THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

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Mr Sanu de Lima
Deputy Director
Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
3rd Floor Spur 1
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Date: 17 February 2017

Dear Mr de Lima,

RE: Corporate Governance Reform Green Paper – The Investment Association's Response

The Investment Association welcomes the opportunity to respond to this consultation on corporate governance reform. The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £5.7 trillion on behalf of clients. As significant investors in UK listed companies, our members have extensive practitioner experience of the UK corporate governance system and its strengths and weaknesses, and are keen to continue to influence its evolution.

The UK's approach to corporate governance is well respected internationally. It has evolved over time and is rooted in the Companies Act, and the Cadbury and Greenbury Reports, and has a strong tradition of market-led promotion of best practice. We agree with the Government that now is an opportune moment to assess the current systems, and to ensure that the corporate governance framework in the UK is operating to the best of its ability.

Our key concern as investors is that boards operate in the long-term interests of the company to create businesses which have a positive impact on the economy, and which generate long-term returns for shareholders. This requires a robust corporate governance framework which helps companies fulfil these long-term goals, without imposing a compliance burden which could inadvertently drive inappropriate behaviour, have unintended consequences or deter high quality companies from listing or incorporating in the UK. That is why we have suggested a targeted approach of reform to key areas that could usefully benefit from change, rather than a complete rewrite of a corporate governance framework which has many benefits and, in some areas, is still bedding in following recent reforms.

We have provided detailed feedback to the questions and the options presented in the Green Paper in Annex 1. Our key positions are:

Section 1- Executive pay

Holding companies to account: The current shareholder powers on executive pay were only introduced in 2013 and are still bedding in. In this context, we assess that minor modifications to the existing provisions on binding Remuneration Policy votes could create stronger consequences for companies that fail to secure significant shareholder support for their annual Remuneration Reports. Specifically, we recommend that:

- Companies that receive less than 75%, but more than 50% in favour of their annual Remuneration Report should be required to bring their Remuneration Policy back to shareholders for a binding vote with a supermajority within 12 months; and

- Companies that receive less than 50% in favour of their annual Remuneration Report should be required to bring their Remuneration Policy back to shareholders for a binding vote with a supermajority within 6 months.

Institutional shareholder engagement: There is already a significant level of engagement between investors and companies in the UK on remuneration issues. Therefore, we recommend that any focus on institutional shareholder engagement should seek to improve the quality, rather than just increase the quantity, of this engagement. A particular area which needs improvement is how companies engage with shareholders following a significant vote against.

Centralised list of votes against: The Investment Association believes it is important to shed greater light on those companies that fail to secure significant support for their annual Remuneration Reports. We judge that this could be achieved through a centralised, public list detailing companies that have received a significant level of dissent on their annual remuneration resolutions. The Investment Association would be willing to coordinate this.

Remuneration committee effectiveness: The Investment Association supports efforts to improve the effectiveness of remuneration committees, as we believe that better remuneration committees make better long-term decisions. We consider it important that the Remuneration Committee Chair has a proper understanding of the company strategy and its performance drivers. Therefore, we would support, on a 'comply-or-explain' basis, the Remuneration Committee Chair being required to serve at least a year on the committee prior to taking up this role.

Total monetary cap: Companies must ensure that their remuneration policies are designed such that they only pay out appropriate levels of remuneration. The Investment Association does not believe that a total monetary cap on pay within a company's Remuneration Policy would achieve this. Rather, we believe that this would act as a disincentive for management who are meant to deliver share price appreciation to shareholders. If Remuneration Committees consider that executives have received a windfall due to factors outside their control, the Committee should use its discretion to reduce vesting levels.

Pay ratios and remuneration disclosure: The Investment Association supports introducing pay ratio disclosure for senior executives. Boards need to better justify the levels of remuneration which they pay to their executives and pay ratios is one way this can be achieved. We also support the Government's suggestion that there should be better disclosure on bonus targets, so that shareholders can better assess the link between pay and performance. We recommend a narrowing of the definition of 'commercial sensitivity' within the 2013 Remuneration Reporting Regulations to facilitate this.

Remuneration structures: Investors want remuneration committees to create the right remuneration structures for their businesses and strategy, which clearly links pay to the long-term success of the business. This has been the focus of market attention over the last 18 months through the work of the Executive Remuneration Working Group and market practice is continuing to evolve. We do not believe that specific remuneration structures should be mandated by the Government or put into law.

