



Department for  
Business, Energy  
& Industrial Strategy

# CORPORATE GOVERNANCE REFORM

Green Paper

November 2016

# CORPORATE GOVERNANCE REFORM

## Green Paper

The consultation can be found on the BEIS section of GOV.UK:

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Any enquiries regarding this publication should be sent to us at:

[corporategovernance@beis.gov.uk](mailto:corporategovernance@beis.gov.uk)

# Introduction from the Prime Minister



**10 DOWNING STREET**  
LONDON SW1A 2AA

This Government will build an economy that works for everyone, not just the privileged few.

I strongly believe in the power of businesses and markets to improve our collective prosperity, and the Government I lead will be unequivocally and unashamedly pro-business. Because for Britain to thrive in a global economy, we need to support strong businesses that focus on long-term value creation and command public confidence and respect.

But for people to retain faith in capitalism and free markets, big business must earn and keep the trust and confidence of their customers, employees and the wider public. For many ordinary working people – who work hard and have paid into the system all their lives - it's not always clear that business is playing by the same rules as they are. And when individual businesses lose the confidence of the public, faith in the business community as a whole diminishes – to the detriment of all. It is clear that in recent years, the behaviour of a limited few has damaged the reputation of the many. It is clear that something has to change.

This Green Paper sets out a new approach to strengthen big business through better corporate governance. The UK is already an established international leader in corporate governance – one reason why we are an attractive destination and a great place to invest and do business. We want to retain and extend that leadership and support companies to take better decisions, for their own long-term benefit and that of the economy overall.

Good corporate governance is about having the right checks and balances within big business to strengthen decision making and accountability. This Green Paper therefore focuses on ensuring that executive pay is properly aligned to long term performance, giving greater voice to employees and consumers in the boardroom, and raising the bar for governance standards in the largest privately held companies. These are issues which are about competitiveness, and creating the right conditions for investment, as much as they are issues about fairness.

We are laying out the case for change, and putting forward a range of options to improve the situation. I want the Government to have an open discussion with businesses, investors, and the public about what needs to be done. This is an important task, and one where both the Government and big business must rise to the challenge of restoring faith in what they do, and in the power of the market economy to deliver growth, opportunity and choice for all.

A handwritten signature in black ink, appearing to be 'R. M. J.', written in a cursive style.

## Foreword from the Secretary of State



One of Britain's biggest assets in competing in the global economy is our deserved reputation for being a dependable and confident place in which to do business. Our legal system, our framework of company law and our standards of corporate governance have long been admired around the world.

One of the reasons why we have maintained such a reputation is that we have kept our corporate governance framework up to date – with reviews and improvements made from time to time such as those made by Cadbury in 1992 and Greenbury in 1995.

During the last few years there have been a number of proposals – including from organisations representing business – to update our corporate governance framework. In some cases these have been made in response to concern that actions by a very small number of businesses can undermine the reputation of British business generally, whose standards are amongst the highest in the world.

This Green Paper seeks views on three areas where we want to consider options for updating our corporate governance framework:

- First, on shareholder influence on executive pay, which has grown much faster over the last two decades than pay generally and than typical corporate performance;
- Second, on whether there are measures that could increase the connection between boards of directors and other groups with an interest in corporate performance such as employees and small suppliers; and
- Third, whether some of the features of corporate governance that have served us well in our listed companies should be extended to the largest privately-held companies at a time in which different types of ownership are more common.

This Green Paper is designed to frame a discussion, so that we can move quickly to consider whether changes are appropriate at this time. Where there is a view that change is appropriate it may not be the case that regulation by Government is needed to secure it. One of the strengths of our system of corporate governance has been the use of non-legislative standards adopted by business itself.

We are determined to make Britain one of the best places in the world to work, to invest and to do business, and part of that means continuing to have a framework of corporate governance that is admired across the world. This review will help us achieve that aim and the views of businesses, investors, employees, consumers and others with an interest in successful business are warmly welcomed.

A handwritten signature in black ink that reads "Greg Clark". The signature is written in a cursive style with a large, sweeping 'G' and 'C'.

**GREG CLARK**

**SECRETARY OF STATE FOR BUSINESS, ENERGY AND INDUSTRIAL STRATEGY**

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# General information

## Purpose of this consultation

The UK has long been regarded as a world-leader in corporate governance, combining high standards with low burdens and flexibility. It is an important part of what makes the UK such an attractive place for both business and investors. We want to build on these strengths and further enhance our competitiveness.

This Green Paper is designed 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 Government does not have preferred options at this stage. We want to use responses to the Green Paper to help us understand the strengths and weaknesses of the different options and build a better evidence base before deciding which of them to develop further. We also welcome other suggestions to help address the corporate governance challenges facing us.

**Issued:** 29 November 2016

**Respond by:** 17 February 2017

**Enquiries to:**

Corporate Governance Reform Team  
Department for Business, Energy & Industrial Strategy,  
3<sup>rd</sup> Floor Spur 1,  
1 Victoria Street,  
London  
SW1H 0ET  
Tel: 0207 215 3433  
Email: [corporategovernance@beis.gov.uk](mailto:corporategovernance@beis.gov.uk)

**Territorial extent:**

The UK Government is responsible for the operation and regulation of business entities in England and Wales, and in Scotland. The Northern Ireland administration has agreed that, while the operation and regulation of business entities remains a transferred matter within the legislative competence of the Northern Ireland Assembly, amendments to the Companies Act 2006 and legislation regulating business entities should be made in the same terms for the whole of the United Kingdom.



## How to respond

Your response will be most useful if it is framed in direct response to the questions posed, though further comments and evidence are also welcome.

Respondents are invited to comment on some or all of the questions summarised in Section 3.

Responses can be submitted in three ways:

- (i) By e-mail to [corporategovernance@beis.gov.uk](mailto:corporategovernance@beis.gov.uk);
- (ii) Via Citizens Space accessible at: <https://beisgovuk.citizenspace.com/strategy/corporate-governance-reform>; or
- (iii) In hard copy to the correspondence address above.

### **Additional copies:**

You may make copies of this document without seeking permission. An electronic version can be found at [www.gov.uk/government/consultations/corporate-governance-reform](http://www.gov.uk/government/consultations/corporate-governance-reform).

## Confidentiality and data protection

Information provided in response to this consultation, including personal information, may be subject to publication or disclosure in accordance with the access to information legislation (primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004).

If you want information that you provide to be treated as confidential please say so clearly in writing when you send your response to the consultation. It would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded by us as a confidentiality request.

We will summarise all responses and place this summary on the [GOV.UK website](#). This summary will include a list of names or organisations that responded but not people's personal names, addresses or other contact details.

## Quality assurance

This consultation has been carried out in accordance with the [Government's Consultation Principles](#).

If you have any complaints about the consultation process (as opposed to comments about the issues which are the subject of the consultation) please address them to:

Email: [enquiries@beis.gov.uk](mailto:enquiries@beis.gov.uk)

# Executive Summary

The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of a company. It involves a framework of legislation, codes and voluntary practices. A key element is protecting the interests of shareholders where they are distant from the directors running a company. It also involves having regard to the interests of employees, customers, suppliers and others with a direct interest in the performance of a company. Good corporate governance provides confidence that a company is being well run and supports better access to external finance and investment.

The UK is recognised as having a world-leading corporate governance framework. It gives us an international competitive advantage and is an important factor in making the UK an attractive place in which to invest. Key pillars of our corporate governance framework include:

- A robust framework of company and financial markets law which promotes accountability and transparency;
- A unitary board system which makes directors collectively responsible for the decisions of the board;
- The Financial Reporting Council's UK Corporate Governance Code which sets out good governance principles and practices on issues such as board responsibilities, composition, remuneration and shareholder relations. It applies to leading listed companies on a "comply or explain" basis and continues to evolve in line with emerging good practice; and
- The FRC's Stewardship Code, which sets out the principles of effective stewardship by investors.

At a time when investment and competitiveness are key and when the Government is developing an industrial strategy, it is right that we look to build on our corporate governance strengths to equip us for the economic challenges and opportunities that lie ahead.

The aim of this Green Paper is to consider what changes might be appropriate in the corporate governance regime to help ensure that we have an economy that works for everyone. It considers three specific aspects of corporate governance where we think there could be particular scope to build on and enhance the current framework:

- Executive pay;
- Strengthening the employee, customer and supplier voice; and
- Corporate governance in the UK's largest privately-held businesses.

Section 1 provides background on the current regulatory framework for executive pay, including significant reforms implemented in 2013. It also includes an analysis of trends in

levels of executive pay and shareholder voting patterns. The Government is committed to ensuring that companies retain flexibility to set remuneration policy and pay appropriate to their business needs and strategy, whilst giving proper consideration to the views and concerns of shareholders and having appropriate regard to the interests of employees and other stakeholders. The section asks for views on a range of options aimed at:

- Strengthening shareholder voting rights;
- Encouraging greater shareholder engagement with executive pay;
- Strengthening the role of remuneration committees, including improved engagement with shareholders and employees;
- Further improving transparency on executive pay; and
- Improving the effectiveness of long-term pay incentives.

Section 2 explores the issue of how to strengthen the employee, customer and supplier voice at boardroom level. It outlines the current legal framework which recognises the importance of stakeholder views. It provides examples of some current approaches used by businesses to hear the voice of employees, consumers and other stakeholders and seeks further examples of existing good practice.

This section also sets out and seeks views on a number of potential options that companies could take to improve the connection between the boardroom and the workforce and other interests. These include the establishment of advisory panels and the appointment of designated non-executive directors to take formal responsibility for articulating particular stakeholder perspectives. The section suggests that there should be higher expectations for companies to engage with employees and others, but that they should be able to select the mechanisms most appropriate for their business, and explain why they have been chosen.

Section 3 considers the position of large privately-held businesses which currently face lower formal corporate governance and reporting standards than many public companies. It explains that this is because, in public companies, the owners or shareholders are distant from the executive directors running the company. Shareholders in such companies need mechanisms to ensure that the company is being run in their interests and to have the information that they need to hold the executive directors to account.

Good corporate governance, however, is about more than the relationship between the owners and the managers of a business. There are other parties with a strong interest in whether a business is well run, including employees, customers, creditors and other companies in the supply chain. This section therefore seeks views on whether the UK's largest privately-held companies – where they are of similar size and economic significance to public companies – should be expected to meet higher minimum standards of corporate governance and reporting. If a stronger framework is required, it suggests either extending the UK Corporate Governance Code or developing a new code tailored more specifically to the circumstances of large privately-held businesses.

These three areas are the main focus of the Green Paper but other views are welcome. Section 4 has been included to provide an opportunity to make suggestions on any other themes, ideas or proposals that could be explored which would strengthen the UK's corporate governance framework.

