

The UK Government Consults on Corporate Governance Reform: What Next?

9 January 2017

On 29 November 2016, Prime Minister Theresa May's government issued a green paper¹ (the "Green Paper") to canvass opinion on proposed reforms to the UK's corporate governance framework.

A green paper is a government consultation document that invites feedback from interested parties (both within Parliament and outside it) on legislative proposals. The document does not form part of the legislative process and is non-binding in nature, and the government has stressed that it is not currently advocating any one proposal. Therefore, while the content of the Paper provides some guidance as to the government's current thinking on corporate governance reforms, there is no guarantee that any of the proposals put forward will ultimately find their way into the regulatory framework.

In her introduction to the Green Paper, Theresa May cites a concern that "in recent years, the behaviour of a limited few [members of the business community] has damaged the reputation of many", and states that "big business must earn and keep the trust and confidence of their customers, employees and the wider public"². The Secretary of State for Business, Energy and Industrial Strategy, Greg Clark, hails the UK's corporate governance regime as "one of Britain's biggest assets in competing in the global economy"³. Citing proposals by members of the business community to update and amend the corporate governance framework, the Secretary of State states the aim of the Green Paper as framing the discussion around possible amendments to the governance regime relating to (i) executive remuneration and incentivisation, (ii) the representation of employees and other stakeholders in company decision-making, and (iii) enhanced governance standards for large private companies. Certain of the proposals develop positions advanced by Mrs May in a speech to launch her leadership campaign on 11 June 2016⁴, and put forward more recently in a report issued by the think tank "High Pay Centre" and authored by the conservative MP Chris Philp⁵. This memorandum summarises each area considered for reform in the Green Paper separately in three sections. To focus consideration and discussion, we have drawn out in relation to each area selected key questions posed as part of the government's consultation.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following author

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

LONDON

Simon Jay
+44 20 7614 2316
sjay@cgsh.com

Melissa Reid
+44 20 7614 2395
mreid@cgsh.com

¹ *Corporate Governance Reform – Green Paper, November 2016*, available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/573438/beis-16-56-corporate-governance-reform-green-paper-final.pdf

² Green Paper, Introduction from the Prime Minister, p. 2

³ Green Paper, Foreword from the Secretary of State, p. 4

⁴ Available at <http://www.wlrk.com/docs/TheresaMayJuly11Speech.pdf>

⁵ *Restoring Responsible Ownership – Ending the Ownerless Corporation and Controlling Executive Pay, September 2016*, available at http://highpaycentre.org/files/HPC_42_WEB_amend_-_Restoring_Responsible_Ownership.pdf



1. Executive remuneration

Under current legislation, quoted companies⁶ are required to submit a remuneration policy to a binding shareholder vote at least every three years. Additionally, they are required to prepare an annual remuneration report that reports on remuneration paid or awarded (including incentives) during the preceding financial year and includes a statement describing how the company intends to implement the current remuneration policy in the financial year following the reporting period. The remuneration report is subject to an advisory shareholder vote at the annual general meeting. If the vote to approve the remuneration report is not passed, the company must re-submit the remuneration policy to shareholders for approval at the next general meeting⁷. Companies (wherever incorporated) that have a premium listing on the London Stock Exchange are also subject to the UK Corporate Governance Code (the “Code”)⁸ on a ‘comply or explain’ basis. The Code contains high-level guidance on the procedure for setting directors’ remuneration (in particular, performance-based remuneration and long-term incentives) and the role of the remuneration committee⁹. Government research shows that there have been few instances of remuneration policies and reports being rejected by shareholders, though instances of significant minority opposition are comparatively high¹⁰. To increase the effectiveness of shareholder oversight the Green Paper puts forward a number of proposals to enhance shareholder voting rights and transparency around executive remuneration, strengthen remuneration committees and simplify

⁶ A UK incorporated company whose shares are admitted to the Official List, or are listed on an exchange in any member state of the European Economic Area, or are admitted to dealing on either the New York Stock Exchange or NASDAQ, see section 385 of the Companies Act 2006

⁷ See sections 420, 439 and 439A of the Companies Act 2006

⁸ *The UK Corporate Governance Code, April 2016*, available at <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

⁹ See Section D of the Code

¹⁰ See BEIS analysis of Manifest data covering UK companies between 1 October 2013 and 20 October 2016, reproduced in the Green Paper at Table 2 (p. 20)

long-term incentive arrangements in quoted companies.

