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Governance *in brief*

BEIS Select Committee inquiry report calls for reforms to the UK Corporate Governance Code and greater enforcement

Headlines

- The BEIS Select Committee's report recommends far-reaching reforms to the Code, in addition to certain legislative changes and reporting proposals to support each of the recommended reforms. The report acknowledges that there are conflicting points of view in many areas.
- The key recommendations are detailed below covering:
  - Improved stakeholder engagement by companies (s172, CA2006)
  - The role and professional development of non-executive directors
  - The importance of gender and ethnic diversity to encourage diverse boardroom thinking
  - Reform and reporting of executive pay
  - Board composition and appointment of board members
  - Thorough, independent and consistent board evaluation
  - A new corporate governance code and enforcement for large private companies
  - Recommendations for investors and the Stewardship Code
- So what happens next? Following the announcement of a June general election, the Government may not respond to the Select Committee's report within the usual timeframe, however corporate governance reform is expected to form part of election manifestos and be continued by the next Government. The FRC has indicated it will be consulting on changes to the UK Corporate Governance Code in the autumn.
- How many of the Committee's recommendations will see the light of day remains to be seen.

This Governance in brief follows on from the Newsflash we published on 6 April 2017, the date of release of the BEIS Select Committee's Report, adding important areas for directors to consider in the light of the Committee's comments.

Background

In June 2016, prior to taking office as Prime Minister, Theresa May spoke about the importance of good governance and trust in business. During September 2016 the BEIS Select Committee launched an inquiry and consultation on corporate governance, asking for responses in November.

This was shortly followed by a separate Government Green Paper on corporate governance reform, for which responses closed in February 2017.

The FRC has announced a "fundamental review" of the UK Corporate Governance Code, on which they will consult in the autumn. This is planned to "simplify and shorten" the Code as well as incorporating Government recommendations and recent areas of focus such as culture, succession planning and diversity.

BEIS Select Committee Report

The BEIS Select Committee welcomes the Prime Minister's commitments on corporate governance and the publication of the Government's Green Paper containing options for corporate governance reform.

Echoing the Government's Green Paper, the Select Committee's report recommends that action must be taken to address a lack of trust in business. Its report highlights the strong reputation of the UK as a place to do business, backed up by the "considerable asset" of the UK Corporate Governance Code and the fundamental principle of "comply or explain".

It adds, "We do not believe that there is a case for a radical overhaul of corporate governance in the UK."

However, the Committee does see benefit in further embedding good corporate governance in all companies, including private companies, supported by investors, regulators and Government, and clearly believes that what gets reported, gets managed, since there are recommendations in almost every area of focus to introduce additional external reporting requirements. The Select Committee calls on the FRC to be active in working against "boilerplate" corporate reporting.

The Summary section of the report is included in the Appendix to this Governance in brief.

Will these recommendations be adopted?

Select Committees do not form part of Government but scrutinise the work of Government departments and therefore their recommendations may not be followed through unless Government agrees. The status of Select Committees and a guide to how they work and interact with Government is available on Parliament's website at http://www.parliament.uk/about/how/committees/select/.

Key recommendations
We set out below the key recommendations by area together with matters for directors to consider on these topics.

Improved stakeholder engagement by companies (s172, CA2006)
Key recommendations
It was widely anticipated that the Select Committee would comment on the importance of s172 of the Companies Act 2006, which focuses on long term thinking and consideration of wider stakeholders by company directors. Without proposing legislative change, as expected the report recommends that the FRC should amend the Code to require more transparent narrative reporting regarding stakeholders, with any identified failures to apply s172 reported on and explained.

Stakeholder advisory panels are also encouraged for all companies as a way of providing valuable feedback from stakeholders to boards.

In order to hold company directors to account, the Select Committee recommends that the FRC should be given additional powers to address failings in directors' duties. These powers would include "name and shame" public reporting on such failings and, ultimately, the authority to initiate legal action for continued breach of duties under s172.

Areas for directors to consider
- Do you have robust mechanisms to seek and to capture the views of a wide range of stakeholders and to bring these views to the attention of the board?
- When making decisions about the strategic direction of the company, are stakeholder views understood/sought when commercially feasible and whose responsibility is it to bring these views to the board?
- In board meetings and papers submitted to the board, are the requirements of s172 of the Companies Act 2006 actively considered and clearly minuted?
- This reporting season, many FTSE 350 companies have started including in the business model details on key stakeholders and how the company engages with those stakeholders. Have you assessed your own company's reporting on engagement with stakeholders?

The report recommends more transparent narrative reporting regarding stakeholders, with failures to consider stakeholders reported on and explained.