This Green Paper is part of wider work to enhance public trust in business as a force for good. This includes Matthew Taylor's review of employment practices in the modern economy and the review of "mission-led businesses" which is looking at ways to encourage businesses that want to pursue a particular social purpose. It includes our support for the work that Sir Philip Hampton and Dame Helen Alexander are doing to increase gender diversity in the boardroom and in senior management, and Sir John Parker's work to consider how to improve ethnic diversity, all of which has relevance to the challenge of connecting boards effectively with their workforce and customer base. It also includes measures to create a responsible prompt payment culture between businesses. These issues are being addressed separately.

The various options set out in the Green Paper are designed to stimulate debate among all those with an interest in corporate governance including businesses, employees, investors and the general public.

We invite feedback on the questions and issues raised throughout this paper and welcome further evidence that will help to build a stronger understanding of the ways in which government, business and other interested parties can work together to improve our corporate governance framework.

# Catalogue of Green Paper Questions

## 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?
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.	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?
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.
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?
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.

## 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.
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?
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.

## 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?
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?
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?
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?

## 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? |
|-----|--|
-



# Executive pay

This section explores options for strengthening shareholder influence over directors' remuneration, increasing transparency and simplifying and strengthening long-term incentive plans.

## The problem

- 1.1. It is right that our major companies should be able to attract and retain top management talent, recognising that many of the leaders of our most successful companies are recruited from outside the UK. However, there is a widespread perception that executive pay has become increasingly disconnected from both the pay of ordinary working people and the underlying long-term performance of companies. Executive pay is an area of significant public concern, with surveys consistently showing it to be a key factor in public dissatisfaction with large businesses.<sup>1</sup> A growing number of institutional investors have also been speaking out, particularly since executive pay reforms in 2013 which gave shareholders a stronger role in executive pay.
- 1.2. Total pay for the CEOs of FTSE 100 companies has increased very significantly over the last 18 years, up from an average of c.£1m in 1998 to c.£4.3m<sup>2</sup> in 2015 (although that is slightly down on a peak of c.£4.75m in 2011). As shown in Figure 1 overleaf, this quadrupling of CEO pay is largely accounted for by the growth in annual bonus payments and long-term pay incentives. It has far outstripped growth in average pay in the UK. In 1998 the ratio of average FTSE 100 CEO pay to the average pay of full-time employees in the UK was 47:1. This ratio increased to 132:1 in 2010 and stood at 128:1 in 2015.<sup>3 4</sup>
- 1.3. A number of shareholders and other stakeholders have queried whether this very significant increase in FTSE 100 CEOs' pay has been matched by increases in the long-term value of the companies they manage. For example, the recent report of the investor-led Executive Remuneration Working Group observed that "rising levels of executive pay over the last 15 years have not been in line with the performance of the FTSE over the same period, feeding the increasingly negative perception of listed

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<sup>1</sup> For example, Opinium research for PWC's 'Time to Listen' paper published in June 2016 found that two-thirds of respondents believe executive pay is too high; and in a YouGov poll for CIPD in Sept 2015, only 14% of respondents agreed that CEO pay is good value for investors

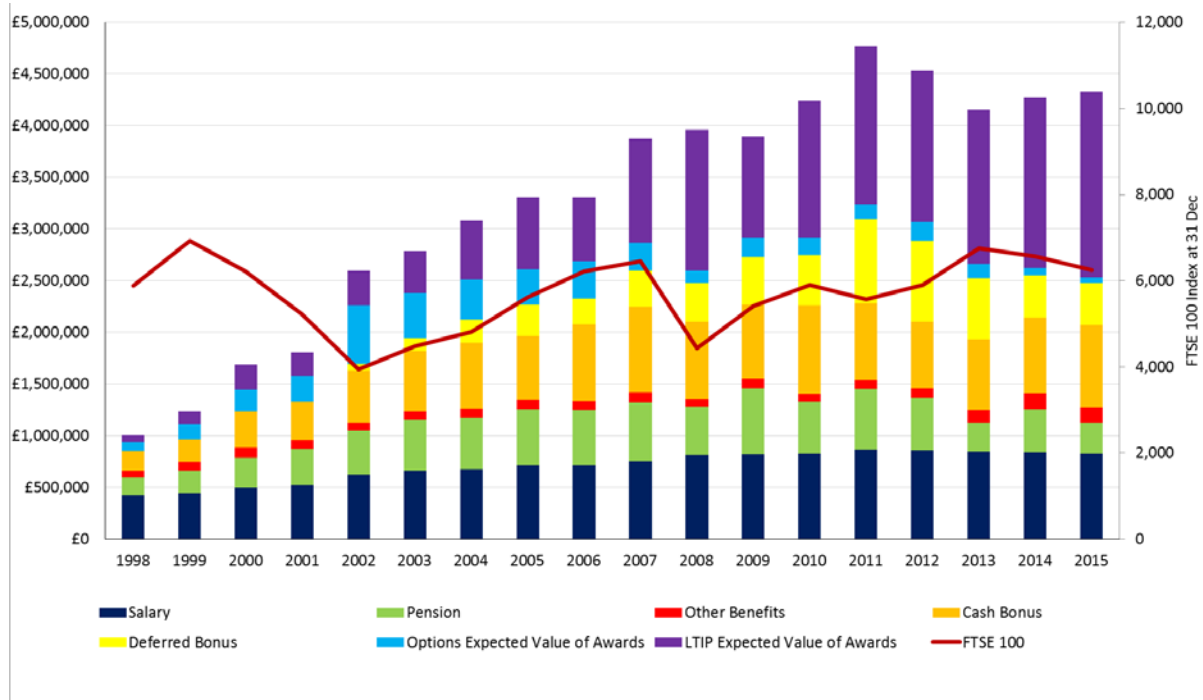
<sup>2</sup> Manifest Pay & Performance Survey 2015

<sup>3</sup> BEIS analysis based on Manifest data on total remuneration of CEOs, and data from the Annual Survey of Hours and Earnings (ASHE) for mean pay of full-time employees

<sup>4</sup> High Pay centre analysis comparing the pay of CEOs with average pay of employees within FTSE100 companies (rather than the UK workforce at large) provides a similar ratio of 129:1 for 2015

companies by the public”.<sup>5</sup> Figure 1 tracks the increase in executive pay alongside the performance of the FTSE 100 share index which has increased only slightly over the same period.

**Figure 1: FTSE 100 CEO pay and company values (Manifest Pay & Performance Survey 2015)**



- 1.4. It is difficult to assert with confidence the link between executive pay and long-term company performance at individual companies. Some UK, US and other international evidence does suggest a correlation between the pay of CEOs and company performance, but it is harder to establish a strong causal link<sup>6</sup>.
- 1.5. Establishing such a link has arguably been made more challenging by the growing complexity of executive pay packages in recent years. The Executive Remuneration Working Group’s report states that:

“Executive pay is opaque to the outsider and difficult even for some participants, remuneration committees and shareholders to understand. Growing complexity has contributed to poor alignment between executives, shareholders and the company, sometimes leading to levels of remuneration which are very difficult to justify.”

<sup>5</sup> Executive Remuneration Working Group Final Report, July 2016

<sup>6</sup> For example, see Frydman & Saks, 2010

## Context

### The 2013 executive pay reforms

1.6. Reforms which came into effect in 2013 introduced new shareholder controls and oversight over executive remuneration in ‘quoted companies’, as defined in section 365 of the Companies Act 2006. These are UK registered companies that are quoted on the main London Stock Exchange or on a stock exchange in the European Economic Area, the New York Stock Exchange or NASDAQ. The reforms gave shareholders a binding vote on pay policies (at least once every three years) and an annual advisory vote on the actual pay awards made to directors under the shareholder-approved pay policies. They also introduced greater clarity in the reporting of executive pay. The key elements of the current regulations are set out in Table 1.

**Table 1: Summary of current executive pay regulations<sup>7</sup>**

- Quoted companies must put their **pay policy** to shareholders at least every three years. This policy includes information on how each director will be paid, how pay is linked to different levels of performance, and the policy on recruitment and exit payments. It must say how the pay and conditions of employees were taken into account in setting the policy and whether, and if so how, employees were consulted. The policy is subject to a binding (simple majority) vote. If the vote is lost, the company must bring forward a new policy for approval as soon as possible. The old policy continues until a new one has been agreed.
- Quoted companies also have to prepare an Annual Remuneration Report setting out how the pay policy has been applied in practice in the previous financial year. This has to:
  - Report the pay of each director in a single figure and set out clearly how the payments relate to the company’s performance;
  - Report the performance measures that had to be met in order for bonuses to be paid, subject to an exemption for measures considered commercially sensitive; and
  - Provide a comparison of the change in pay for the CEO and the wider workforce.
- The pay report is subject to an advisory vote by shareholders at the AGM.
- Where a majority of shareholders reject the report, then the company must submit a pay policy to a binding vote at the AGM the following year (or sooner).

<sup>7</sup> The full changes set out in the 2013 regulations can be found at:  
[http://www.legislation.gov.uk/ukxi/2013/1981/pdfs/ukxi\\_20131981\\_en.pdf](http://www.legislation.gov.uk/ukxi/2013/1981/pdfs/ukxi_20131981_en.pdf)

- 1.7. Additionally, companies with a premium listing in the UK, whether they are incorporated in the UK or elsewhere, are subject to 'comply or explain' reporting requirements on executive pay policies and awards as set out in the UK Corporate Governance Code. In particular, the Code states that executive pay policies and awards should be transparent, promote the long-term success of the company and be sensitive to pay and employment conditions in the wider workforce. The Code, which is the responsibility of the Financial Reporting Council, is explained in more detail in Table 4 (Section 3).
- 1.8. The UK Listing Rules require premium-listed companies, including overseas companies, to report on compliance with the Main Principles and other relevant provisions of the Code. The Listing Rules are the responsibility of the Financial Conduct Authority.
- 1.9. Since the 2013 executive remuneration reforms were brought into effect, most quoted companies have received large shareholder votes in favour of both their pay policies and their annual remuneration reports, with an average 93% vote in favour, as shown in Table 2 below. There have, however, been a small number of examples of shareholders voting down pay policies and remuneration reports. To date, only one company has lost a binding vote on its pay policy, and six companies have lost advisory votes on their remuneration reports.
- 1.10. It is also worth noting that a significant percentage of shareholders – 28% on average in the case of FTSE 100 companies – are not making use of their shareholder voting rights and therefore not expressing a view, one way or the other, on executive pay arrangements.