1. Shareholder voting rights

Options tabled to enhance shareholder voting rights on executive remuneration include the following:

- making the executive pay package detailed in the remuneration report or elements of it, such as variable pay subject to an annual binding vote. It is unclear under the Green Paper whether such approval would be retrospective or forward-looking (i.e. whether the shareholder vote would relate to pay awards made during the reporting period or contemplated for the following financial year). Under the proposal, the measure might be applied either to all quoted companies or alternatively as an escalation mechanism for companies that experience significant minority opposition to a remuneration report (in either the previous year or two consecutive years). The Paper invites comments on an appropriate threshold to be set to determine “significant” minority opposition, putting forward for consideration a range of 20-33%;
- imposing more stringent consequences for companies that lose an advisory vote, for example, requiring any such company to obtain 75% approval for its next remuneration policy;
- requiring or encouraging companies to set an upper limit for aggregate pay (including any variable elements) in their remuneration policy, and requiring any pay in excess of such limit to be approved through a binding shareholder vote;
- requiring the remuneration policy to be put to a binding shareholder vote more frequently than every three years, or giving shareholders discretion to bring this vote forward;
- amending the Code to include more specific guidelines on companies’ engagement with shareholders on remuneration (including stronger guidance on how companies should engage with shareholders following a failed advisory vote).

The cited government research shows that to date only six companies have failed to obtain approval of an annual remuneration report and there has been

only one instance of a remuneration policy being rejected by shareholders. By contrast, 185 companies have experienced significant minority opposition (between 20 and 25%) to a remuneration report and significant minority opposition has been recorded in 80 binding shareholder votes on the remuneration policy¹¹. In light of these figures, we suggest that to have a tangible impact on shareholder oversight of remuneration, measures must be triggered by significant minority opposition. Measures that simply increase the scope or frequency of shareholder majority votes risk failing to address current concerns unless coupled with effective measures to increase shareholder engagement. As the Paper itself concedes, however, much further thought will be required to flesh out the concepts and work through the practical implications of a binding no-vote on executive pay in any particular year.

2. Shareholder engagement

As noted above, a challenge in the area of remuneration oversight is an apparent lack of shareholder engagement – an impression borne out by relatively low shareholder participation in votes on remuneration¹². The Green Paper acknowledges that as pay is seldom a large part of a quoted company's costs, shareholders have little incentive to oppose a remuneration package and risk losing a good management team. To address this issue, the Green Paper puts forward the following options:

- mandatory disclosure of fund managers' voting records, and the extent to which they have made use of proxy voting or voting advisory services. It is noted that the UK Stewardship Code¹³, directed at institutional investors and administered by the Financial Reporting Council, already encourages institutional investors to disclose this information, and that most investors comply with this guidance;

¹¹ Ibid.

¹² On average, 28% of shareholders of FTSE100 companies do not participate in remuneration votes, 40% in the case of smaller quoted companies – see Green Paper paragraph 1.30.

¹³ *The UK Stewardship Code, September 2012*, available at <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx>

- establishment of a senior shareholder committee to engage with executive remuneration arrangements. The Green Paper concedes that this risks introducing complexity into the existing unitary board structure in the UK (viewed as a strength of the system) and moving closer to a continental model, where oversight functions are structurally separate to executive functions; and
- introduction of measures to increase the engagement of individual and retail shareholders. The Green Paper notes that individual shareholder engagement is hindered by the fact that most retail shareholders hold their shares through nominee structures, and that there is little demand on the part of retail investors to make use of existing rights relating to shareholder votes and pass-back of information by brokers.