Senior shareholder committees: The Investment Association is not in favour of senior shareholder committees. We consider that their use undermines the principle of 'one share, one vote', and that they have an adverse impact on the well-established roles and responsibilities of directors and shareholders. Their use would not fit well with the current UK market structure, and we assess there would be potentially large costs and practical difficulties involved in implementing this.

Section 2 – Strengthening the employee, customer, and wider stakeholder voice

Directors' Duties: The Investment Association believes that current Directors' Duties are appropriately drafted in law. They are sufficiently balanced and already require directors to take into account the interests of differing stakeholders. However, we judge that the implementation of directors' duties could be improved.

Mechanisms for stakeholder engagement: The Investment Association supports the Government's comments in the Green Paper that mechanisms for stakeholder engagement should not be mandated in law. We prefer a flexible approach which allows boards themselves to choose the best approach for the company and its stakeholders.

We support the use of any of these options presented in the Green Paper, except the use of a stakeholder director. We are concerned that there is an inherent conflict in the idea of a director simultaneously representing a particular stakeholder group, whilst also observing their directors' duties which require them to give weight to the views of all stakeholders. We also have concerns about the impact such a development would have on the 'unitary board' principle which is a key feature of the UK corporate governance framework.

Code requirement for board responsibility for stakeholder engagement: A flexible approach to better board engagement with stakeholders should be implemented through a change to the UK Corporate Governance Code requiring companies to ensure that they have appropriate mechanisms to hear and respond to the views of all stakeholders, so that they can fulfil their directors' duties when taking long-term decisions.

Reporting requirement on stakeholder engagement: We recommend that a Corporate Governance Code requirement should be underpinned by a specific reporting requirement that boards outline how they have received the views of their stakeholders, and how these views have in turn affected their decision-making processes. This disclosure should form part of the Governance or Strategic Report in the annual report.

Section 3 – Corporate Governance in large privately held companies

Our members are primarily interested in companies with publicly listed securities (both equity and debt). However there is little public awareness of the distinction between private and public companies, and numerous governance scandals have damaged the public trust in business and affects business as a whole. Private companies should not use their legal status to hide from their obligations to society.

There are some broad governance principles that are used in public companies which could be applied to private companies, but it is not clear whether there are adequate enforcement mechanisms to make this a workable or cost-effective approach. Public companies receive external capital, so it is right that they are subject to higher standards of oversight on governance matters. Overly onerous requirements should not be placed on a large number of companies without justification or a clear rationale.

Section 4 – Other issues

In this section we have commented on several other areas of the corporate governance framework that we think need attention:

- Information on the skills, experience, and other roles held by the directors.
- More clarity on the regime for disqualification or sanction of directors.
- Review of the cost of proposing shareholder resolutions.
- Scrutiny of the board effectiveness review process.
- Protections for minority shareholders.
- Mandatory poll voting at general meetings.

We hope this feedback is helpful. Please do not hesitate to contact me if you wish to discuss any of these points further.

Yours sincerely,

Andrew Ninian

Director, Corporate Governance and Engagement

ANNEX I

RESPONSES TO QUESTIONS

Section 1 – Executive Pay

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

   The requirement for a binding shareholder vote on a company's Remuneration Policy was only introduced in 2013. Companies held their first binding vote on their Remuneration Policies at their AGMs in 2014, and since the policy vote is only required every three years, the majority of companies will only now be holding their second policy vote during 2017. In our view it is still very early to be able to make a full assessment of the benefits of this new vote. However, experiences from the first cycle of operation have generally been positive.

   Investors have seen some improvement in how companies approach executive remuneration since the introduction of a binding policy vote in 2013. Prior to its introduction, companies were free to regularly amend their remuneration frameworks. This led to increased uncertainty, regular changes to structures and increases in pay potential, and an inappropriate focus on short-term performance rather than the delivery of longer-term value creation.

   The three-year policy has helped to increased certainty as companies have had to secure support for, and commit to, a longer-term approach on pay and more clearly articulate how executive performance links to that long-term approach. We have also heard from Remuneration Committee Chairs that they now have more ability to say no to Executives who are seeking changes or increases in their remuneration, as the Remuneration Committee Chair did not want to seek a new binding policy within the three-year cycle.

