that the company has on society. As such it eliminates unnecessary regulation and cost, and focuses stakeholder involvement on the areas which are of particular concern. The law might also provide - as the directives mentioned above do - that, in the absence of agreement, default stakeholder panels would be established. This creates an incentive to engage in meaningful negotiations. We would be happy to provide further suggestions as to how such legislation might be formulated.

A lower cost approach would be to include an obligation to set up stakeholder panels within a code that would be applied on a comply or explain basis. Companies would be required either to establish stakeholder panels in relation to various designated groups, or to explain publicly why those groups were not relevant to its business. The difficulty with this latter solution is the low level of full compliance with the existing comply or explain based code;[18] that it would simply add to the disclosures which are made at present; and that any pressure for a more inclusive approach would have to come primarily from shareholders. There is no evidence at present that shareholders are pressing company boards to engage with stakeholders.

Corporate governance in large, privately-held businesses

> 10. What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

As a matter of principle, it is right that private companies face fewer regulations than public companies. Many private companies are effectively incorporated sole traders or partnerships without outside investors, and with little separation between shareholders and managers. However, this has created incentives for financial institutions which have taken over companies to convert them to private companies in order to benefit from lighter regulation and fewer disclosure obligations. For example, where control of a listed public company is acquired through a takeover, the new controller often takes the company private, giving them much greater flexibility as regards dividends and share buybacks, and exposing them and the company to far less public scrutiny. This can further prejudice those stakeholders, such as employees, who have a long-term interest in the success of the business.

[18] Willmott, H. and Veldman, J. "Reimagining the Corporation: The Relevance of Legal, Economic and Political Imaginaries." Pioneers of Critical Accounting. Palgrave Macmillan UK, 2016. 231-257.

To the extent that the corporate governance system has conventionally been viewed as ensuring accountability exclusively to shareholders, this has not been viewed as a problem: once ‘ownership’ and control were reunited in the new controlling shareholder, the protective norms of the corporate governance regime, aimed at dispersed shareholders, were no longer required. However, once we recognise that a wider range of interests are at stake in corporate governance, it becomes imperative to extend the reach of corporate governance norms beyond public companies.

> 11. If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

We would recommend using a size threshold, such as the one contained in s. 465 Companies Act 2006, to identify companies which have significant public impact, and are therefore subject to the evolving system of corporate governance norms. If this suggestion is rejected, we would suggest that public company norms, including any new stakeholder engagement laws, should continue to apply to companies that are taken private for a period of up to ten years. The Takeover Code adopts this approach, applying to public companies which are taken private for a period of ten years. This would at least partly obviate the incentive for controllers of companies to take them private in order to escape the reach of any new norms introduced to enhance stakeholder engagement.

> 12. If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

The answer to this question depends on how the corporate governance framework is strengthened. To the extent that greater stakeholder input is sought, this should be achieved through mandatory rules, although these could take the form of procedural rules, requiring negotiation against default rules, as discussed above. To the extent that the process for setting pay is reformed, it would be desirable for this to be included in legislation. This would mean that all companies, listed, public and private (above the relevant size threshold) would be caught. Once such norms are extended beyond listed companies, it is clearly no longer appropriate to rely on the ‘comply or explain’ principle, as there is no longer an active share market that can monitor compliance. Companies should be required to include a statement in their directors’ report setting out the details of their stakeholder engagement processes, and confirming that they comply with the relevant rules on the setting of executive pay.

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

Yes. The issue is whether the business has significant social and environmental impact, not whether it is incorporated. Whilst size thresholds are a crude proxy for these types of impacts, they are the best proxy available.

Other issues

14. Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

Mainstream corporate governance models have been narrowing since the 1970s, placing the maximisation of shareholder value at the centre of corporate and executive attention. The result is a focus on short-term share price rises, undermining companies' ability to invest in their future and diminishing their capacity to anticipate and mitigate both firm-specific and 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 2006, 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 might be subject to a legal obligation to disclose:
   a) How they identify and evaluate their specific and systemic impacts, such as impacts on the environment,
   b) How they identify and take into account stakeholders' interests,
   c) How both 1) and 2) are reflected in the company's strategy.

3. The existing 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, and explain companies' long-term value proposition to investors and other audiences. Integrated reporting may be supplemented by other frameworks, such as the GRI G4 Guidelines, which help companies to identify relevant metrics and KPIs to report against.

4. Parliament might establish an authority with powers to intervene where corporate governance and decision-making contravenes the law.[19] Such an institution can also have a mandate to oversee board members' adherence to requirements and provide further training and guidance to directors.

[19] See the example of the broad mandate given to the Australian Securities and Investments Commission (ASIC) (s. 1 of the *Australian Securities and Investments Commission Act 2001*). A good example of ASIC's active role in monitoring and enforcing the obligations of directors can be found in *Australian Securities and Investments Commission v Healey* [2011] FCA 717.