Key principles of a new corporate governance model

Summary

Event co-hosted by Cass Business School and Frank Bold
22 March 2017

The Sports Direct and BHS scandals, as well as the parliamentary inquiry, prompted Theresa May's government to propose the most significant corporate governance reforms in the last 20 years. At the "Key principles for a new corporate governance model" event, a panel of high-level experts assessed the potential of these reforms to lead to meaningful change.[1] Further discussion was held with the diverse group of participants from the business, investor, legal and academic communities under Chatham House Rules.

Speakers:

- Iain Wright MP, Chair of the Business, Energy and Industrial Strategy Committee, UK Parliament (Keynote)
- Stefan Stern, Director of the High Pay Centre and Financial Times columnist
- Marilyn Croser, Director at CORE Coalition
- George Dallas, Policy Director at the International Corporate Governance Network (ICGN)
- Janet Williamson, Senior Policy Officer at Trades Union Congress (TUC)
- Stephen Hockman QC, Head of Chambers at Six Pump Court Chambers
- Colin Melvin, Chair of the Social Stock Exchange
- Charles Cotton, Performance and Reward Adviser at the Chartered Institute of Personnel and Development (CIPD)

Initial notes

In September 2016, the parliamentary Business, Energy, and Industrial Strategy (BEIS) Committee launched an inquiry on corporate governance, concentrating on (1) executive pay, (2) directors duties, and the (3) composition of boardrooms, including worker representation and gender balance in executive positions.

The Department for Business, Energy and Industrial Strategy subsequently published a Green Paper to "stimulate a debate on a range of options for strengthening the UK's corporate governance framework, including options for increasing shareholder influence over executive pay and strengthening the employee, customer and supplier voice at boardroom level."

The Cass event addressed three key topics examined by the parliamentary inquiry and the Green Paper:

- fiduciary duties
- stakeholder engagement
- executive pay

Opening keynote

Iain Wright MP, chair of the Business, Energy and Industrial Strategy Committee stressed in his opening keynote speech the relevance of the debate by saying that "people only tend to think about corporate governance when there is a crisis, similar to people only thinking of plumbing when they are knee deep in trouble". Indeed, according to the last Edelman Trust Barometer, we have reached record-low levels of trust in business: the credibility of corporate CEOs fell to 37%, a 12-point drop from the previous year. Interestingly, trust in business is higher in China and India than in the UK. In addition, the relationship between society and business is souring due to the fact that many of our current global challenges are intrinsically connected with the economy and by extension with business. There is a general crisis of trust, which goes beyond businesses to include politics and the media. The problem is that trust is difficult to build but easy to lose and then increasingly hard to rebuild.

No issue better exemplifies the loss of trust in business than the issue of executive pay. Mr Wright argued that there are two forms of disconnect with respect to executive remuneration: first, that executive pay has risen rapidly while worker wages have stagnated, thereby contributing to inequality. Second, payouts to CEOs and executives have not been connected to financial performance or returns to shareholders.

It is clear that running a large and complex organization is an onerous task that requires great leadership and talent. However he suggested that the notion of a superstar CEO who will singlehandedly unlock value profoundly misunderstands the origins of corporate success. Rather, the success of a company stems from its entire executive team, with a pipeline of innovative ideas from employees. Companies' biggest assets are their workers – yet contemporary pay structures reflect another reality.

Shareholders are often traders who are not interested in the corporate governance of a specific company. We are therefore witnessing the rise of the 'ownerless corporation'. The diversification of portfolios means that investors own increasingly smaller amounts of shares in larger numbers of companies.

Mr Wright noted that corporate governance is about balancing interests and we need to build corporate culture and values that promote the long-term. Good corporate governance cannot fix every problem but poor corporate governance will surely lead to poor results, both in terms of financial performance and broader impacts on society. He emphasised that there is no silver bullet in corporate governance and declared that his committee was working to "put forward meaningful recommendations" to ensure that the standards of corporate behaviour match societal expectations from society, focusing on the remuneration system of companies, duties and obligations of directors and strengthening stakeholder voice in boardrooms. The rationale behind these measures is to tackle short-term thinking and most importantly, restore public trust and the social license for business to operate in a post-Brexit scenario.

Panel 1: Directors duties

Is company law sufficiently clear on the roles of directors and non-executive directors? Are those duties the right ones?

Background

Company directors have fiduciary duties to make decisions that are in the best interest of the company, which are codified in sections 170-177 of the Companies Act 2006. Section 172 entrenches the so-called principle of enlightened shareholder value, requiring that directors act in the way that "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" the interests of specified stakeholders and wider issues.