Reform and reporting of executive pay

Key recommendations

The Select Committee agrees with the Prime Minister that high and unwarranted executive pay is an issue that needs to be addressed for the benefit of society as a whole, however the committee suggests that 'the current scale of opposition to remuneration reports and policies' does not justify annual binding votes on pay levels.

Its report includes the following recommendations on pay:

- Companies should make it their policy to **align bonuses with broader corporate responsibilities** and company objectives and take steps to ensure that they are **genuinely stretching**.
- Following consultation with stakeholders, the FRC should amend the Code **to establish deferred stock options rather than LTIPs** as best practice in terms of incentivising long-term decision making.
- LTIPs should be phased out as soon as possible. **No new LTIPs should be agreed from the start of 2018 and existing agreements should not be renewed**.
- The FRC should revise the Code to include a **requirement for a binding vote on executive pay awards in the year following there being a vote against of more than 25%**. This requirement should be included in legislation at the next opportunity.
- Any Chair of a Remuneration Committee should normally have **served on the committee for at least one year** previously. To further incentivise strong engagement, the Chair of a Remuneration Committee should be **expected to resign** if their proposals do not receive the backing of 75% of voting shareholders.
- The FRC should amend the Code to require the **publication of pay ratios** between the CEO and both senior executives and all UK employees.
- The FRC should amend the Code to require companies to set out clearly their **people policy**, including approach to investing in and rewarding employees and clear reporting on remuneration levels.

The Select Committee also believes that employee representation on remuneration committees would represent a powerful signal on company culture and commitment to fair pay and that this should be included in the Code. The report adds that it expects leading companies to adopt this approach. This would only be possible where an employee is a full board member, as discussed in the Board composition section below.

Areas for directors to consider

- Does the remuneration committee believe that variable pay should be and is sufficiently aligned with broader corporate responsibilities and company objectives and that targets are genuinely stretching?
- To what extent does the remuneration committee engage with the wider employee population on executive pay policies and structures?
- As part of its activities, does the remuneration committee consider the ratio of CEO pay to that of employees and how this has changed over time?
- Should the succession planning process be updated to reflect the recommendation for a remuneration committee chair to have served on the committee for at least one year previously? Are there individuals currently on the committee who have sufficient tenure and could be appointed in case of a sudden vacancy?
- If there is an employee who also acts as a director of the company, is that individual on the remuneration committee?

Publication of pay ratios between the CEO and both senior executives and all UK employees recommended for inclusion in the Code.

The role and professional development of non-executive directors

Key recommendations

The report emphasises the importance of the role of non-executive directors in holding companies and executive directors to account.

The Select Committee calls on the FRC to revise the Code to include best practice guidance on additional professional support for non-executive directors, such as advice, training and continuing professional development, and to require disclosure regarding training of board members. It draws out the importance of continued training of board members, which should take account of the responsibilities of individual non-executive directors, and of focusing on the importance of director evaluation. It recommends that companies should be required to identify and explain any specific responsibilities held by particular non-executive directors.

When a non-executive director plans to serve on more than one board, they should be asked to demonstrate convincingly to their companies that they have the time to fulfil their responsibilities to each board.

Areas for directors to consider

- Do you consider there is sufficient professional support available to non-executive directors, and does this include professional advice, continuing training and other continuing professional development?
- Have suitable third parties been identified to support these needs or are they sourced on a case by case basis?
- Are non-executive director training needs assessed regularly in the light of the strategy and the current principal risks of the company, for example training on cyber or other technology/data risks?
- Where non-executive directors take on particular responsibilities within the unitary structure of the board, are the expectations of that role fully reflected in professional support and training offered and in the annual performance evaluation process?
- Where non-executives serve on more than one board, how has the board determined that they have enough bandwidth to adequately perform their duties? Has the board considered that additional time commitment may be required for training, site visits and should a crisis happen? Does the annual report already include any of the additional information recommended in the report, since some is already considered best practice, for instance information on training of board members?

The Committee recommends that non-executive directors should be asked to demonstrate convincingly that they have the time to fulfil their responsibilities to each of their boards.

The importance of gender and ethnic diversity

Key recommendations

The Select Committee is positive about current initiatives, including the Hampton Alexander Review and the McGregor Smith Review. It encourages the FRC to address these in the revision of the Code and to embed consideration of ethnic diversity in the revised Code with as much prominence as gender diversity.

The report argues for stricter targets for the Hampton Alexander Review, suggesting that from May 2020 at least half of all new appointments to senior and executive management level positions throughout listed companies should be women. It recommends an amendment to the Code to require all listed companies from May 2020 to explain in annual reports if strict diversity targets are not achieved, to report on gender diversity of the executive committee in line with the Hampton Alexander Review, and to explain how they plan to rectify gender composition of the executive committee if it does not meet the targets.