**Table 2: Summary of shareholder voting on pay policies and remuneration reports since 2013 reforms<sup>8</sup> (BEIS analysis)**

	FTSE100	FTSE250	FTSE Small cap
<b>Remuneration Reports</b>			
Annual Remuneration Reports approved (advisory vote)	272	645	697
<i>Approved with less than 2/3rds majority</i>	21	39	52
<i>Approved with less than 4/5ths majority but greater than 2/3rds majority</i>	14	31	28
Annual Remuneration Reports rejected (advisory vote)	4	0	2
Average percentage of votes in favour of Annual Remuneration Report	90%	93%	95%
Average registered abstention rate <sup>9</sup> for Annual Remuneration Report votes	2.3%	2.2%	1.5%
Number of instances where the abstention rate for an Annual Remuneration Report vote was greater than 15%	6	16	9
Average percentage turnout for Annual Remuneration Report votes	72%	71%	60%
<b>Remuneration Policies</b>			
Remuneration Policies approved (binding vote)	122	314	326
<i>Approved with less than 2/3rds majority</i>	4	11	27
<i>Approved with less than 4/5ths majority but greater than 2/3rds majority</i>	7	11	20
Remuneration Policies rejected (binding vote)	0	1	0
Average percentage of votes in favour of Remuneration Policy	92%	94%	94%
Average abstention rate for Remuneration Policy votes	1.9%	1.7%	1.6%
Number of instances where the abstention rate for a Remuneration Policy vote was greater than 15%	1	6	6
Average percentage turnout for Remuneration Policy votes	71%	71%	62%

1.11. In parallel, there are indications that companies are seeking to be more transparent about the nature of the performance targets that trigger the payment of annual executive bonuses. This year, for example, all FTSE 100 companies have disclosed retrospective measures (up from 95% last year) with 70% of companies including financial measures linked to bonus targets (up from 50% last year).

<sup>8</sup> BEIS analysis of Manifest data, covers UK incorporated companies between 01/10/2013 and 20/10/2016

<sup>9</sup> Votes to abstain are formally cast and counted within the total voter turnout

- 1.12. Some institutional investors are also being more pro-active in developing and updating guidance on what they expect from companies when bringing forward new executive pay policies and pay awards<sup>10</sup>. This is being supported by collective initiatives from within the investor community, including new guidance on executive pay by the Investment Association which stresses the importance of pay being linked to “sustainable long-term value creation”<sup>11</sup>, and the recent report of the Executive Remuneration Working Group, which recommends simplifying long-term executive pay packages and linking them more effectively to long-term company performance<sup>12</sup>.
- 1.13. CEO pay increases have shown some signs of restraint in recent years. The median 2016 increase so far for FTSE100 CEOs is c.2% (the same as the median increase in 2015), and less than 1% for the top 30<sup>13</sup>. This comes after very big gains since 1998, however, with a median pay package for FTSE100 CEOs in 2016 of £4.3m. Such high levels of pay may feed a public perception that the top end of the corporate world has become disconnected from the experiences of ordinary working people.
- 1.14. We want companies to retain flexibility on setting remuneration policies most appropriate to their business needs and strategy. But it is right to ask whether the executive pay reforms made in 2013 require further refinement to enable companies to demonstrate that they are listening and acting on the views and concerns of shareholders and having appropriate regard to the interests of wider stakeholders.
- 1.15. These are not issues that are unique to the UK. Executive pay levels in many of our international competitors are at similar levels, if not higher, and these countries are also addressing public dissatisfaction at the perceived disconnect between executive pay and wider society. The United States, France, Sweden, Belgium, Switzerland, Australia and the Netherlands, for example, have all recently introduced, or are actively considering, new measures to strengthen shareholder rights over executive pay and increase public transparency<sup>14</sup>.

## Options for reform

- 1.16. We are inviting views on the case for changes to the UK’s executive pay framework for quoted companies in five areas: (A) shareholder voting and other rights; (B) shareholder engagement on pay; (C) the role of remuneration committees; (D) pay disclosure; and (E) long-term pay incentives. Many of the specific options identified in this section come directly from early discussions with institutional investors and others. As we examine

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<sup>10</sup> An example is Hermes Investment Management’s recently published remuneration principles <https://www.hermes-investment.com/blog/perspective/remuneration-principles-clarifying-expectations/>

<sup>11</sup> <https://www.ivis.co.uk/media/12445/Principles-of-Remuneration-2016-Final.pdf>

<sup>12</sup> Investment Association Executive Remuneration Working Group report, July 2016

<sup>13</sup> PWC 2016 mid-season executive pay snapshot

<sup>14</sup> See Appendix A

them, our objective and guiding principles will be to achieve executive pay which is long term, fair and transparent, and related to performance.

## A - Shareholder voting and other rights

Quoted companies are already required to subject their pay policy to a binding vote every three years and their annual pay awards to an annual advisory vote. Increasing shareholder voting rights further might include one or more of the options below.

**Option (i): Make all or some elements of the executive pay package subject to a binding vote. This could be the full remuneration report or refer only to variable pay elements of the pay award (such as the annual bonus, the Long-Term Incentive Plan and any proposed increase in basic salary). It could be applied annually to all companies or only to companies that have encountered significant shareholder opposition to the remuneration report.**

- 1.17. Introducing annual binding votes on all or some elements of executive pay would enable shareholders to hold executives to account for performance on an annual basis. There would be clear and immediate consequences flowing from an adverse shareholder vote, rather than the current situation where the annual vote on the remuneration report is merely advisory. It may also encourage greater uptake of voting rights by shareholders, and a sharper and more active interest in scrutinising the annual remuneration report, if shareholders know they have real power to approve or reject it.
- 1.18. However, extending a binding vote to all or some variable elements of the annual remuneration report could have some practical difficulties. For example, it might involve requiring businesses not to award pay before shareholder consent has been obtained, or restricting future pay awards. Directors' service contracts would need to be clear that pay was conditional on shareholder approval to avoid conflict with employment law and clear on contractual entitlements.
- 1.19. Consideration would also need to be given to how a shareholder vote against pay would be resolved. An adverse vote clearly indicates dissatisfaction with what is being proposed but does not signal what the right package of pay should be. Companies and shareholders would need to develop structures for speedily and effectively agreeing a revised remuneration report where the original is rejected.
- 1.20. Alternatively, an escalation process could be introduced for companies which encounter significant minority opposition to pay awards in the previous year<sup>15</sup> or previous two consecutive years. The definition of a "significant minority" would require further consideration, but might be set in the range 20% to 33%. The consequence for these

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<sup>15</sup> This proposal is included in the final report of the Investment Association's Executive Remuneration Working Group, July 2016

companies could be a binding vote regime. This targeted approach<sup>16</sup> could encourage more effective prior engagement.

**Option (ii): Introduce stronger consequences for a company losing its annual advisory vote on the remuneration report**

- 1.21. A different approach would be to target stronger measures at the companies that lose the existing annual advisory vote. Where a company loses an annual advisory vote, for example, the company could be required to win the backing of a ‘supermajority’ of shareholders (e.g. 75%) to approve the next pay policy that must (under the current system) be brought forward within a year where an advisory vote is lost.
- 1.22. Alternatively there could be a requirement to hold a binding vote on pay the following year.

**Option (iii): Require or encourage quoted company pay policies to (a) set an upper threshold for total annual pay (from all elements of remuneration), and (b) ensure a binding vote at the AGM where actual executive pay in that year exceeds the threshold.**

- 1.23. Some investors and other stakeholders have suggested that a company’s pay policy could set upper limits on CEO and other executive pay<sup>17</sup>. This option would not involve an externally imposed pay cap, but would give shareholders an opportunity to give specific consent for pay exceeding certain pre-determined limits set out in the pay policy.
- 1.24. Shareholders already have a binding vote on the three year forward pay policy. The policy will commonly include a range of different elements, from basic salary to bonus, to Long-Term Incentive Plan (LTIP). Given the complexity of this sort of pay package, the likely overall level of remuneration at different levels of company performance will not necessarily be clear. This problem could be addressed by requiring the pay policy to state explicitly a maximum intended level of total annual remuneration (or indeed a multiple of performance to basic pay), based on stretching performance targets. Companies would retain the flexibility to pay more than this to reward exceptional performance, but this would be subject to a binding vote on pay in that particular year.
- 1.25. There would also be difficulties in setting an upper threshold on elements of pay linked to the company’s share price. Setting a pre-determined limit on share awards could disincentivise executives from maximising long-term performance. To deal with this concern, share awards could either be excluded from the threshold or could be based

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<sup>16</sup> The approach has some similarities to the principles adopted in the Australian “two strike” system – see Appendix A

<sup>17</sup> For an example, see Hermes Investment Management’s recently updated Remuneration Principles (p.4) <https://www.hermes-investment.com/blog/perspective/remuneration-principles-clarifying-expectations/>



on a maximum number of shares which can be awarded rather than the maximum value.

**Option (iv): Require the existing binding vote on the executive pay policy to be held more frequently than every three years, but no more than annually, or allow shareholders to bring forward a binding vote on a new policy earlier than the mandatory three year deadline.**

- 1.26. This option could enable shareholders to respond to significant new developments within a company or its business environment on a more regular basis, or allow shareholders to re-examine the pay policy before its maximum three year cycle is complete. Such a response might be given if, for example, a company substantially re-structured its business model, substantially changed the composition of its executive team, or there were other developments that called into question the ongoing effectiveness of the existing policy. Alternatively, the pay policy could be reviewed annually rather than once every three years, so that prospective pay awards could be designed in a more sensitive way to the company's recent performance and current operating context. This could be applied to all companies, or just to companies that have encountered significant shareholder opposition to the remuneration report. While these measures would certainly give shareholders a further means for setting pay, they would also risk incentivising short-term strategies focused on hitting annual targets above long-term success, so shareholders would need to consider carefully the circumstances in which this would be appropriate.

**Option (v): Strengthen the Corporate Governance Code to provide greater specificity on how companies should engage with shareholders on pay, including where there is significant opposition to a remuneration report**

- 1.27. The Corporate Governance Code ("the Code") already sets out principles for quoted companies to follow in devising executive remuneration policies and awards. These include the need for remuneration committees to be sensitive to wider employee pay and conditions in the organisation when setting executive pay, to avoid an excessive focus on benchmarking executive pay levels with other companies and to devise remuneration packages that strike an appropriate balance between fixed, short-term and long-term and deferred pay.
- 1.28. Any changes to the Code would be a matter for the Financial Reporting Council but, in principle, the Code could be amended to include more guidance on how companies should meet their obligations to shareholders when deciding on remuneration. Options might include setting out a process for remuneration committee engagement with shareholders (including pension funds) and employees before the annual remuneration report is presented to the AGM. The FRC could also consider providing stronger guidance on how companies should engage with shareholders following a vote which has revealed significant opposition to a remuneration report.