The appetite among institutional investors for greater administrative burdens (be it through mandatory disclosure requirements or the establishment of supervisory committees) is unlikely to be great, and, as the Green Paper remarks, any increase in burden on major shareholders risks discouraging investment in UK companies. Equally, while additional steps could be taken to educate retail investors on their information and voting rights, it is open to question whether individuals are likely to engage with the companies in which they have invested to a sufficient extent to allow them to constitute a significant voting bloc. We do not, therefore, expect to see significant legislative developments in this area.

3. The role of the remuneration committee

The role and composition of remuneration committees is governed by a number of high-level principles under the Code, which provides guidance as to a minimum number of directors that should sit on it, managing conflicts of interest, its role in determining executive remuneration and performance targets, and its chairman's obligations to maintain contact as required with principal shareholders about remuneration¹⁴. However, the Green Paper cites a concern that remuneration

¹⁴ The Code, Section D

committees are not as effective as they could be in overseeing executive pay arrangements, both because in many cases they are not seen to proactively engage with shareholders and employees, and because there is a perception that they are reluctant to take positions that do not align with the executive team's expectations. The government's proposals are the following:

- remuneration committees should be required to consult shareholders and employees in advance of preparing the company's remuneration policy. The method by which such consultation could be conducted would likely depend on any enhanced measures taken in relation to stakeholder representation (see Section 2 below), and we would suggest that the likelihood of reform in this area is very much dependent on the ultimate success of such corresponding proposals.
- To enable remuneration committees to more effectively challenge executives, chairs of the remuneration committee should be required to have served for at least 12 months on a remuneration committee before taking up the role. The Code already provides in its general guidelines on the effectiveness of corporate leadership that boards and their committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their duties effectively¹⁵. Arguably, therefore, a requirement for a minimum level experience for remuneration committee chairs merely fleshes out a concept that is already applied (on a more flexible basis) by Code-compliant companies.

4. *Transparency in executive remuneration*

In her speech on 11 June 2016, Mrs May made waves by advocating the introduction of disclosure of ratios comparing CEO pay to pay in the wider company workforce. This proposal has formed part of discussion around pay reporting in the UK for some time, and publication of such ratios became mandatory for US public companies for financial years beginning on or after 1 January 2017. In the UK, the proposal has been put forward (in slightly different forms) respectively by Pension and

Investment Research Consultants Limited (PIRC)¹⁶ and the Trade Union Share Owners¹⁷, and by conservative MP Chris Philp in a recently issued report¹⁸. The Green Paper acknowledges the value to investors of having access to pay ratios, when they are presented in the context of the company's performance during the relevant year. However, it cautions that there is a risk that the ratios might produce misleading results that could be misconstrued in public discourse. Given widespread calls for such ratios to be disclosed, it appears likely that a reporting requirement of this nature will be introduced. The detail (including the composition of any ratios) will doubtless form the topic of significant further debate.

The Green Paper additionally invites opinion as to whether existing reporting requirements relating to performance targets triggering bonus payments and benefits under incentive plans should be reinforced. Under current legislation, such targets must be reported by quoted companies in their annual remuneration reports. However, information which, in the opinion of the board, is 'commercially sensitive' is exempt from this requirement¹⁹. There has been considerable pressure from investor associations for companies to provide full disclosure of performance targets, and, where such targets legitimately constitute commercially sensitive information, to commit to make subsequent disclosure²⁰. The Green Paper invites views on either (i) making retrospective disclosure of bonus targets within a specified timeframe a mandatory reporting requirement or, alternatively, (ii) increasing non-legislative pressure to disclose performance targets, whether through institutional shareholder guidelines or strengthening existing Code provisions²¹.