   The experience of investors is that the Remuneration Policy vote has also led to an increase in the amount and quality of engagement between companies and investors, as companies are aware that they need shareholder support for their Remuneration Policy.

   In 2017 a large proportion of companies will only just be completing the three-year cycle. Many will therefore be only bringing forward their second Remuneration Policy to a binding shareholder vote for the second time. In our view, for many companies it is not yet clear what long-term effect the new system is having in terms of their approach to structures of remuneration or overall pay levels. We are therefore concerned that it is, at present, too early to instigate a complete change to the current shareholder powers.

   The proportion of companies that receive a large vote against, or rejection of, their Remuneration Policy or Remuneration Report has grown in recent years, but that this remains relatively small. This is highlighted in the data in the Green Paper which shows that only six companies in 2016 had their Remuneration Reports rejected.

Investors, however, continue to be frustrated by situations where non-binding Remuneration Reports are rejected, but there are no further repercussions for companies. A number of our members are concerned that companies can elect to ignore the dissent of their shareholders, or a significant minority of their shareholders on remuneration issues, which only serves to undermine shareholders' ability to hold companies to account over excessive or inappropriate pay levels.

Investors believe that the focus of reform should be on the small number of companies that receive a large vote against, yet do not experience appropriate sanctions. We believe that it would be disproportionate to impose a binding vote on remuneration payments on all companies and potentially penalise the large number of companies that do respond to investor concerns, and understand and comply with the spirit of current best practice.

For these reasons, the majority of our members are in favour of an escalation-style approach (option ii), which specifically targets those companies that have received votes against under the current Remuneration Report. We recommend that:

- If a company fails to get 75% vote in favour of their Remuneration Report, they should be required to bring their binding Remuneration Policy back to shareholders at the next AGM with a supermajority requirement (i.e. as a special resolution), and

- If a company fails to get a majority vote in favour of their Remuneration Report (over 50%), they should be required to bring their binding Remuneration Policy back to shareholders within six months at a General Meeting with a supermajority requirement (i.e. as a special resolution).

We have outlined this position in more detail below, along with comments on all of the other options presented in the Green Paper.

<u>Option i) Make all or some elements of the executive pay package subject to a binding vote</u>

Investors have been frustrated in the past by the consequences of the non-binding vote on the Remuneration Report. Companies that have their Remuneration Report voted down have often ignored the outcome of the advisory vote, as the payments have already been made and there is no appetite from the board or remuneration committee to try and clawback the payments. Whilst those companies are required to bring their policy vote back to shareholders at the next AGM, it is only after a year has passed. Their engagement with investors to understand the reasons behind the vote against is often insufficient or ineffective.

A binding vote on actual payments made does have the benefit that it would prevent any payment being made until it had been approved by shareholders, so any payment rejected by shareholders could not be made. For this reason, some of our members would be in support of an annual binding vote on all remuneration paid.

A binding vote on pay outcomes was considered as an option when implementing the 2013 remuneration reforms, and rejected on the basis that it would be practically unworkable. There are several legal and practical obstacles to consider, such as:

- How would this vote interact with employment law and contracts?
- What would the obligations of companies be on receiving a negative vote? Different investors may vote against a pay package for a variety of often different reasons, so one resolution may not provide clarity on what element of pay shareholders are opposing.

A clear legal context would have to be established before this system would be workable. We believe that one solution to these concerns would be to have at least two binding votes on remuneration payments actually made, one on fixed pay to be paid during the coming year (forward-looking), and one for variable pay to be paid for performance achieved during the previous year (backward-looking). In reality, a vote on each element of variable pay may be required.

We have concerns that a binding vote for variable pay alone, as suggested in the Green Paper, could result in companies putting more pay into fixed elements (i.e. in the salary and pension), to avoid the need for shareholder approval. Binding votes would need to cover all aspects of pay to avoid this. We also have concerns with what changes in behaviour might be triggered by this new system:

- Executives may not be willing to take up roles at UK plcs if their pay has to be ratified by shareholders prior to the actual payment being made.
- Binding votes on pay in this format are not required by any other market internationally. This system may impact on companies' decision to list in the UK, or impact on the overall competiveness of these companies on a global level.
- A loss of certainty could increase the discount that executives apply to their pay, leading to an overall increase in quantum to compensate, further exacerbating existing issues in the UK associated with levels of executive pay.
- Companies may start to pre-consult shareholders on the pay-outs they intend to make in order to pre-empt any potential opposition. We do not believe that this the right type of consultation to encourage.
- Investors might not be willing to vote against these resolutions, given that this could cause significant disruption to the management team. There may be scenarios where investors are satisfied with the management team overall, but dissatisfied with the remuneration, specifically the decisions made by the remuneration committee (rather than management), and yet they may be concerned about damaging their shareholder-company relationship by exercising this vote. Shareholders may also consider the broader destabilising effects that a negative Remuneration Report vote would have on a management team and the reputation of the company and decide that this action is disproportionate.

<u>Option ii) Introduce stronger consequences for a company losing its annual advisory vote on the remuneration report</u>

We favour this option as the most pragmatic response to the problem the Government has identified. In light of a system that has only been in place for a few years, it is sensible to focus reform on those companies that are not responding to shareholder concerns.

Indeed, some members of the Investment Association are already using an escalation approach in their voting policies, such that on the second time that they vote against the Remuneration Report at a particular company, they also vote against the chair of the remuneration committee. This is growing as best practice among investors.

In terms of structural changes to the voting system that could be beneficial, we believe that the voting system should force companies to acknowledge dissent against their Remuneration Report, with action to improve their remuneration practices. Therefore we would propose that those companies that do not receive significant support for their Remuneration Report should be required to bring back their binding Remuneration Policy to shareholders

Due to the increasing internationalisation of the shareholder base, it is not often that Remuneration Reports are voted down by a majority of shareholders, therefore we would suggest there is escalation for those companies who do not receive a supermajority (75% approval) as well. We envisage that such a binding escalation system could work as follows:

- If a company fails to get 75% vote in favour of their Remuneration Report, they should be required to bring their binding Remuneration Policy back to shareholders at the next AGM with a supermajority requirement (i.e. as a special resolution), and

- If a company fails to get a majority vote in favour of their Remuneration Report (over 50%), they should be required to bring their binding Remuneration Policy back to shareholders within six months at a General Meeting with a supermajority requirement (i.e. as a special resolution).

We feel that this would provide meaningful consequences to those companies that receive significant dissent against their Remuneration Reports. A 75% threshold would be easy to implement as it would only require the Remuneration Report becoming a special resolution. To implement the Remuneration Policy supermajority at the next meeting would also mean using a special resolution. The Government would need to introduce a new resolution type if it considered a different supermajority threshold such as 66.6% would be more appropriate. In addition, the process for bringing back the Remuneration Policy to shareholders would almost certainly require extensive dialogue with investors about the problems which influenced the negative votes.

There are some potential drawbacks to a 75% threshold. It would allow those shareholders who have a significant shareholding to exert control of the company through the remuneration of management. For example, if the significant shareholder does not believe that the company's strategy is right, then they can keep voting the Remuneration Report and Policy down until their views on the company's strategy are listened to. This strategy might not be in the long-term interests of all shareholders. In addition, given that not every shareholder votes, any shareholder seeking to exert such influence might only need to hold approximately 15% of the company's issued share capital as compared to the implied 25% stake.

We also acknowledge that those companies who lose their remuneration report vote will incur additional costs of setting up a general meeting when seeking approval for a new remuneration policy.

Additionally, this escalation approach means that the pay that may have triggered the shareholder dissent will still be paid, and won't necessarily be retracted by the company. However, we feel that the threat of bringing back the Remuneration Policy with a supermajority requirement will be a significant behavioural deterrent for companies and remuneration committees, which will lead to overall better outcomes for shareholders and other stakeholders.

<u>Option iii) Require or encourage quoted company pay policies to a) set an upper threshold for total annual pay, and b) ensure a binding vote at the AGM where actual executive pay in that year exceeds the threshold.</u>

We do not support this option. In practice it is not significantly different to the current binding Remuneration Policy vote, which requires companies to set a limit on each element of their pay. The only difference between the policy maximums (and the data presented in the Scenario Charts within the Remuneration Policy) and the proposed annual limit on pay would be the value of any vested share awards where share price appreciation has occurred. Share price appreciation is made irrelevant by a pay cap. Investors want executives to focus on long-term value creation, and have concerns that a pay cap would be disincentivising because share appreciation above an arbitrary level would be discounted.