On board diversity, the Committee recommends that the Code should require a public explanation of why board members are appointed to the board and a detailed narrative about actions taken to promote diversity and how seriously diversity is taken by the board.

The Committee recommends that Government should legislate for disclosure of workforce data broken down by ethnicity and pay band, in the spirit of the McGregor Smith Review published recently.

Areas for directors to consider

- Has the board already considered whether to adopt some or all of the recommendations of the Hampton Alexander Review and the McGregor Smith Review, bearing in mind that Government has indicated it may regulate if recommendations from the McGregor Smith Review are not followed on a voluntary basis?
- Is the executive talent process set up to identify and mentor a diverse range of talent in order to develop a strong pipeline for future promotion?
- Has management determined whether the company's HR systems include sufficient detail to enable reporting on ethnic diversity?

Ethnic diversity recommended to be embedded in the revised Code with as much prominence as gender diversity.

Board composition and appointment of board members

Key recommendations

In addition to diversity, the Select Committee supports the inclusion of workers on boards in the form of an employee being appointed as a director in their own right with full responsibilities. It cites NHS Foundation Trusts, John Lewis and First Group as boards where this is the norm and encourages companies to consider this as something that should become the norm. The report does not recommend a compulsory requirement but believes the insight and challenge brought by worker directors would benefit many boards.

The Committee also recommends that the FRC should update the Code to require the use of open advertising and / or use of an external search consultancy for appointments to the board with detailed disclosure if these methods are not used.

Areas for directors to consider

- Has the board considered the pros and cons of an employee becoming a director?

The Select Committee believes the insight and challenge brought by worker directors would benefit many boards.

Thorough, independent and consistent board evaluation

Key recommendations

The Select Committee recommends that the FRC should be given new powers to oversee the three-yearly external board evaluation process for FTSE 350 companies to ensure it is "genuinely independent, thorough and consistent across companies."

Areas for directors to consider

- Does the provider of the three-yearly external board evaluation process have any other connections with the company? If so, has the board thoroughly considered their independence?
- Does the board consider the provider to be thorough and do they develop thought-provoking recommendations that have enhanced the operation of the board, committees and / or individual directors?
- Does the board perform its own evaluation of the provider of the external board evaluation?

The report recommends new powers for the FRC to oversee external board evaluations.

A new corporate governance code and enforcement for private companies

Key recommendations

A newer area of focus on which the Report issues recommendations for potential reform is private company corporate governance. The Report recommends that the FRC works together with the Institute of Directors and with the Institute for Family Business to develop a new Code for the largest privately held companies, to be followed on a comply or explain basis. This Code should broadly mirror the proposed amendments to the Code for listed companies in terms of reporting on duties under s172. The Report suggests that the initial threshold for private companies could be those with over 2,000 employees.

The challenge with private companies is to determine a method to oversee compliance, and the Report proposes establishing a new body to oversee the Code and report on compliance, with a complaints mechanism to raise concerns with the companies concerned. The body would be funded by a levy on companies subject to the scheme.

Recognising that this "voluntary regime" requires teeth, the Report contemplates the introduction of a mandatory regulatory regime if standards remain low or there is a significant level of non-compliance in a three year timeframe.

Recommendation that companies with over 2,000 employees to report against a new corporate governance code with a regulatory regime if standards remain low after three years.

Recommendations for investors and the Stewardship Code

Key recommendations

The Select Committee also calls on the FRC to review and improve the Stewardship Code. The new Stewardship Code should encourage high quality engagement between investors and companies, include more detail on requirements and undertake to flag poor performance annually.

The report also proposes that the Stewardship Code should require disclosure of voting records by asset managers to continue to promote active engagement, and that those who do not vote should be named.

It asks the Investor Association's Investor Forum to seek to be a more "pro-active facilitator of dialogue between boards and investors."

For companies, the Committee recommends that the FRC should update the Code to require a section in annual reports on engagement with investors.

Other recommendations

In addition, the report recommends that the Institute of Directors' Good Governance Index should be adopted and adapted by the FRC to provide FTSE 350 companies with a new annual rating of their governance arrangements on a "traffic light" system, which should then be reported in their annual reports.

Some of the evidence heard by the Select Committee highlighted large fees paid to advisors on transactions and lack of transparency regarding the basis for those fees, and how and by whom advisors were engaged. The report calls on government to consult on new requirements for listed and large private companies to disclose engagement with advisors on certain transactions that exceed a threshold to be determined.