## Green Paper Question

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|----|---|
| 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 (above) would you support? Are there other options that should be considered? |
|----|---|

### B –Shareholder engagement on pay

- 1.29. Stronger shareholder voting rights on pay will only have an impact if shareholders are prepared to cast their votes, and to use them, where necessary to vote down pay awards that they consider are unjustified. The record on this is mixed. As Table 2 (above) shows, since the introduction of the 2013 reforms, shareholders have rejected pay packages only in a very small number of cases, usually where outcomes have clearly been out of line with performance. The big majority of companies' pay policies have continued to be voted through with little apparent challenge.
- 1.30. On the other hand, Table 2 shows that there have been a number of occasions where a "significant minority" of shareholders have voted against a pay package or registered a vote of abstention, indicating that they are not fully satisfied with the company's pay proposals. Table 2 also reveals that a significant percentage of shareholder votes are not used at all - 28% on average in the case of FTSE100 companies, 40% in the case of smaller quoted companies.
- 1.31. Some major domestic institutional shareholders are, nonetheless, taking a strong interest in executive pay. They are being increasingly pro-active in setting out their principles on remuneration and their expectations of remuneration committees in advance of pay resolutions being presented to AGMs. However, this level of interest is not universal. For many shareholders, the quantum of pay will not be a particular concern because it is not often a large proportion of company costs. So if shareholders are broadly content with the CEO and the executive team, there will often be a rational reluctance to risk losing key individuals by challenging the detail of pay outcomes.
- 1.32. The interest of overseas investors in the quantum of executive pay and how it relates to wider UK society may also be limited. This is an important consideration since overseas investors now hold 54% of the value of the UK stock market, an increase from only 31% in 2008.<sup>18</sup>

<sup>18</sup> Ownership of UK Quoted Shares: 2014 Office of National Statistics (ONS)

- 1.33. The role of proxy advisers is also important. Investors who hold relatively small stakes in a large number of companies will often outsource shareholder voting decisions to a professional corporate governance specialist. It is a market solution to the fact that it is often uneconomic to undertake the necessary research in house. It does, however, place a lot of power and influence with a limited number of proxy advisers.
- 1.34. The Government wants to explore options for strengthening shareholder powers, but is also interested in ways of encouraging shareholders to make full use of their existing and any new powers on pay, and engaging in active stewardship of the companies they own.

**Option (i): Mandatory disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting**

- 1.35. The UK Stewardship Code administered by the Financial Reporting Council already states that institutional investors should publicly disclose their voting records, including abstentions, on executive pay and other resolutions put to shareholders<sup>19</sup>. Institutional investors are also advised in the Code to disclose what uses they may have made of proxy voting or voting advisory services. Most investors comply with this guidance<sup>20</sup> but there may be merit in considering whether such disclosure should be made mandatory. Existing guidance could also be strengthened to encourage institutional investors to publish more detail on the rationale for their voting decisions, but this would have to be weighed against the downside of introducing new burdens for those investing in UK companies and any legal risk from the disclosure of the rationale.

**Option (ii): Establish a senior "shareholder" committee to engage with executive remuneration arrangements**

- 1.36. A complementary or alternative way to enable greater shareholder engagement on pay might be to establish a senior Shareholder Committee to scrutinise remuneration and other key corporate issues such as long term strategy and directors' appointments<sup>21</sup>. The full implications of adapting any such model in the UK, however, would need careful consideration given its potential impact on our long-established unitary board structure.

**Option (iii): Consider ways to facilitate or encourage individual retail shareholders to exercise their rights to vote on pay and other corporate decisions**

- 1.37. Individual investors can have perspectives and views on corporate issues that are different from those of professional, institutional investors. They can play an important role in improving corporate governance. Their engagement, however, has become more difficult because of changes in the way shares are held.

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<sup>19</sup> <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf>

<sup>20</sup> A 2015 survey by the Investment Association found that 68% of signatories to the Stewardship Code routinely disclose their voting records. (<http://www.theinvestmentassociation.org/assets/files/surveys/20150526-fullstewardshipcode.pdf>)

<sup>21</sup> [http://highpaycentre.org/files/Restoring\\_Responsible\\_Ownership\\_-\\_Chris\\_Philp\\_HPC\\_copy.pdf](http://highpaycentre.org/files/Restoring_Responsible_Ownership_-_Chris_Philp_HPC_copy.pdf)

- 1.38. Many individual investors now hold their shares in nominee accounts managed by stockbrokers. This is an efficient and popular means of holding shares, which reduces costs for the underlying investor, but it means that the broker is the shareholder and automatically holds the information and voting rights for the shares. Under the Companies Act 2006, arrangements can be made to establish proxy voting by the investor, and to ‘pass back’ the information rights to the investor. In practice, though, many brokers do not pro-actively offer individual investors this option, because of a perceived lack of interest by investors in being active shareholders<sup>22</sup>.
- 1.39. Concerns have been expressed that this is undermining individual shareholder engagement with companies<sup>23</sup> and could, in the long-run, reduce the attractiveness of the existing nominee shareholder model<sup>24</sup>.
- 1.40. Solutions could potentially lie in:
- Doing more to clarify and publicise existing options for individual investors to vote;
  - Brokers doing more to enable investors to vote, by offering to ‘pass back’ information rights to investors, and by facilitating electronic voting; or
  - Amending the Companies Act 2006 to require brokers to offer underlying investors the option to opt-in to voting and wider information rights.
- 1.41. We are also interested in providing more visibility for the voting decisions of individual investors as a group as a subset of the overall votes cast. This might encourage such investors to use their votes, and would flag occasions where there is a significant divergence of opinion between institutional and private shareholders which companies might then be expected to investigate.

## Green Paper Question

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|----|--|
| 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? |
|----|--|

<sup>22</sup> <https://www.gov.uk/government/publications/shareholding-the-role-of-intermediaries>

<sup>23</sup> For example, <http://www.sharesoc.org/shareholder-rights.html>

<sup>24</sup> Wealth Management Association press release, 22 March 2015

## C – The role of the remuneration committee

- 1.42. The FRC's Corporate Governance Code recommends that companies covered by the code should establish a remuneration committee made up of at least three, or in the case of smaller companies, two independent non-executive directors. Its role is to ensure that remuneration arrangements support the strategic aims of a business and enable the recruitment, motivation and retention of senior executives, while still having sensitivity – as the Code stipulates – to the pay and conditions of the wider company workforce. The committee has delegated authority to carry out this role from the main company board.
- 1.43. It is acknowledged that remuneration committees, and frequently remuneration consultants who advise them, have a challenging role to play in balancing a range of interests and considerations in setting proportionate and effective pay policies and remuneration packages. A number of committees already engage in informal dialogue with shareholders to ensure that all these interests are taken into account before formal proposals are put to the annual AGM. Nonetheless, there is concern that this is not universal, and that remuneration committees are not sufficiently or visibly pro-active in consulting formally with shareholders and with the company's workforce. There are concerns too, that some lack the authority or inclination to take positions that may not align with the CEO or wider executive team's expectations.

### **Option (i): Require the remuneration committee to consult shareholders and the wider company workforce in advance of preparing its pay policy.**

- 1.44. This option could strengthen the existing requirement on the committee to take account of the views of the workforce and shareholders before making recommendations on executive pay. This could allow a much broader range of views to be heard from across all areas of a large public company. There are a number of ways that greater consultation with employees and shareholders could be achieved, for example, through more specific guidance within the Corporate Governance Code - although changes would be a matter for the FRC. Furthermore, where companies designate a specific NED to be responsible for representing workforce and wider stakeholder interests (as set out later in Section 2), this individual could also sit on the remuneration committee to ensure that such perspectives were properly reflected in board deliberations on pay.

### **Option (ii): Require the chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role**

- 1.45. The recent report of the Executive Remuneration Working Group has proposed that the chairs of remuneration committees should have served for at least 12 months on a remuneration committee before taking up the role, on the basis that “remuneration

committees need to have extensive knowledge of the company, the personalities of the executives, and the shareholder base in order to be truly effective".<sup>25</sup>

- 1.46. Views are invited on the value and practicability of this suggestion, which could be reflected in future versions of the Code subject to the Financial Reporting Council's consultation requirements.

## Green Paper Question

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| 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? |
|----|--|

### D - Transparency in executive pay

- 1.47. The 2013 pay reforms apply to quoted companies and require them to produce a single annual pay figure for each member of the executive board. They also require the remuneration report to compare the annual change in the CEO's salary to the annual change to the median salary in the company. Additionally, companies must disclose the performance targets which trigger bonus awards, although these can be withheld in whole or in part where the company regards them as commercially sensitive.
- 1.48. The Government wants to explore whether there is additional information which companies could provide which would make shareholders more effective in holding boards to account on their executive pay arrangements.

#### Option (i): Pay ratio reporting

- 1.49. Recent public discussion on executive pay has raised the question of whether companies should publish ratios comparing CEO pay to pay in the wider company workforce.
- 1.50. Proponents consider that this would enable shareholders, employees and the wider public to judge how executive pay compares across different companies, particularly those within the same sector. It would also be possible to measure how pay ratios have

<sup>25</sup> Investment Association Executive Remuneration Working Group, July 2016

changed over time within the same company. Publication of this ratio will, in fact, become a requirement for listed companies in the US from January 2017.

- 1.51. The biggest benefit, however, could come not from the ability to make comparisons between companies, but from requiring boards to explain to shareholders and wider stakeholders why the ratio is appropriate given the performance of the business and rewards for the general workforce. Context is vital if ratio reporting is to add value. Shareholders could then take a more informed view on whether pay levels are proportionate and reasonable.
- 1.52. Additionally, there is interest from the Investment Association and others in understanding the pay ratios between the CEO and executive team and the next layer of management, for example to understand the dynamics of the senior management team, whether any individuals are unduly dominant and succession planning issues.
- 1.53. Indeed, the Investment Association has recently updated its Principles of Remuneration to encourage companies to disclose pay ratios between the CEO and median employee, and the CEO and the executive team, to provide the context of the remuneration provided.<sup>26</sup>
- 1.54. The counterargument is that pay ratios would represent a new reporting obligation which would add little of value in helping to set appropriate pay levels. A simple ratio of CEO pay to the median salary in the company could produce misleading results which could be misunderstood or misconstrued in public discourse. There would, for example, be a much narrower ratio at financial services companies, where average salaries are generally high, compared to companies in the retail sector where average salaries are much lower, even though CEO pay at both kinds of company may be equally high. It might also have the unintended effect of incentivising outsourcing and offshoring to exclude the lowest paid workers from the calculation.
- 1.55. Any new reporting measure would need to be designed in a way which genuinely improves the ability of shareholders to understand company pay policies and to take an informed view on pay outcomes.

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<sup>26</sup> <https://www.ivis.co.uk/media/12445/Principles-of-Remuneration-2016-Final.pdf>

## Green Paper Question

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.

### Option (ii): Disclosure of bonus targets

- 1.56. We are also seeking views on whether the existing, qualified, requirement for companies to report the performance targets that trigger annual bonuses and benefits under long-term incentive plans should be strengthened.
- 1.57. The 2013 pay reforms require the disclosure of bonus targets and performance measures in the annual remuneration report. However, there is an important exemption for information which, in the directors' opinion, is "commercially sensitive". This might, for example, include information in a director's performance plan that, if known to a competitor, could cause commercial damage to the company.
- 1.58. The reliance on this exemption has decreased since the reforms were first introduced, partly in response to pressure from the Investment Association and corporate governance advisers. In 2014, only 36% of companies made full disclosure of threshold, target and maximum performance targets. In the 2016 AGM season so far, 64% of companies have disclosed the full range (although a portion of these delay disclosure by one year), and 95% have disclosed at least one performance target.<sup>27</sup>
- 1.59. Views are invited on whether to:
- Increase non-legislative pressure on companies through the Investment Association and other shareholder advisers to provide full disclosure of performance targets and to consider strengthening the FRC's remuneration guidance (which is part of the Corporate Governance Code); or to
  - Make retrospective disclosure of all bonus targets within a specified timeframe a reporting requirement.
- 1.60. While the Government shares investors' wish for greater transparency on the disclosure of bonus targets, we recognise that there will be legitimate instances where disclosure of certain information could harm companies' commercial prospects.