¹⁶ See *PIRC UK Shareholder Voting Guidelines 2016*

¹⁷ See *Trade Union Voting and Engagement Guidelines (March 2013)*

¹⁸ See footnote 5

¹⁹ See *The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, Schedule 8*

²⁰ See, for example, *GC100 Directors' Remuneration Reporting Guidance (August 2016) para 2.1*

²¹ Currently, the Code provides high level guidance only, see Principle D.1 ("Performance related elements [of executive remuneration] should be transparent, stretching and rigorously applied") and Schedule A

¹⁵ See section B.1 of the Code

5. Long-term incentive plans

The Green Paper notes that investor associations have increasingly expressed unease with the complexity of existing long-term incentive arrangements²². In response, the Green Paper introduces for discussion the replacement of long-term incentive plans (“LTIPs”) in their current form with restricted share awards, and opens the floor to other proposals and wider discussion on the issue.

Additionally, the Paper touches on mandatory holding periods for shares awarded under an LTIP. To address concerns raised by investor associations²³, the Green Paper suggests extending this period from the current guideline minimum period of three years under the Code to a five year minimum. It is suggested that this requirement be combined with a requirement for executives to retain shares until they have built up a shareholding equivalent to 2x gross salary, which, again, mirrors a familiar theme in investor and proxy voting guidelines²⁴.

Given that the proposals pick up concerns raised widely among institutional investors, we expect that reforms to current regulation of LTIPs are likely to be introduced. The Green Paper suggests that new requirements may be enshrined in the Code, so only premium-listed companies would be required to adopt any amendments on a comply or explain basis. However, with existing investor pressure and the increased focus on LTIP structures that any reforms would bring, it is likely that quoted companies more broadly would seek to comply with any new requirements.

Key consultation questions:

- Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance?

²² See, for example, the *Investment Association Principles of Remuneration Section C; Institutional Shareholder Services – UK and Ireland Proxy Voting Guidelines: 2016 Benchmark Policy Section 3*

²³ See, for example, the *Investment Association Principles of Remuneration Section C para 2(i)*

²⁴ See for example *Institutional Shareholder Services – UK and Ireland Proxy Voting Guidelines: 2016 Benchmark Policy Section 3*

- 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 steps need to be taken to improve the effectiveness of remuneration committees?
- Should a new pay ratio reporting requirement be introduced?
- Should existing, qualified requirements to disclose performance targets that trigger annual bonus payments be strengthened?
- How could LTIPs be better aligned with the long-term interests of quoted companies and shareholders?

2. Stakeholder representation

The Green Paper notes that under existing companies legislation, companies are required to take into account the interests of different stakeholder groups in their corporate decision-making²⁵ and must prepare a strategic report detailing the ways in which these obligations have been met²⁶. Citing recent examples of “particularly poor corporate conduct”, the government advances the view in the Green Paper that companies may need to do more to reassure the public that they are being run with an eye to the interests of the wider stakeholder community. The Green Paper contains proposals to strengthen the voice of employees, suppliers, customers, pension-beneficiaries and other parties with a direct or close interest in the performance of a company.

In her speech on 11 June 2016, Theresa May announced plans to introduce consumer and employee representatives on company boards.

²⁵ See section 172 of the Companies Act 2006, which provides that directors are under a duty to promote the success of the company, having regard to the interests of certain specified stakeholder groups (including employees).

²⁶ See sections 414(A) and 414(C)(1) of the Companies Act 2006. Note that the extent of the disclosure obligations varies depending on the size and legal status of the company in question.

employee representatives on company boards. The Green Paper raises, but expressly rejects this proposal, citing concerns around the practical workability of the system and its applicability to wide ranges of companies. However, the Green Paper acknowledges the need for greater stakeholder (and specifically employee) representation in corporate decision-making and puts forward the following alternative proposals by which more effective representation may be achieved:

- *The creation of stakeholder advisory panels.* The Green Paper notes that in practice, advisory panels may interact with company boards in a variety of ways, including by giving preliminary consideration to issues to be discussed at board meetings, or by attending board meetings themselves in an advisory capacity. The advantage cited is that the regime could give companies flexibility to determine the composition of such advisory panels to suit the circumstances of their business. It is unclear what, if any, framework requirements would be set out in legislation.
- *The designation of existing non-executive directors to represent key stakeholder groups at board level.* The Green Paper notes that companies will typically already allocate areas of responsibility to different non-executive directors. New measures would have the effect of formalising this relationship and giving designated non-executive directors standing to ensure that the voice of stakeholders is heard and taken into account in corporate decision-making. The government envisages that such a measure would interact with other corporate governance reforms, for example the introduction of a stakeholder advisory panel and the strengthening of the role of remuneration committee. However, it is also noted that designated non-executive directors would remain constrained by their directors' duties and would therefore be restricted from prioritising the interests of different stakeholder groups where this was not in the best interests of the company as a whole.
- *The strengthening of reporting requirements related to stakeholder engagement.* While companies are obliged to publish an annual

strategic report to explain the steps they have taken to comply with section 172 of the Companies Act 2006²⁷, the requirement is not prescriptive as to the format and content of any disclosure. The Green Paper notes that as a consequence, there is often a lack of clear and transparent information. The government therefore invites views as to how more specific guidance might be formulated with the aim of achieving greater transparency in companies' engagement with their stakeholders' interests.

The government notes that the different measures proposed are not mutually exclusive, and that it is open to views as to the flexibility that should be granted to companies in relation to implementation. It suggests that, at the most flexible end of the spectrum would be the establishment of a set of high-level expectations, allowing bodies such as the Financial Reporting Council to establish guidelines on how such expectations should be met. Therefore, while we would expect the proposals to result in some measure of reform in this area, it remains to be seen whether this will result in any further mandatory requirements for companies to meet.

Key consultation questions:

- How can the way in which the interests of employees, customers and wider stakeholder are taken into account at board level in large UK companies be strengthened?
- Which type of company should be the focus for steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?
- Should a legislative, code-based or voluntary approach be used to drive change?

3. Large private companies and other issues

Under the current regime, the strongest corporate governance and reporting requirements apply to public and/or quoted companies, on the basis that

²⁷ See footnote 25

private companies are subject to more close control by their shareholders. However, research indicates that large businesses are increasingly choosing to operate as private companies in the UK, and the Green Paper therefore invites views as to whether large private companies should be subject to more stringent corporate governance and reporting requirements. The Green Paper canvasses views on whether existing specific corporate governance frameworks should be applied more widely to the largest private companies. Specifically, it proposes that the Code might be applied to private companies that meet a certain size threshold on a comply or explain basis: it notes however that much of the Code may not be applicable to unlisted companies and expresses the concern that the effectiveness of the “comply or explain” regime may be eroded if a large proportion of disclosure simply “explains away” many of the governance requirements.

With reference to recent practice, the Green Paper also invites views on whether reporting requirements imposed on public and listed companies under existing legislation should be applied on the basis of the size of a business rather than its legal status. It invites input on the appropriate level at which a size threshold should be set.

In a final ‘sweep-up’ section, the Green Paper invites views more broadly on the current corporate governance framework in the UK and how it might be improved. The general question focuses in particular on the flexibility of the ‘comply or explain’ system, asking whether the regime strikes the right balance between high standards and low burdens.

Key consultation questions:

- What is your view of the case for strengthening the corporate governance framework for the UK’s largest, privately-held businesses?
- Which privately-held businesses should be in scope? Where should any size threshold be set? Should legislation be used or would a voluntary approach be preferable?

- Should non-financial reporting requirements be applied on the basis of a size threshold rather than on the basis of the legal form of a business?
- Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens?

4. Next steps

The government consultation on the proposals outlined in the Green Paper will be open until 17 February 2017. The government has expressed a preference for responses to be framed as direct responses to some or all of the questions posed in the paper (though notes that any other comments are also welcome). If you would like to submit your views on the proposals outlined, you may do so by e-mail or online through the Citizens Space portal, or by post.

The government has stressed that it does not currently favour any one or more of the measures proposed and is simply canvassing opinion. We therefore await the closing of the consultation and any government response to gauge likely future developments with any confidence.

...

CLEARY GOTTlieb