For further information:

The BEIS Select Committee's full report is available at: https://www.publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/702.pdf

The transcripts, written evidence and other material collected by the Select Committee can be accessed at http://www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/inquiries/parliament-2015/corporate-governance-inquiry/publications/

The Financial Reporting Council has released a press release in response to the report at https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2017/April/FRC-comments-on-Business,-Energy-and-Industrial-St.aspx

Deloitte's Governance in brief on the Government's Green Paper can be read here: https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/audit/deloitte-uk-governance-in-brief-december.pdf

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Deloitte's executive remuneration practice helps clients develop executive remuneration strategies in line with corporate objectives and advises remuneration committees on the corporate governance and regulatory framework that applies to executive remuneration in the UK.

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Deloitte facilitates self-assessments or conducts independent effectiveness reviews for boards and committees. Importantly, we understand that effectiveness is more than structures and processes – our approach goes beyond this and considers dynamics and behaviours.

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The Deloitte Academy

The Deloitte Academy provides support and guidance to boards, committees and individual directors, principally of the FTSE 350, through a series of briefings and bespoke training. Membership of the Deloitte Academy is free to board directors of listed companies, and includes access to the Deloitte Academy business centre between Covent Garden and the City.

Members receive copies of our regular publications on Corporate Governance and a newsletter. There is also a dedicated members' website www.deloitteacademy.co.uk which members can use to register for briefings and access additional relevant resources.

For further details about the Deloitte Academy, including membership, please email enquiries@deloitteacademy.co.uk.

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Appendix – extract from BEIS Select Committee report on Corporate governance

Summary

Following the evidence that this Committee found in 2016 of major corporate governance failings at BHS and Sports Direct, we welcome the Prime Minister's commitment to improving behaviour by big business, as demonstrated by the publication of its Green Paper containing options for reform.

In looking more broadly at this issue, we have found that, 25 years after the Cadbury Report, the UK retains a strong system of corporate governance. However, the environment has changed since then, with new business models, technological developments and growing expectations from stakeholders. The changing ownership structure of British business in a globalised economy has contributed to increased pressures on companies to deliver short-term financial gains for shareholders, rather than invest for their long-term benefit. A worrying lack of trust in business by the general public has been fuelled by recent high profile examples of bad practice, as well as pay levels being ratcheted up to levels so high that it is impossible to see a credible link between remuneration and performance. In this context, these developments demand that our existing framework be improved to keep the UK in the lead globally on corporate governance.

Whilst supporting the current comply or explain basis of the UK Corporate Governance Code, we propose a series of reforms designed to require directors to take more seriously their duties to comply with the law and the Code relating to corporate governance. These include requirements relating to more specific and accurate reporting, better engagement between boards and shareholders, and more accountable non-executive directors. Crucially, to combat what are currently very weak enforcement mechanisms, we recommend a wide expansion in the role and powers of the Financial Reporting Council, to enable it to call out poor practice and engage with companies to improve performance.

Given the increasing number of major private companies, which are subject to weaker reporting requirements, we recommend that a new governance Code for the largest private companies be developed. Compliance with this Code would be examined by an expanded FRC, funded by a small levy on businesses, able to pursue complaints relating to compliance with the Code.

In relation to high levels of executive pay, we agree with the Prime Minister that this is an issue which needs to be addressed for the benefits of society as a whole and in line with her vision of an economy that works for everyone. Whilst there are some encouraging signs that shareholders are beginning to exert some pressure on high executive pay, there are structural problems that need to be addressed. We recommend the abolition of long-term incentive plans, which have become too complex and are liable to create perverse incentives and short-term decisions. Instead, we recommend a more simple pay structure, comprising salary, bonus relating to stretching targets, including those relating to wider performance criteria, and payment by means of equity over the long term.

We also propose measures to improve engagement, including with employees, on pay, and to incentivise better stewardship through more transparency and better reporting. This should include the annual publication of pay ratios.

On board diversity, we fully support the recommendations of recent reviews on gender and ethnic diversity. Whilst progress is being made, we recommend further measures to ensure that diversity is promoted at all stages of careers to broaden the pool of talent at the executive level. To this end, the Government should set a target that from May 2020 at least half of all new appointments to senior and executive management level positions in the FTSE 350 and all listed companies should be women.

We also believe that diversity can be improved by the appointment of workers on boards. This model has worked for some companies, here and abroad, and can help provide both challenge and a different perspective on the board.

We believe that our recommendations will make a strong contribution towards embedding the behaviours of good corporate governance in the culture and values of British businesses, to the benefit of both business and society as a whole.

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