<sup>27</sup> PWC – '2016 mid-season executive pay snapshot'



## Green Paper Question

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| 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? |
|----|---|

### E - Long-term executive pay incentives

- 1.61. Long-Term Incentive Plans (LTIPs) are currently the model of choice for almost all quoted companies. They aim to align directors' incentives with the long-term interests of the company, on the basis of share awards which must be held for a set number of years, usually at least three years. As shown in Figure 1 above, they now comprise over a third of the average FTSE100 CEO's remuneration package, compared to around 5% in 1998.
- 1.62. However, they can be highly complex and shareholders have increasingly called for simpler and more transparent ways of incentivising long-term performance. Some long-term investors have also expressed concern that the proxy measures used in long-term incentive plans, such as total shareholder return or earnings per share, may not be helpful in tracking long-term changes in the value of the company, taking into account a range of financial and non-financial factors such as changes in the strategic strength and reputation of a company over the period of a CEO's tenure.
- 1.63. Finally, there is growing evidence that the usual one to three year holding period for share options provided in executive remuneration packages is too short, and can incentivise short-term behaviour; for example, by encouraging CEOs to postpone new investments or expenditure as the vesting period for their shares falls due, in order to avoid any temporary reduction in the company's share price and the value of their soon-to-be-exercisable shares<sup>28</sup>.
- 1.64. A number of specific stakeholder and academic proposals have emerged in response to these concerns, including:
- **Consideration of 'restricted share' awards as an alternative to LTIPs:** this would involve executives being awarded annual share options that could be exercised at some point in the future based on the executives' continued employment at the

<sup>28</sup> For example, see 'Equity Vesting & Investment', (Edmans, Fang, Lewellen; October 2016) , and The Purposeful Company interim executive remuneration report, November 2016 ([www.biginnovationcentre.com](http://www.biginnovationcentre.com))

company. They would not involve the complicated performance criteria usually found in LTIPs, and executives would be motivated primarily by long-term increases in the company's share price. Some critics argue that restricted share awards provide some kind of guaranteed reward even when the share price falls significantly over time, but supporters have suggested that the value of these simpler awards could be set at around 50% of the typical LTIP, in recognition of their potential increased attractiveness to executives.<sup>29</sup>

- **Extension of holding periods for share options to 5 year minimum:** The Corporate Governance Code currently stipulates that “In normal circumstances, shares granted or other forms of deferred remuneration should not vest or be paid, and options should not be exercisable, in less than three years. Longer periods may be appropriate.” In light of the emerging evidence that a three year holding period for shares is not sufficient to deter executives from avoiding long-term expenditures that may negatively impact on the share price, one option might be to consider whether the Corporate Governance Code should require share options to be held by executives for a minimum of five years.

- 1.65. This option could be combined with a requirement for executives to retain share awards until they build up a shareholding equivalent to 2 x gross total salary, to help further encourage a focus on long-term value creation at the companies they lead<sup>30</sup>.
- 1.66. We welcome views on both these options and any other proposals to simplify and increase the effectiveness of long-term pay awards, including any drawbacks or unintended consequences.

## Green Paper Question

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.

<sup>29</sup> For example, see the Executive Remuneration Working Group Final Report, July 2016

<sup>30</sup> The Purposeful Company interim executive remuneration report, November 2016 - [www.biginnovationcentre.com](http://www.biginnovationcentre.com)

# Strengthening the employee, customer and wider stakeholder voice

This chapter examines approaches to strengthening the stakeholder<sup>31</sup> voice at board level in large UK companies, particularly the voices of employees and customers.

## The problem

- 2.1. UK company law already enshrines the importance of wider interested groups in corporate governance. Section 172 of the Companies Act 2006 gives directors a responsibility to create successful businesses for the benefit of shareholders, whilst having regard to a range of other interests. The challenge is to ensure that all companies are taking the steps needed to understand and take account of wider interests and different social perspectives. New ways of connecting boards to a wider range of interested groups need to be explored, building on much existing good practice.
- 2.2. Many 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. Improving the diversity of boardrooms so that their composition better reflects the demographics of employees and customers is a part of this, ensuring that a broader range of social perspectives, talent and experience can be brought to bear on decision-making.
- 2.3. There have, of course, been a limited number of examples of particularly poor corporate conduct where the views and needs of stakeholders – such as employees, suppliers and pension beneficiaries – have not been given appropriate consideration. These examples are not representative of the UK business community as a whole, and we need to consider how to respond appropriately and proportionately to the concerns they have raised.
- 2.4. All the best companies know that there are economic benefits to be derived from bringing external perspectives to bear and in properly understanding and maintaining

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<sup>31</sup> In this Green Paper, the term “stakeholder” is used to mean parties - other than shareholders - with a direct or close interest in the performance and operation of a company, particularly employees, customers, suppliers and the other interests specified in section 172 of the Companies Act 2006

healthy relationships with interested groups. Listening to the employee voice, for example, can lead to better engagement, productivity improvements and reduced absenteeism; and listening to the voice of local communities can open up new opportunities. All good companies have a relentless focus on their customers and a healthy relationship with their suppliers which includes paying bills promptly. Many companies also recognise the commercial importance of reflecting the diversity of their employees and customer base on their boards. However, we need to consider what more can be done to ensure that all UK companies are equipped with an appropriate model of employee, customer and wider engagement to compete effectively in the period that lies ahead.

## Context

### Company law and the wider stakeholder interest

- 2.5. Our company law recognises and encourages account to be taken of wider stakeholder interests in two key ways.
- 2.6. First, directors have certain statutory duties to their company in relation to stakeholders. Directors of all UK companies, irrespective of size, have an ultimate duty to promote the success of their company for the benefit of its members (in most cases, this means the shareholders) unless the company has set out a different purpose in its company articles. Directors, however, must also have regard to a number of other specified stakeholder and wider issues. These include the interests of the company's employees and the need to foster relationships with suppliers, customers and others. This approach, known as "enlightened shareholder value", is set out in section 172 of the Companies Act 2006 (see Table 3).
- 2.7. Second, there are disclosure requirements. All companies, other than companies qualifying as "small" in the Companies Act 2006<sup>32</sup>, have to prepare a strategic report as part of their annual report to provide shareholders of the company with information that will enable them to assess how the directors have performed their duties under section 172.<sup>33</sup> For some companies the reporting has to go into more detail. For example, all public companies and large private companies must, where appropriate, report analysis and information relating to environmental and employee matters, to the extent necessary for an understanding of the development, performance or position of the company's business<sup>34</sup>. Existing stakeholder-related reporting requirements are set out in more detail in Appendix B.

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<sup>32</sup> Sections 382 to 384 of the Companies Act 2006

<sup>33</sup> Section 414(A) and 414(C)(1) of the Companies Act 2006

<sup>34</sup> Section 414C(4)(b) of the Companies Act 2006 (companies qualifying as medium-sized – see sections 465 – 467 – need not provide this information)

- 2.8. The existing legal framework is not prescriptive about how companies should meet these requirements. This is a strength since it provides companies with the flexibility to tailor their approach to suit their specific circumstances. They are able to determine for themselves which are their most important stakeholder voices. Even the specific stakeholders mentioned in section 172 of the Companies Act 2006 are not all relevant to all companies. In 2016, for example, more than 800,000 companies did not employ anyone aside from the owner.<sup>35</sup> Conversely, other potential company stakeholders are not specifically mentioned in section 172, for example, pension fund beneficiaries.
- 2.9. Having identified its key stakeholders, a company is then faced with the challenge of considering their interests. They may not be consistent. Employees and suppliers may not have the same interests in relation to any particular issue and it may be hard to define who at any given point in time is a customer of a particular company.
- 2.10. Nevertheless, many businesses have put considerable effort into stakeholder issues. Some have taken steps to minimise their environmental impacts or improve the local communities in which they operate. Others have paid particular attention to nurturing supply chains.

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<sup>35</sup> BIS Business Population Estimates for the UK and the regions (2016)

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**Table 3: Text of Section 172 of the Companies Act 2006<sup>36</sup>**

Duty to promote the success of the company

(1) 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.

(2) Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.

(3) The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

2.11. Some companies have well-developed mechanisms for listening to their employees' views, such as works councils, trade unions and consultative bodies.<sup>37</sup> A small number of companies have also chosen to appoint employee representatives to their boards, First Group plc being the most well-known example. There is nothing in UK company law that prevents the appointment of employee representatives to company boards – individual companies have the final decision on board composition – but the practice has not been generally adopted.

2.12. The use of employee representatives on company boards is prevalent in a number of European countries but the corporate governance framework in many of these countries is very different to that of the UK. In particular, in Germany, a two-tier board system operates with worker representatives sitting on the supervisory board. Companies in the

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<sup>36</sup> <http://www.legislation.gov.uk/ukpga/2006/46/section/172>

<sup>37</sup> It should be noted that employers are legally required to consult with employees in certain circumstances on a range of issues including transfer of undertakings and collective redundancies

UK, however, operate within a unitary board system where all the directors have the same set of duties, and collective responsibility applies. It is a system that we consider serves the UK well and we do not intend to change it.

- 2.13. It has been reported that only five countries - Sweden, Norway, Spain, Greece and Ireland - combine a unitary board structure with established worker participation rights and, of these, three - Spain, Greece and Ireland - have rights mainly in state-owned or privatised companies.<sup>38</sup> Company boards in Scandinavian countries also operate rather differently to those in the UK and rarely include executive directors.<sup>39</sup>

## Options for reform

- 2.14. This section explores a range of options for strengthening the voice of employees, customers and other interested parties at boardroom level and building confidence that section 172 of the Companies Act 2006 is properly understood and applied.

### **Option (i): Create stakeholder advisory panels**

- 2.15. Company boards could create stakeholder advisory panels for directors to hear directly from their key stakeholders and amplify voices with different backgrounds and perspectives to those more commonly found in the boardroom. These could operate in a number of ways. Company directors (executive or non-executive) could seek the views of the stakeholder advisory panel on particular issues as they arise to be considered later at full board meetings. Advisory panel members could be invited to full board meetings to offer views whenever relevant agenda items are scheduled. A stakeholder advisory panel could also have a role in initiating discussions on topics that they feel are important, perhaps requesting specific executive or non-executive company directors to attend their meetings to answer questions.
- 2.16. A stakeholder advisory panel could, for example, be consulted on the company's executive remuneration policy and the annual remuneration report. The non-executive chairman of the company's remuneration committee could be asked to consult the stakeholder advisory panel during the development of the three year pay policy and the annual remuneration report. Or a stakeholder panel made up of companies in a supply chain could help advise the board, at regular intervals, on relationships with suppliers.
- 2.17. Companies could tailor the composition of such panels to fit the needs of their business and their particular stakeholder community, and the composition of the panel could evolve over time to adapt flexibly to the main issues that a company is facing at any particular time.