While there is clearly a need to address the level of executive pay in the UK, investors have concerns about the practicalities of setting a figure which limits total annual pay. There have been unintended consequences where limits or controls on absolute levels of executive pay have been imposed in other countries. For example, in the US the tax deductibility of executive pay was capped at US $1 million, at which point all major listed companies moved CEO salary to this level as it was seen as the 'going rate', otherwise companies risked being seen as be undervaluing their executives if they did not pay them a salary at this maximum level. This limit also led to a shifting of pay into other (largely more opaque) forms such as share options, and has certainly not served to limit the overall quantum of executive remuneration in the US.

A key concern with including explicit monetary figures for total pay in the Remuneration Policy is that these figures could become an expected level of pay for some executives, irrespective of performance or other factors, putting the remuneration committee under considerable pressure if they do not pay the executives this level.

We predict that having a vote for amounts above a cap could drive another kind of unwanted behaviour, in that we think that the upper threshold would be set so high that a vote on exceeding it would never be triggered. We see this as a likely outcome given that the prevalence of share based payments would make it difficult to set a realistic cap, due to the variety of different monetary outcomes that could arise from a vested share award.

A small number of companies are considering a limit on amounts vesting from Long Term Incentive Plans (LTIPs) for their 2017 Remuneration Policies. These companies include those that tend to have particularly volatile share prices connected to the commodity markets and there is a danger of windfall gains which are realised outside the control of management. All the companies that are considering this limit have company-specific reasons for this being appropriate. Investors support this flexibility for these companies to adopt this approach, and note that this small proportion of companies are able to achieve this under the current regime without further regulatory change.

We recognise that this option is trying to address scenarios where large amounts vest to executives from LTIPs due to sharp share price appreciation or financial performance of the business that does not seem to be directly influenced by the executive themselves. In such cases, as investors, our members would expect remuneration committees to exercise discretion to reduce vesting. When the outcomes do not reflect the underlying performance, performance targets are unlikely to have been the appropriate measures of performance for the business, and we would also expect remuneration committees to review the KPIs that were used.

<u>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.</u>

Investors find that the current system allows a remuneration framework to be agreed between shareholders and companies, which then maintains shareholder expectations for a three-year cycle and links remuneration to a longer term view of the business and its long term strategy. If companies were forced to hold more frequent binding votes on policy, these agreements would not carry the same weight, as both parties would be aware that the remuneration framework could be easily changed at the next

AGM. Prior to the last remuneration reforms, remuneration frameworks would change frequently, and investors value the certainty that the three-year cycle provides.

Investors have also heard from boards that the current three-year cycle has empowered boards to resist calls from executives to increase pay, as the policy sets the framework and the expectations for a longer period.

Companies can already decide to bring forward a binding vote on a new policy if the current policy is felt to be unsuitable due to a change in business strategy or management. Investors support this flexibility to allow changes to remuneration structures in light of unforeseeable changes to the business, or investor discontent around the existing Remuneration Policy. However, investors believe that the three-year cycle will remain appropriate for many companies, so would not support a requirement for a more regular binding vote on pay, unless under the escalation approach (as outlined under option ii).

This year will be the second cycle of three years for many companies, so will be an opportunity to observe how companies behave throughout the whole cycle.

In terms of giving shareholders greater power to bring forward votes on pay, we are unsure whether additional mechanisms are either feasible or necessary. Investors can already bring forward a pay policy vote by rejecting the vote on the current policy or the Remuneration Report, or by engaging with boards and persuading them that a new Remuneration Policy should be brought to a vote. We believe that this current flexibility, supplemented by our proposals under the escalation approach under option ii, is sufficient to make sure that inappropriate remuneration approaches are reassessed.

<u>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</u>

Shareholders spend a significant amount of time engaging on pay with companies. These engagements will range from written correspondence, to individual and collective meetings with companies in advance of the AGMs. There will often also be extensive engagement following the AGM, particularly where a company has received a high proportion of dissent.

This year has seen an even larger amount of consultation on this topic given that in 2017 many companies will bring back their Remuneration Policies to shareholders. The Investment Association works as a coordinator for many company-shareholder engagements on this issue. As an illustration of the volume of consultation that has occurred this year, the Investment Association has received over 160 letters on remuneration since 1st September 2016. This represents the volume of written correspondence only, with meetings and other forms of communication also being heavily utilised. On average the Investment Association would receive between 180-200 letters or engagement requests per year.