The Green Paper notes that "[m]any companies and their boards recognise clearly the wider societal responsibilities they have and the enormous benefit they gain through wider engagement around their business activities. However, some have said that companies need to do more to reassure the public that they are being run, not just with an eye to the interests of the board and the shareholders, but with a recognition of their responsibilities to employees, customers, suppliers and wider society" (2.2). Perhaps the most significant challenge in this respect is the question of how boards should reconcile the often conflicting interests of shareholders versus other stakeholders, and versus the interests of the company itself.

Proposals that have been raised in the debate in the UK and worldwide include improved reporting by boards, clarifying the relationship between the success of the company and shareholders' interests, and specifying the content of fiduciary duties with respect to environmental and social issues.

In its response to the UK Government Green Paper on corporate governance, the Financial Reporting Council argued that “this duty must be reinvigorated” and is currently reviewing UK Corporate Governance Code to “consider the appropriate balance between the Code’s principles, provisions and guidance”.

Discussion

Both Stephen Hockman QC, Head of Chambers at Six Pump Court Chambers, and Stefan Stern, Director of the High Pay Centre, stressed that the best interest of the company is difficult to ascertain but it cannot be equated with maximising shareholder value, and especially not in the short-term. Directors are free to instead choose to invest in innovation, research and development, employee training, improvements to sustainability or other areas if that will ensure the long-term vitality of the firm.[2]

→ Clarifying the duties of directors

Mr Hockman proposed to amend s. 172 to delete for the ‘benefit of its members as a whole’ so that the responsibility of the directors would be recognised in law as being to promote the success of the company as an ongoing enterprise. He suggested it would also be possible to move the consideration of members/shareholders as one of the factors to be considered by directors, such that s. 172 would read as follows:

> “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 members of the company and
> (g) the interests of the company’s members as a whole.”

Janet Williamson, Senior Policy Officer at the Trades Union Congress (TUC), said that the TUC recommended reform of directors duties and that its recommendations were extremely similar to Mr Hockman’s. The TUC advocates for requiring directors to consider the long-term success of the company, and therefore supports the deletion of the requirement to consider the interests of the company’s members.

George Dallas, Policy Director at the International Corporate Governance Network (ICGN), called for more guidance on how directors should comply with s.172 and encouraged the use of ‘integrated reporting 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.”

→ Improving disclosure requirements and aligning the strategic report

Mr Hockman noted that listed companies are required to report on some, but not all, of the matters covered in s. 172 in their annual strategic reports under s. 414C of the Companies Act 2006. Furthermore, this is not an absolute requirement as disclosure is required only “to the extent necessary for an understanding of the development, performance or position of the company’s business.”[3] Mr Hockman suggested that the disclosure requirements should be aligned with the contents of directors’ obligations under s. 172 of the Companies Act 2006.

→ Enforcing directors duties

The point was made that neither courts nor policymakers have clearly defined the scope of the obligations set out in s. 172. Mr Hockman identified a clear problem with the enforcement of the obligations of directors contained in s.172 and asked “don’t we need some sort of remedy as a result of failure to comply with s. 172 duty?”. Mr Hockman also suggested that an option would be to widen the range of situations where directors’ disqualification could occur. He left open the question of whether the FRC is best placed to oversee disqualification proceedings, noting that we do not necessarily want to clog up the courts with these types of disputes.

Panel 1: Stakeholder engagement

How can the interests of employees, customers and wider stakeholders be better taken into account at board level in large companies?

Background

UK Prime Minister Theresa May suggested plans to include employee representation in companies' boards, a proposal that was later on taken out from the government's Green Paper. The Government instead put forward four options for stakeholder representation in the Green Paper: (i) create stakeholder advisory panels, (ii) designate existing non-executive directors to ensure that the voices of key interested groups, especially that of employees, is being heard at board level, (iii) appoint individual stakeholder representatives to company boards, and (iv) strengthen reporting requirements related to stakeholder engagement. It was also asked whether any new stakeholder engagement requirements should be applied to certain forms of company or above a certain employee/size threshold. Equally, there is a debate whether stakeholder engagement should be on an entirely voluntary basis or rather legislative/ code-based (mandatory versus comply or explain basis).

Discussion

During the event, Janet Williamson advocated for board level employee representation, noting that the rate of investment in R&D doubles in countries with employee directors. She also added that "workers participation on boards encourage boards to take a long-term approach to decision-making as they have an interest in the long-term success of their company". Ms Williamson suggested that stakeholder advisory panels would be a poor substitute for employee representation on boards.