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<sup>38</sup> <https://www.tuc.org.uk/economic-issues/corporate-governance/workplace-issues/all-aboard-making-worker-representation>

<sup>39</sup> <http://www.corporategovernanceboard.se/corporate-governance/swedish-corporate-governance/swedish-corporate-governance-model/board-of-directors>

2.18. Although establishing a stakeholder advisory panel would not give stakeholder representatives a direct input into board decisions, it would offer greater transparency into how well a company is addressing its stakeholder issues. Rather than stakeholder discussions happening within the confines of formal board meetings, introducing a dialogue between the board and its stakeholder advisory panel could increase transparency, particularly if implemented alongside a strengthening of relevant reporting requirements.

**Option (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**

2.19. There will typically already be executive board members with responsibilities for human resources or customer or supplier relations. However, designating existing non-executive directors (NEDs) to provide an independent and clear voice for key interested groups as a formal part of the board structure would be a means of directly inputting that voice into boardroom discussions and would not add to boardroom size.

2.20. Each designated NED could chair a board-level committee with the status to ensure that executive decision-making takes appropriate account of employee, supplier or consumer issues. In addition to the NED, the committee might comprise other relevant board members, such as the HR director or an executive director responsible for customer relations. This would mirror the formal boardroom committee structure that already exists in other areas of the business, such as the audit and risk committee which is responsible for assisting the board in its oversight of issues such as financial and business reporting processes, and compliance with legal and regulatory requirements.

2.21. The designated NED might also be a member of the remuneration committee, to help ensure that wider workforce considerations are brought to bear on decisions about executive pay.

2.22. Designated NEDs would need to develop practical ways of ensuring that they have a good understanding of their stakeholder constituency (whether it be employees, customers, the supply chain or others) as a means of identifying and resolving issues that are relevant to their business. They would have flexibility to tailor their communication channels to suit their organisation. One approach could be for the company to create one or more stakeholder advisory panels (see option (i) above).

2.23. Each designated NED could set out their objectives each year and report on how they have tackled issues identified and generally taken forward their responsibilities. In addition, the designated NED would have the flexibility to use other methods of reporting back to constituent stakeholders.

2.24. Over time, as existing appointments come to an end, companies may see the benefit in recruiting NEDs with particular skills and perspectives or wider experience in relation to a given stakeholder group in order to represent that group effectively.



2.25. Designated NEDs would, however, be constrained by directors' duties and their appointment may also carry the risk of other board members taking less of an active interest in issues affecting employees and other key interested groups.

**Option (iii): Appoint individual stakeholder representatives to company boards**

2.26. Those in favour of employee representatives on boards argue that businesses may wish to appoint individual representatives to company boards. This can bring a new perspective to board discussions, particularly adding a longer-term perspective. Those against argue that it can lead to greater conflict in board discussion and delayed decision-making. Others point to the risk of real decision-making shifting away from the boardroom and into less formal channels. Some point to limits on how much impact a single employee director could have in practice, and that there is a risk of tokenism, unless steps to improve employee engagement are fostered at every level in the business.

2.27. Another challenge would be how any given stakeholder representative would be chosen. In the case of employees, options could include a simple election but this would be more complex for very large employers and multinationals. The process for other stakeholders, such as consumers, could be even more challenging.

2.28. Any individual appointed to a company board would be subject to the same set of duties as other company directors. This means that, although an individual representative could bring insights and knowledge to bear on board-level deliberations, they would be constrained by the common directors' duty to promote the success of the company. Secondly, they would be constrained by the confidentiality of board discussions on how much they could report back on a given issue to the stakeholder they were representing.

2.29. We know that some companies find these models work best for them, such as FirstGroup plc. However, as we have set out, these models will not work for every company. As the Prime Minister has made clear, we are therefore not proposing to mandate the direct appointment of employees or other interested parties to company boards.

**Option (iv): Strengthening reporting requirements related to stakeholder engagement**

2.30. As already explained, all companies (except small companies) have to prepare an annual Strategic Report to provide shareholders with information that will enable them to assess how the directors have performed their duties under section 172 of the Companies Act 2006.<sup>40</sup> But there are no further details on how this should be done, which often leads to a lack of clear and transparent information about the steps that

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<sup>40</sup> Section 414(C)(1) of the Companies Act 2006

companies are taking to fulfil their duties to have regard to workers, suppliers or customers, and other requirements under section 172.

- 2.31. Stronger reporting requirements could be designed to raise not only boardroom, but wider awareness of the duties directors owe their company as set out in section 172 and provide greater confidence that boardroom decisions are being taken with regard to wider stakeholder interests.
- 2.32. There are some specific reporting requirements related to stakeholder issues, particularly in relation to employees. For example, UK companies where the weekly average number of UK-based employees exceeds 250 have to provide a description of the action that has been taken during the financial year to introduce, maintain or develop arrangements aimed at informing or consulting employees on a number of specific issues.<sup>41</sup>
- 2.33. This requirement could be developed further to ask companies to provide information on how often, and by which mechanism, company boards are giving consideration to different stakeholder interests. This would involve a clear articulation of their progress to date on specific stakeholder issues, and their objectives for the coming year. Companies could be encouraged to provide detailed information and measures where possible, so that they can be held to account.
- 2.34. If a non-executive director has been designated to represent employee views or another stakeholder perspective, then increased reporting through the annual report could be particularly powerful. The stakeholder committee that they chair would be required to publish its own report that would be available for shareholder scrutiny. This would provide a clear public articulation of what issues have been raised and the extent to which these are being addressed, while holding an individual at board level directly accountable for performance.
- 2.35. The Government is interested in ideas for how additional reporting of the wider section 172 interests could best be introduced.

### **Further considerations**

- 2.36. All of the options described above could contribute to ensuring stakeholder interests are appropriately taken into account. They are not mutually exclusive, and could work in combination. A designated NED, for example, could be supported by stakeholder advisory panels, and visibility for the work undertaken could be achieved through effective reporting.

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<sup>41</sup> Part 4 of Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008

- 2.37. Different approaches could be taken to implementation. The most flexible would be to establish a principle, or high expectation, on companies that they will take active steps to ensure appropriate account is taken of stakeholder interests. This principle could be backed by legislation or a change to the Corporate Governance Code or a combination of the two. Alternatively, an industry-led, voluntary approach could be used. This can be effective in achieving results. The Davies Review of women on boards which set targets but not legal requirements has led to female representation on the FTSE 100 doubling in less than five years.<sup>42</sup>
- 2.38. Having set the expectation, it could then be for individual companies to decide how to meet it, drawing on corporate governance guidance which would set out a range of options, including the ones described in this paper. The Financial Reporting Council, or other body, could be responsible for preparing the guidance, taking advice from business bodies, employee representatives and others.
- 2.39. Consideration will also need to be given to which companies would be expected to put stronger formal stakeholder engagement mechanisms in place. Where should any employee-based size threshold or other criteria be set? Section 3 (below) considers in more detail the extent to which large businesses of all kinds should be expected to meet higher formal corporate governance standards.

## Green Paper Questions

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.
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?
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.

<sup>42</sup> [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/482059/BIS-15-585-women-on-boards-davies-review-5-year-summary-october-2015.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/482059/BIS-15-585-women-on-boards-davies-review-5-year-summary-october-2015.pdf). This work is being taken forward by the Hampton-Alexander Review which has extended targets on gender diversity to the top executive levels of FTSE 100 companies. John Parker has recently completed review of ethnic diversity on boards

# Corporate governance in large privately-held businesses

This section explores whether and to what extent our largest, privately-held businesses should meet higher minimum corporate governance and reporting standards.

## The problem

- 3.1. The UK's strongest corporate governance and reporting standards are focused on public companies where the owners or shareholders are distant from the executives running the company. These standards provide independent shareholders with reassurance that the company is being run in their interests and that they have the information needed to hold the executive to account.
- 3.2. The UK, however, is home to a significant number of large, private companies and limited liability partnerships (LLPs). There are, for example, approximately 2,500 private companies and 90 LLPs with more than 1,000 employees<sup>43</sup>. (Appendix C provides more information about the number of public and privately-held companies). These businesses are not expected or required to meet the same formal corporate governance and reporting standards as publicly listed companies, yet the consequences when things go wrong can be equally severe for other stakeholders.
- 3.3. The main rationale for the different treatment lies in the ownership structure. The owners of privately-held businesses do not need the same levels of reassurance and information as owners of public companies because ownership and control are usually closely intertwined. There are, nevertheless a number of reasons for exploring whether similar standards should apply to at least some of these businesses.
  - First, good governance is about more than the relationship between the owners and the managers of a business. There are other stakeholders with a strong interest in whether a business is well run, including employees, customers, supply chains and pension fund beneficiaries. They all suffer when a private company fails as the recent failure of BHS has demonstrated.

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<sup>43</sup> FAME database. This may underestimate the total because some companies do not include employee numbers in their annual report

- Second, society has a legitimate expectation that companies will be run responsibly in return for the privilege of limited liability, a privilege that is enjoyed by all companies and LLPs, irrespective of their size and status. High standards of corporate governance can help provide the necessary assurance that limited liability will not be abused. The majority of businesses already meet these expectations and standards.
- Third, since 1999, there has been a steady decline in the number of public companies whilst in the same period there has been an increase in privately-held businesses. There are a range of reasons suggested for this trend, including the diminishing importance of public equity markets as a source of capital. Irrespective of the reasons, increasing numbers of large businesses are choosing to operate as private businesses. In doing so, they are excluded from the higher levels of public scrutiny and formal corporate governance discipline associated with being traded on a public market.
- Finally, it is in the interests of businesses themselves to have good corporate governance. It provides confidence not just to shareholders but to other key stakeholders that a company is being well-run. In particular, it can help build and sustain the confidence of banks, investors and suppliers giving businesses better access to external finance at a lower cost and on a longer-term basis than would otherwise be the case. It can help build a company's reputation and ensure its long-term success.

## Context

- 3.4. Corporate governance is the system of common rules, practices and processes under which companies can operate effectively. It is generally focused on the composition and workings of company boards and the engagement with shareholders, but also looks at the relationships companies have with other stakeholders. It covers factors such as having appropriate internal controls in place to mitigate and manage risks and making use of independent non-executive directors with different perspectives to challenge and develop company strategy. Effective corporate governance frameworks also include reporting standards because transparency is a key tool in providing information about key aspects of how the business is being run.
- 3.5. In the UK the strongest corporate governance and reporting standards are set out in the Financial Reporting Council's UK Corporate Governance Code. This applies on a "comply or explain" basis only to companies with a Premium Listing on the London Stock Exchange. As Appendix C shows, this is only a small proportion of the UK's largest companies, although the Code has a wider influence on governance codes, principles and guidance drawn up for other parts of the business population.
- 3.6. Public companies that are listed on the Alternative Investment Market (AIM) are not subject to the Code but are required to state which governance standards they apply. The majority choose to follow the Corporate Governance Code for Small and Mid-Size

Quoted Companies published by the Quoted Companies Alliance.<sup>44</sup> This adopts key elements of the Code but applies these to the needs and particular circumstances of smaller companies.