We are cautious of mandating a particular consultation approach or requirements, as we believe this will superficially increase the quantity of engagement on remuneration, rather than the quality. These are issues which were discussed by the Executive Remuneration Working Group in their Final Report, and in the Investment Association's 2016 Principles of Remuneration. We have talked more about this under Question 3.

There is a specific area of the Code on engagement on pay that could be improved. Investors support the need for improvement in engagement where there is significant opposition to a Remuneration Report. Companies are required under E.2.2. of the Corporate Governance Code to report alongside the voting results what actions they intend to take to understand the reasons behind the vote result. However our members find that this requirement is not often taken seriously, with very boilerplate disclosure and little acknowledgement of the issues which triggered the negative vote.

This was confirmed by the FRC's annual Developments in Corporate Governance and Stewardship Report which was published in January 2017. Of the six companies that had resolutions defeated in 2016, the FRC notes that only a few provided extensive commentary on their AGM results. Of the 60 resolutions which received a significant minority vote against (>20% against), 20 companies covering 29 resolutions (including remuneration matters) did not make any statement on how they intended to engage with shareholders following the vote.

Investors want greater follow-up from companies that have received these votes against to ensure that they fully understand the views of their shareholders, and work constructively for future remuneration votes. This will be helped by greater requirements for companies to respond through the escalation approach we have outlined in option ii.

We are proposing a centralised list, hosted by an organisation such as the Investment Association, of those companies that have received a significant vote against. This would ensure that those companies that are obliged to follow up with their shareholders after a vote against receive the appropriate oversight while doing so. Publicly identifying these companies may also serve as a deterrent for other companies.

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?**

Our members see corporate governance as integral to the investment process, as they believe that well-governed companies will enhance value over the long-term. This is why investors spend extensive time and resource on voting and engagement on corporate governance issues to understand the qualities of the board, and how the board hold management to account through an assessment of strategy and risk.

This attitude to corporate governance and engagement is not held by all investors internationally. Institutions in some jurisdictions will not engage with companies, or do not use their voting rights to the same extent as we see here in the UK. In some international investment houses and jurisdictions, corporate governance and voting is seen as a compliance exercise rather than as an integral part of the investment process. UK plcs have an increasingly international shareholder base, with only 48% of UK plcs controlled by UK institutions, down from 62% 20 years ago. Given this, we would argue that average turnout of 73% is a positive sign of engagement of institutional investors (90% turnout within the UK-held segment)[1].

Our members believe that engagement is fundamental in managing their investments, and ensuring that the companies they invest in are enhancing value in the long-term. However, the responsibility of good governance will always remain that of the board. Shareholders will play their part in influencing this process through engagement, voting or, in extreme cases, through the withdrawal of financial capital. However, these mechanisms should not detract focus from tackling governance issues on boards.

Retail investors are not currently engaged to the same extent as institutional investors. This is largely because the dematerialisation of company shares has made holding

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[1] Source: Makinson Cowell

shares in nominee accounts the most cost-effective way to hold shares as an individual. However, as a holder in a nominee account the individual is either unable to exercise their voting rights, or it costs to exercise that voting right as they are not the legal owner of the shares (they are 'owned' by the nominee account). Engaging more retail investors in the voting process would require a cost-effective solution which would return the voting rights to the end user, as this is not possible in the current format.

Additionally, members have found in their experience that only a small proportion of retail investors are motivated, or interested, in the voting and engagement process. There is certainly scope for more financial education and information for retail investors so that individuals are aware of their rights as shareholders and are motivated to engage in the voting and engagement process.

We have addressed the specific suggestions in the Green Paper below:

<u>Option i) Mandatory disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting</u>

The Investment Association and its members are keen supporters of the UK Stewardship Code. The Stewardship Code requires signatories to disclose their voting activities.

The majority of the members of the Investment Association are signatories of the Stewardship Code and have received Tier 1 status from the FRC. The majority of our members publicly disclose their voting records on their websites, and publish their policy for the use of proxy advisory services in their Stewardship Code statements. As the Green Paper notes, this practice is widespread among investors, with 68% of investors routinely disclosing their voting records. The data for the 2016 Investment Association Stewardship Survey (yet to be published) shows that this has now increased to 72% of respondents disclosing their voting records. We believe that 28 out of the top 30 investors by UK equity AUM in the UK disclose their voting records.