George Dallas explained that the aim of the institutional investors that ICGN represents is to future-proof businesses, which includes identifying points of sensitivity in the way that they interface with stakeholders and society. He suggested that promoting the long-term success of the company requires moving beyond the shareholder versus stakeholder debate to recognise that in the long-term, their interests are aligned. Investors expect directors to look at long-term issues, and pointed to the Integrated Reporting Framework as an important way to conceptually unite the different forms of capital being managed and reporting on that to capital markets. He nevertheless noted that there was not only one way to promote long-term business success and was skeptical about employee representation, suggesting that policymakers should be careful about imposing prescriptive legislation.

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. One proposal would allow employees to express their views on executive compensation schemes through an appropriate consultative body, and, ideally, through representation on the remuneration committee.

Panel 2: Executive Pay

Should shareholders and/or employees have greater say on executive remuneration? Are changes to remuneration committees or new pay reporting requirements likely to be helpful?

Background

Executive remuneration has been hotly debated for many years, starting from the Greenbury Committee in 1995 and the Government's consultation in 1999. Since then, as the Green Paper points out, CEO pay in FTSE 100 companies has quadrupled and increased as a ratio of the average pay of full-time employees from 47:1 to 128:1.

There are two main approaches to engage with executive remuneration. The first is to see it as a principal-agent problem, whereby executive remuneration is the outcome of managers extracting value from the firm without any connection to their performance. The second is to argue that rising executive pay is problematic in the light of a social license for business. Executives are perceived by the general public to be drawing wages that are increasingly high relative to that of the average or median worker. The relation of this practice to rising inequality gives rise to social dissonance, and is frequently pointed to as a contributor to the return of populist politics.

The Green Paper focuses primarily on proposals to increase shareholder control over remuneration, with the exception of a proposal for remuneration committees to consult employees to develop their recommendation, and a proposal to disclose the pay ratio of executives to workers.

Other proposals that have been suggested in a broader debate include capping executive pay relative to average, median, or minimal salary; and making bonuses conditional on the sustained achievement of long-term goals, including ESG goals, R&D, employee and/or customer satisfaction, and economic performance.

Discussion

Colin Melvin, Chair of the Social Stock Exchange, argued that excessive executive remuneration is symptomatic of a bigger problem, which is the misallocation of capital. He argued that the problem cannot be addressed through regulation or stewardship (shareholder voting) until the underlying problem is solved. He suggested that the transactional mindset behind current executive pay reflects the broken relationship between companies and top management as well as broader stakeholders. He suggested that companies need to move away from a short-term transactional mindset to focus instead on relationships, which will help to generate value over the long-term.

Charles Cotton, Performance and Reward adviser at the Chartered Institute of Personnel and Development (CIPD), said that evidence from behavioural economics and neuroscience suggests that the way executives are rewarded do not have a positive impact on their performance. People do not value rewards that they do not understand and over which they have no control, which he argued is a characteristic of modern, complex pay packages. CIPD is advocating for a return to simpler pay models, on the basis that long-term incentive plans (LTIPs) are not fit-for-purpose. He suggested that rather than focusing exclusively on financial metrics such as earnings per share, there should be a reliance on human capital indicators. He argued that variable pay is only effective for manual and repetitive jobs, such as plucking chickens, where competition and easily measurable performance can promote productivity. In knowledge jobs, it becomes difficult to differentiate individual performance.

Janet Williamson noted that disclosure and shareholder votes have been the primary means of addressing executive remuneration but this approach has not only failed to fix the problems with executive pay but may actually have aggravated the situation.[4]

Closing Keynote

Marilyn Croser, Director of CORE, called for company law to reflect the interests of stakeholders other than shareholders. This includes advocating for a requirement for directors to consider, act and mitigate any negative impacts on affected stakeholders, including employees, local communities, and even the environment.

Ms Croser argued that affected communities should gain access to effective remedy when they are harmed by companies, and to report on their social and environmental impacts. CORE suggested that market forces alone have failed to deliver on these outcomes, particularly in an increasingly competitive and short-term oriented business climate.

In the decade since the Companies Act 2006 was adopted, we have experienced a global financial meltdown caused by short-termism with very few individual and institutions been held to account for that or the accident at Alton Towers, which was caused by systemic management failings. On the human rights and environmental side, there was the collapse of the Rana Plaza factory in Bangladesh killing 1200 workers. There have also been scandals related to BHS and Sports Direct. At the same time, and paradoxically, FTSE 100 bosses now earn 386 times more than workers on the National Living Wage.

In CORE's response to the UK Government's Green Paper on corporate governance in 2017, it argued that the current framework of enlightened shareholder value, combined with a voluntary Corporate Governance Code and an emphasis on 'culture' has failed to address egregious corporate malpractice and failed to provide collective and individual accountability for management failures. Only genuine reform, not minor adjustments and more voluntary schemes can address these issues. Framing the discussion as a choice between 'high standards and low burdens' is outmoded and unhelpful. Instead, Ms Croser argued the emphasis should be on how to create meaningful accountability to drive a change in practices.