**Table 4: Overview of UK Corporate Governance Code<sup>45</sup>**

The UK Corporate Governance Code sets out good governance practice on issues such as board composition and effectiveness, the role of board committees, risk management, remuneration and relations with shareholders. The Code is the responsibility of the Financial Reporting Council (FRC). It contains broad Principles and more specific Provisions and operates on a “comply or explain” basis.

Companies with a Premium Listing on the London Stock Exchange<sup>46</sup> are required by the Financial Conduct Authority’s Listing Rules to make a statement about:

- How they have applied the main principles of the Code; and
- Their compliance with the provisions of the Code, explaining the reasons for any areas of non-compliance.

The “comply or explain” approach is capable of dealing with a wide variety of circumstances, which can vary substantially from company to company depending on factors such as size, stage of development, ownership structure and the complexity of its activities. It provides shareholders with relevant information to enable them to make judgements about the governance practices of the companies in which they invest and to engage with them where they consider it necessary. In addition, under UK company law, shareholders are able to hold the company to account through extensive voting and other rights.

The Code is updated regularly to lead market practice. In addition to the Code, the FRC publishes guidance notes which assist companies to address specific aspects of governance and accountability. These cover board effectiveness, the role of audit committees and risk management, internal control and assessing and reporting on the viability of the business.

The Code is used by others - such as mutual organisations - to promote best practice, suitably adapted to take account of their particular circumstances.

<sup>44</sup> <http://www.thegca.com/shop/guides/70707/corporate-governance-code-for-small-and-midsize-quoted-companies-2013.shtml>

<sup>45</sup> <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Final-Draft-UK-Corporate-Governance-Code-2016.pdf>

<sup>46</sup> There are 725 companies with a Premium Listing on the London Stock Exchange (see Appendix C). They are expected to meet the UK’s highest standards of regulation and corporate governance

- 3.7. The fact that privately-held businesses are not required to meet formal standards does not mean that they are ignoring good corporate governance. On the contrary, many privately-held businesses understand the business benefits and have voluntarily adopted good practices. Some have adopted sector-specific codes. The four leading accountancy firms (EY, Deloitte, PWC and KPMG), for example, all of which are limited liability partnerships, have signed up on a voluntary basis to the FRC's Audit Firm Governance Code. This mirrors the UK Corporate Governance Code.<sup>47</sup>
- 3.8. Other privately-held businesses have adopted the Institute of Directors' *Corporate Governance Guidance and Principles for Unlisted Companies in the UK*. This sets out a number of voluntary principles, some of which are applicable to all unlisted companies, the remainder suitable for large or more complex unlisted companies.
- 3.9. The Government would be interested to learn more about how large, privately-held businesses are already applying corporate governance principles to improve the way they are run.

## Options for reform

### **Option (i): Applying enhanced standards of corporate governance more widely**

- 3.10. On the face of it, the simplest way to ensure large, privately-held businesses with limited liability status adhere to high standards of corporate governance would be to extend the application of the UK's Corporate Governance Code from Premium Listed companies to encompass these businesses. It exists already, and there is a well-established framework and process for keeping it up to date and monitoring levels of compliance.
- 3.11. The drawback with this approach is that the Corporate Governance Code has been designed primarily with Premium Listed companies in mind and some of its provisions will not be appropriate for privately-held businesses. The "comply or explain" principle could be used to overcome that difficulty by giving businesses the flexibility to report against the relevant requirements, and explain the limited circumstances where this would not be appropriate. This would, however, be a question of balance - if too much of the Code is explained away, it would lose credibility as a means of raising standards.
- 3.12. An alternative could be to invite the FRC or a business organisation such as the Institute of Directors to develop a separate governance code. A new code would be able to draw on the various existing codes and standards which have been described earlier, but would need to be tailored specifically to the needs and challenges faced by privately-held businesses.

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<sup>47</sup> <https://www.frc.org.uk/Our-Work/Audit/Audit-and-assurance/Audit-Firm-Governance-Code.aspx>

- 3.13. Care would need to be taken with the way stronger corporate governance standards are extended to ensure they are proportionate and practicable. The majority of companies are small and medium-sized or start-up companies that remain under the ownership and control of the founder or founding family. Whilst corporate governance practices can contribute to the success of companies of all sizes, we think that it would be proportionate to consider applying these only to the very largest privately-held firms.
- 3.14. Adoption of the principles of a code could be entirely voluntary; there could be a stronger expectation that companies would apply elements of a formal code, but it would remain a matter for their discretion; or consideration could be given to a “comply or explain” approach similar to the one used to apply the FRC’s Code. A single model could be applied to all of the largest companies, or that group could be further segmented and a differentiated approach could be taken based on the size, nature and economic significance of the business.
- 3.15. A voluntary approach to encouraging best practice amongst the largest privately-held companies could involve work with the FRC and business organisations such as the Institute of Directors in defining a set of best practice principles and encouraging companies to sign up to them. This would draw on the various existing codes and standards which have been described earlier, but would need to be tailored specifically to the needs and challenges faced by privately held businesses.
- 3.16. Such an approach could have considerable force. Encouraging better business behaviour through a voluntary approach has led to significant success over the past decade. For example, the Davies Review succeeded in doubling the representation of women on the boards of the FTSE 100 through exhortation and by encouraging companies to disclose the steps they were taking to increase female representation.

## Green Paper Questions

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?

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?



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| 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? |
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### Option (ii): Applying reporting standards more consistently

- 3.17. Public companies generally, and in particular those that meet the Companies Act definition of a “quoted company”<sup>48</sup>, have to meet stronger corporate governance and reporting standards than privately-held businesses. Quoted companies, for example, have to report a greater level of detail about the remuneration of individual directors than other large companies. They also have to report on social and community issues, and on their greenhouse gas emissions. The Financial Reporting Council has published detailed guidance on what different companies are required to report in their Strategic Report.<sup>49</sup>
- 3.18. It is notable that most of the new reporting requirements introduced recently have been applied to all companies or all businesses above a certain size irrespective of their legal form or status. Some examples are:
- Businesses operating in the UK and with a turnover of £36m or more are required to disclose the steps they have taken to prevent modern slavery in both their own business and their supply chains;<sup>50</sup>
  - Employers with more than 250 employees will need to report by April 2018 on gender pay issues. Regulations will be introduced shortly<sup>51</sup> requiring large employers to publish their overall gender pay gap, as well as gender bonus gaps and the proportions of men and women in the four pay quartiles of their organisation (putting the UK at the forefront of gender pay transparency);
  - Large companies and large LLPs will need to report on their prompt payment practices and on their performance against these practices for financial years starting from April 2017.<sup>52</sup>
- 3.19. A further development has been the work of the British Private Equity and Venture Capital Association (BVCA) which has published Guidelines for Disclosure and Transparency in Private Equity. Compliance with these guidelines means that private-equity backed companies above a certain size now disclose a range of information

<sup>48</sup> See section 385 of the Companies Act 2006.

<sup>49</sup> <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf>

<sup>50</sup> Section 54 of the Modern Slavery Act 2015

<sup>51</sup> Regulations are being made under section 78 of the Equality Act 2010.

<sup>52</sup> Regulations are being made under section 3 of the Small Business, Enterprise and Employment Act 2015.

comparable to that published by public companies in the FTSE 250. The BVCA has set up a group to monitor and report on compliance with the guidelines.<sup>53</sup>

- 3.20. The BVCA's initiative was a response to demands for more information about large private-equity backed companies which now account for more than 8% of the private sector workforce. This represents real progress, but consistency between different voluntary initiatives, and the businesses to which they apply, could be examined further.

## Green Paper Question

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| 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? |
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<sup>53</sup> <http://privateequityreportinggroup.co.uk/wp-content/uploads/2016/03/Improving-Transparency-and-Disclosure---Good-Practice-Reporting-by-Portfolio-Companies---March-2016.pdf>

## Other Issues

This section invites suggestions on any other themes, ideas or proposals that could be explored which would strengthen the UK's corporate governance framework.

### Other corporate governance issues

- 4.1. The strength of capital flows into the country reflects confidence in the UK's framework of corporate governance and associated regulation. This framework is based on a unitary board system which makes all directors collectively responsible for the decisions of the board. We also have strong shareholder rights, but a clarity of roles between shareholders and boards, which leaves directors free to get on with the day-to-day running of the business.
- 4.2. A key strength is the "comply or explain" framework associated with the UK Corporate Governance Code. This provides a degree of flexibility in the way companies adopt and adapt governance practices. The overall aim is to combine high standards with low burdens and the flexibility for leading businesses to innovate, rather than being unduly constrained by rules that can become rapidly outdated. This flexibility is particularly important given the diversity of UK companies which vary considerably in size, ownership structure and complexity of operation.
- 4.3. The Government wishes to build on the strengths of our corporate governance framework and retain its international pre-eminence. However, we cannot afford to stand still. In addition to the specific issues addressed in the Green Paper, there may be other areas where improvements could be made.

### Green Paper Question

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| 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? |
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## Appendix A: Examples of recent executive pay reform in other countries

A number of countries have recently introduced or are in the process of introducing new shareholder voting, claw-back and disclosure requirements on executive pay. Some key examples are set out below.

**Table 5: International Examples of Corporate Pay Reform**

Country	Summary of reforms introduced or proposed
Australia	<ul style="list-style-type: none"> <li>In 2011, Australia introduced a “two-strike” rule whereby if more than 25% of shareholder votes cast are against the remuneration report in two consecutive years then shareholders will be asked to vote on a motion which, if passed by 50% or more of the eligible vote, will require the company’s directors to stand for re-election.</li> </ul>
Belgium	<p>The 2010 Corporate Governance Act altered rules for executive pay for listed and state-owned companies. Key provisions of the Act include:</p> <ul style="list-style-type: none"> <li>The general meeting of shareholders must hold an annual advisory vote on the company’s remuneration report.</li> <li>Severance pay arrangements for executive directors and senior executive officers that exceed the amount of 12 months’ remuneration or, on a reasoned opinion of the remuneration committee, of more than 18 months’ remuneration, must first be approved by the shareholders at the next following general meeting.</li> </ul>
France	<ul style="list-style-type: none"> <li>The French Government’s proposed new law on executive pay, including an annual binding shareholder vote on the variable elements of pay has been approved by the French Parliament and Senate. It is subject to final approval by the Constitutional Council within the next few weeks.</li> </ul>

Country	Summary of reforms introduced or proposed
The Netherlands	<ul style="list-style-type: none"> <li>• Since 2014, there has been legal provision for the full or partial claw-back of bonuses awarded based on incorrect information regarding whether targets were met or whether agreed specific events occurred.</li> <li>• This law builds on an existing requirement for shareholders to approve new or amended executive pay policies (although not the actual pay awards).</li> <li>• Pay policies must also be shared with employee councils, who can then choose to share their opinion on the policy with shareholders at general meetings.</li> </ul>
Switzerland	<ul style="list-style-type: none"> <li>• A new law introduced in 2014 requires an annual binding shareholder vote on both fixed and variable elements of executive pay.</li> </ul>
United States	<ul style="list-style-type: none"> <li>• In 2015, the U.S. Securities and Exchange Commission (SEC) adopted a rule mandated by the 2010 Dodd-Frank Act, requiring medium and large public companies to disclose the ratio of the compensation of chief executive officers to the median compensation of their employees (starting in 2017). The rule provides companies with some flexibility in calculating this pay ratio (for example, the potential to exclude some overseas employees from the calculation).</li> <li>• In 2011, also pursuant to provisions in the Dodd-Frank Act, the SEC adopted rules to introduce advisory votes on the pay of executive officers at shareholder meetings. The vote, which has to be held at least every three years, is on the overall compensation package and does not allow shareholders to directly voice an opinion on specific elements of executive compensation.</li> </ul>

## Appendix B: Summary of companies' stakeholder-related reporting requirements

All companies in the UK are required to produce an annual report and accounts. Companies' reporting requirements differ depending on the size of the company and whether it is public or private. In recent years more emphasis has been placed on the non-financial section of the annual report and accounts.