The Investment Association and its members have been working to improve the level of disclosure, as well as trying to standardise the format and time period during which disclosures are made. Examples of best practice in this area will also typically go into more detail on the specific engagement themes during the year as well as rationale where votes against have been cast.

Investors are cognisant of the growing need to demonstrate what their stewardship activities consists of in practice. Stewardship Code statements are not often reflective of the actual activity that is going on, instead reflecting an overarching policy. Growing demand from clients and the public has meant that there is now a concerted effort to improve reporting in this area to provide evidence of how investors are holding companies to account.

While investors have for many years provided detailed reports to their clients in private about this, increasing public interest in investor stewardship has meant that there must also be some public record of these activities. For this reason, the Investment Association worked with members to create a Stewardship Reporting Framework which provides a template to help investors report publicly on their stewardship activities in a consistent way and share best practice among members. This framework includes guidance on voting disclosure.

Due to the increasingly robust disclosure already in the market, we are cautious on the impact of mandating voting disclosure. Firstly, we are sceptical that this will bring real benefits to the system. Even those investors who disclose in depth reports of their voting and stewardship activities on their public websites and would be considered "best in class" receive negligible hits to these sites. Additionally, there may be unintended consequences of imposing a mandated disclosure requirement on asset managers. Our members who have operations in the US where voting disclosure is mandated, have found that their resources are overwhelmed by the volume of disclosure they are required to make, to the detriment of undertaking the stewardship activities themselves. There is a danger that voting would be viewed as a compliance exercise rather than a valuable part of the investment process if there is a large burden of mandatory disclosure.

Investors are aware of concerns relating to the use of proxy advisers. It is important to note that the degree of influence on the voting decisions of investors varies widely across the market. Many investors will use a range of research inputs in their voting decisions, of which the recommendations of proxy advisers will be one. However, proxy advisers tend to have greater influence over overseas investors who are required to vote, such as US investors.

<u>Option ii) Establish a senior "shareholder" committee to engage with executive remuneration arrangements</u>

We do not believe that a system of senior shareholder committees would be a positive addition to the current powers given to shareholders, or indeed encourage further engagement between institutions and companies.

Shareholder committees are used in Sweden, where the governance regime, market size, and shareholder base differ significantly to the UK. In Sweden, there are fewer listed companies and they have a prominence of block or family shareholders. The purpose of the shareholder committee in Sweden is to provide an independent shareholder perspective into the nomination process.

In the UK, however, the shareholder base is far more fragmented. Giving certain shareholders positions on shareholder committees would afford them disproportionate influence in relation to their actual holding. If such committees are allocated based on shareholding size, most committees at UK plcs would consist of the same large institutional shareholders. Not only would this hinder a diverse range of views being put forward, it would also impose a large burden on that group of shareholders who would have to take up these committee positions. These committees would also significantly change the current roles and responsibilities of non-executive directors and shareholders in the UK, placing responsibility for some non-executive director duties with shareholders.

We believe in the importance of the 'one share, one vote' principle that underpins the UK system. Senior shareholder committees would be incompatible with 'one share, one vote' as it moves away from the idea that all investors are encouraged to engage. In a system of senior shareholder committees, the responsibility to engage on governance matters would be limited to a small number of investors, rather than the broader ownership. Shareholders who were previously directly engaging with the company would be disenfranchised if they are not appointed to the committee.

It is important to establish whether a shareholder committee would be ultimately accountable to the board or to other shareholders or stakeholders. If members were to be elected by other shareholders, this would make the contact with the company indirect for many shareholders, as they are electing representatives rather than directly engaging. This would also add to the already large number of resolutions at AGMs.

In the current system, directors on the board select NEDs who are then proposed to shareholders at the AGM for approval. Board members are well-placed to make this selection as they understand the company's strategy and the skills they need or are currently lacking on the board. They also understand what is needed in terms of cultural fit.

We do not see how shareholder committees would be able to provide suggestions for additional candidates which take into account all the needs of the Board with the resources they currently have. Therefore, even in a shareholder committee-style structure, we predict that shareholders will only be able to comment on a slate of candidates provided (this is how many Swedish committees currently operate).