Organisers

This event was the first in a series of three on corporate governance held at Cass Business School in 2017 aimed at charting the development of practice and policy towards a governance model fit for the challenges of the 21st century. The following two events cover the following topics:

- **Systemic Risk and Corporate Governance (May 10, 2017)** - How companies, long-term investors, and insurers relate to systemic risks, such as climate change and financial stability, and what changes in regulation, transparency, and incentives are needed to foster good practice. Summary available here.
- **Corporate Governance and Reporting (June 7, 2017)** - Examination of the evolution of corporate accounting practice and policy, taking into account the needs of long-term investors and an integrated approach to value creation, as well as the need to guide companies on how to comply with a rapidly evolving regulatory environment. Summary available here.

The Cass events have been jointly hosted by Cass Business School and Frank Bold with support from Ecole des mines and Hertfordshire Law School. Dr. Jeroen Veldman and Prof. Hugh Willmott run the Modern Corporation Project at Cass Business School and provide the academic basis for the Purpose of the Corporation Project, an open-source platform led by Frank Bold, a European purpose-driven law firm. The Project brings together 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.

Between 2014 and 2016, Cass Business School and Frank Bold hosted a global series of roundtables on corporate governance with events held in Brussels, Breukelen (The Netherlands), London, New York, Oslo, Paris and Zurich. The results of the series of events are compiled in the Corporate Governance for a Changing World report.

[1] The event built on the results of a global series of roundtables on corporate governance hosted by Cass Business School and Frank Bold between 2014 and 2016.

[2] Mr Hockman referred to the Innovation Centre's report on the Purposeful Company (2017) http://www.biginnovationcentre.com/purposeful-company.

[3] 414C Contents of strategic report

(1) The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (duty to promote the success of the company).

(2) The strategic report must contain—

(a) a fair review of the company's business, and

(b) a description of the principal risks and uncertainties facing the company.

(3) The review required is a balanced and comprehensive analysis of—

(a) the development and performance of the company's business during the financial year, and

(b) the position of the company's business at the end of that year, consistent with the size and complexity of the business.

(4) The review must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

(a) analysis using financial key performance indicators, and

(b) where appropriate, analysis using other key performance indicators, including information relating to environmental matters and employee matters.

(5) In subsection (4), "key performance indicators" means factors by reference to which the development, performance or position of the company's business can be measured effectively.

(6) Where a company qualifies as medium-sized in relation to a financial year (see sections 465 to 467), the review for the year

need not comply with the requirements of subsection (4) so far as they relate to non-financial information.
(7) In the case of a quoted company the strategic report must, to the extent necessary for an understanding of the development, performance or position of the company's business, include—

(a) the main trends and factors likely to affect the future development, performance and position of the company's business, and

(b) information about—

(i) environmental matters (including the impact of the company's business on the environment),

(ii) the company's employees, and

(iii) social, community and human rights issues,

including information about any policies of the company in relation to those matters and the effectiveness of those policies. If the report does not contain information of each kind mentioned in paragraphs (b)(i), (ii) and (iii), it must state which of those kinds of information it does not contain.

(8) In the case of a quoted company the strategic report must include—

(a) a description of the company's strategy,

(b) a description of the company's business model,

(c) a breakdown showing at the end of the financial year—

(i) the number of persons of each sex who were directors of the company;

(ii) the number of persons of each sex who were senior managers of the company (other than persons falling within sub-paragraph (i)); and

(iii)the number of persons of each sex who were employees of the company.

(9) In subsection (8), "senior manager" means a person who—

(a) has responsibility for planning, directing or controlling the activities of the company, or a strategically significant part of the company, and

(b) is an employee of the company.

(10) In relation to a group strategic report—

(a) the reference to the company in subsection (8)(c)(i) is to the parent company; and

(b) the breakdown required by subsection (8)(c)(ii) must include the number of persons of each sex who were the directors of the undertakings included in the consolidation.

(11) The strategic report may also contain such of the matters otherwise required by regulations made under section 416(4) to be disclosed in the directors' report as the directors consider are of strategic importance to the company.
(12) The report must, where appropriate, include references to, and additional explanations of, amounts included in the company's annual accounts.
(13) Subject to paragraph (10), in relation to a group strategic report this section has effect as if the references to the company were references to the undertakings included in the consolidation.
(14) Nothing in this section requires the disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the interests of the company.

[4] See e.g. Mas, A., 2016A, Does Disclosure Affect CEO Pay Setting? Evidence from the Passage of the 1934 Securities and Exchange Act, Working Paper, Princeton University, Available at https://www.princeton.edu/~amas/.