All companies, other than companies qualifying as "small" in the Companies Act 2006, have to prepare an annual strategic report to inform shareholders and help them assess how the directors have performed their duty under section 172 of the Act.

For some companies, the strategic report has to provide more detail on stakeholder issues. For example, all public companies (*both quoted companies and any other public companies*<sup>54</sup>) as well as large and medium-sized private companies must include, to the extent necessary for understanding the company's business, analysis using key non-financial performance indicators, including (where appropriate) information relating to environmental and employee matters.<sup>55</sup>

All public and private companies<sup>56</sup>, whose weekly average number of UK-based employees exceeds 250, have to provide a description of action to introduce, maintain or develop arrangements for their UK-based employees aimed at: informing them about matters of concern to employees; encouraging their involvement in the company's performance; hearing their views about matters concerning them to take those into account; and making them aware of financial and economic factors affecting the performance of the company.<sup>57</sup>

Businesses with a turnover of £36m or more are required to disclose whether they have taken any steps, and if so, what steps they have taken, to prevent modern slavery in both their business and their supply chains.<sup>58</sup>

In addition to the above, quoted companies are required to report on:

- Their strategy and business model;
- Environmental, employee, social community and human rights issues, where necessary for an understanding of their business;
- Their greenhouse gas emissions; and

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<sup>54</sup> "Public company" is defined in section 4 of the Companies Act 2006

<sup>55</sup> Section 414C(4)(b), (6) of the Companies Act 2006

<sup>56</sup> A large company is one which exceeds the thresholds for a medium-sized company, see sections 465 to 467 of the Companies Act 2006 for the thresholds for a medium-sized company

<sup>57</sup> Part 4 of Schedule 7 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, SI 2008/410

<sup>58</sup> Section 54 of the Modern Slavery Act 2015; the turnover threshold is set by the Modern Slavery Act 2015 (Transparency in Supply Chains) Regulations 2015, SI 2015/1833

- The number of men and women on their board, in senior management positions and in the company as a whole.<sup>59</sup>

## Forthcoming developments

The UK is required to transpose the Non-Financial Reporting Directive (Directive 2014/95/EU). The new obligations will apply to financial years beginning on or after 1 January 2017 and will affect very large companies (>500 employees) which are Public Interest Entities (PIEs) such as banks, insurers, financial services and quoted companies. PIEs will be required to disclose their policies and main risks in relation to environmental, employee and social matters; respect for human rights, anti-corruption and bribery matters; and whether they have diversity policies in respect of their boards and management structures, and details of these<sup>60</sup>.

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<sup>59</sup> <https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf>

<sup>60</sup> <https://www.gov.uk/government/consultations/non-financial-reporting-directive-uk-implementation>

## Appendix C: Data on the UK business population

At the start of 2016, there were around 3.6 million private sector businesses registered in the UK<sup>61</sup>. The three main legal forms of businesses are: sole proprietorships, limited liability companies and ordinary partnerships.

The vast majority of limited liability companies are **privately-held** (“Ltd”). Some privately-held companies are limited by guarantee, e.g. Community Interest Companies (CICs), but most are limited by shares.

In 2000, a new business form with limited liability was introduced: the **Limited Liability Partnership** (“LLP”). LLPs are businesses that are privately-held. Unlike ordinary partnerships in England and Wales an LLP has a separate legal personality and the liability of the partners is limited.<sup>62</sup>

A **public limited company** (“Plc”) is a company limited by shares whose certificate of incorporation states that it is a public company and whose shares may be offered to the general public. There are some sub-categories of public limited companies:

- The Companies Act 2006 defines a “**quoted company**” as being a company whose equity share capital has been included in the official list in accordance with the provisions of Part 6 of the Financial Services and Markets Act 2000; or is officially listed in an EEA State, or is admitted to dealing on either the New York Stock Exchange or the exchange known as NASDAQ (see section 385 of the Companies Act 2006); and
- Some quoted companies choose a “**Premium Listing**” on the London Stock Exchange’s Main Market. Under the UK Listing Rules, these companies have to adopt the FRC’s UK Corporate Governance Code which operates on a “comply or explain” basis.

It should be noted that public companies are often referred to colloquially as “quoted” or “listed” even where they do not meet the Companies Act legal definition of a “quoted company”. A good example of that is a company with its shares listed on AIM, the Alternative Investment Market. It is also possible to be a public limited company and not be currently “quoted” or “listed” on any market

<sup>61</sup> “Companies register activities 2015-16” Companies House statistics

<sup>62</sup> Ordinary partnerships have a different legal status in England & Wales compared to in Scotland. In England & Wales, “partnership” is the relationship between persons carrying on a business for profit and all are jointly and severally liable for debts of the partnership; in Scotland partnerships are a separate legal person, distinct from the partners in the firm. In Scottish Limited Partnerships (SLPs) some partners, but not all, have limited liability



The following table show the numbers of UK businesses in the categories defined above that meet two different criteria for being large: (a) more than 250 employees; and (b) either an annual turnover of more than £36m or a balance sheet of more than £36m or a balance sheet of more than £18m.<sup>63</sup>

**Table 6: Number of UK registered companies by type<sup>64</sup>**

<b>Business category</b>	<b>Total number of registered entities</b>	<b>Number with more than 250 employees</b>	<b>Number with more than 1,000 employees</b>	<b>Number that have an annual turnover of more than £36m or total assets greater than £18m</b>
“Premium Listing”	720			
“Quoted company”	900	430	340	750
AIM Listed companies	710	180	54	500
Non-listed public companies	4,000	390	170	1,700
Privately-held companies (not including LLPs)	3.1 million <sup>65</sup>	9,900	2,600	37,000
Privately-held companies (not including LLPs) excluding companies owned by a UK incorporated company listed on the London Stock Exchange	3.1 million	9,000	2,200	33,000
LLPs	55,000	220	60	1,300

Source: FAME database (Bureau Van Dijk Electronic Publishing, October 2016); London Stock Exchange statistics list of all companies as of 31st October 2016; all numbers rounded to 2 significant figures

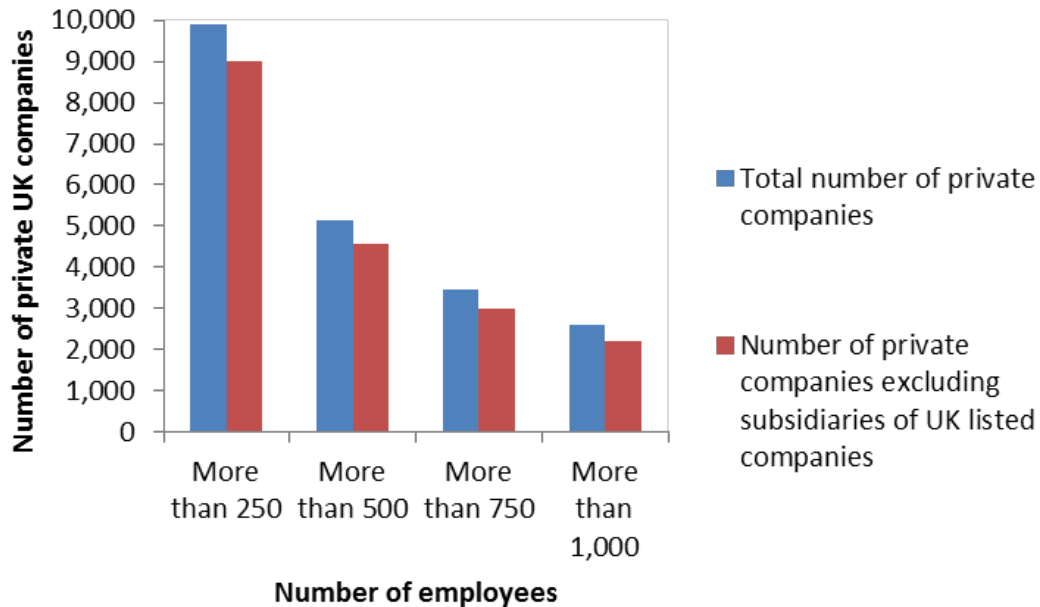
<sup>63</sup> These are the thresholds set out in The Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008. Under the Companies Act framework, large companies are companies that meet two or more of these criteria

<sup>64</sup> Captures companies for which the FAME database records employee/turnover/asset data. Employee/turnover/asset figures may in some instances refer to those of a group rather than the individual entity and some companies captured may be holding companies. In addition, employee figure may in some instances refer to the company’s total global employees, as such these numbers should only be viewed as indicative

<sup>65</sup> Lower than the 3.6 million Companies House figure due to removal of dormant companies

The following graph shows the number of private companies (including and excluding the subsidiaries of UK listed companies) at various employee size thresholds.

**Figure 2: Number of UK private companies by number of employees**



Source: FAME database (Bureau Van Dijk Electronic Publishing, October 2016)

The final table identifies the main categories of large, privately-held businesses which employ staff and engage in trading activity.

**Table 7: Categories of large, privately-held businesses**

- Private company subsidiaries of UK-listed parent companies (e.g. Tesco Stores Limited)<sup>66</sup>
- Large companies owned by private equity investors (e.g. Monarch Airline Limited)
- UK subsidiaries of foreign parent companies (e.g. ASDA Group Limited)
- Significant “founder” or family-owned businesses (e.g. Warburtons Limited)
- Large mutuals and co-operatives (e.g. Co-Operative Group Limited)

<sup>66</sup> The UK Corporate Governance Code only applies to the listed parent (assuming it has a Premium Listing) although, in practice, many groups adopt elements of the corporate governance framework in their subsidiary businesses as part of their internal risk management, particularly in the financial services sector.