This already occurs under the current system in the UK, in which large shareholders are often asked for their opinion on a selection of proposed candidates. This is primarily for Chairman or Chief Executive appointments, where shareholders will be consulted on the qualities and expertise required by the company in view of its specific circumstances and strategy. In some cases, large shareholders are consulted on specific candidates, which in most cases requires them to become insiders.

<u>Option iii) Consider ways to facilitate or encourage individual retail shareholders to exercise their rights to vote on pay and other corporate decisions</u>

Members of the Investment Association are institutional investors and not retail investors, so our interest predominantly lies with voting issues for institutional investors.

However, as we have outlined above, we believe that there is only a small proportion of retail investors who are currently interested in corporate governance and voting and that the main barrier to retail investor voting is demand. We believe that greater interest in exercising their shareholder rights should be driven by financial education and information for retail investors around the role and value of voting.

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?

The Investment Association supports efforts to improve the effectiveness of remuneration committees, as we believe that better remuneration committees make better long-term decisions. There is a range of quality when it comes to remuneration committees and investors are keen to help raise the standards.

We believe that board effectiveness, and therefore remuneration committee effectiveness, is a function of having the right individuals on the board making the right decisions for the long-term success of the company. In the case of remuneration committees, weak members may not stand up to executives on pay, and may be too reliant on their advisers.

We are supportive of the Government's focus on improving consultation and on making sure the board has the right calibre of directors within the remuneration committee and board to make the right decisions. However in our response to this question we wish to make the following points clear:

- In relation to consultation, the focus should be on improving the overall quality of consultation not the quantity. We have concerns that mandated shareholder and workforce consultation would be counterproductive.

- Board consultation of the workforce around executive pay should be framed in terms of the reinvigoration of the directors' duties to consider the stakeholder voice.

- We agree with the need to amend the Corporate Governance Code to include a requirement of 12 months committee membership for the remuneration committee chair.

- We support the existing requirements for reporting on pay and conditions in the wider workforce (paragraphs 38-39 of the 2013 regulations) and on consideration of shareholder views (paragraph 40). Instead of proposing additional requirements on this we think that the focus should be on improving disclosure and therefore the process to report under the existing reporting frameworks.

- In relation to advisers to the Remuneration Committee, we believe that responsibility for decisions should always remain with the remuneration committee and not be outsourced to advisers. It is important that these advisers maintain independence from the company and have the appropriate policies on conflicts of interests. As investors we would like to see greater transparency in relation to the independence of remuneration advisers, such as in relation to fees received by the adviser for other services.

We have outlined our response to the options presented in the Green Paper in more detail below.

<u>Option i) Require the remuneration committee to consult shareholders and the wider company workforce in advance of preparing its pay policy</u>

Most remuneration committees already consult their shareholders when preparing their new pay policy, and a large volume of engagement occurs between these two parties at this part in the remuneration voting cycle. This engagement is not often visible to the wider public, but investors will regularly comment on remuneration proposals which leads to their revision prior to the release of the annual report.

Investors keenly feel the need for improvement in this process. However, the focus needs to be on improving the substance of consultation rather than mandating that companies merely 'consult'.

In advance of the 2017 AGM season, investors are already inundated with correspondence from remuneration committees on their new policies. However, investors feel that in many cases this correspondence is not true consultation, instead seeming to be aimed at affirming the policy of the company rather than inviting investor views. The Investment Association has received over 160 letters on remuneration since September 2016, some which just reaffirm the current policy, while others are seeking substantial change. Investors want to focus on material changes to structures, where companies are seeking views and comment, rather than where they are trying to guarantee a certain vote outcome.

There is a risk that a requirement for consultation with shareholders will only exacerbate this problem and increase the volume of so-called consultation, rather than improving the quality of the dialogue between remuneration committees and shareholders. It is the role of the board and remuneration committee to set the level and structure of remuneration of the executives, it is the role of shareholders to approve the policy and payments actually made, taking account of the business needs and strategy. However, far too often it seems that directors want the shareholders to set the structure of pay. Shareholders want remuneration committees and boards to ultimately take responsibility for their decisions, rather than outsource them to their shareholders. In turn, investors need to analyse a company's remuneration structure from a governance and investment perspective, taking account of the strategy of the company, and provide clear feedback.

Investors are clear on the need for market-led improvements to the consultation process. The recent report of the Executive Remuneration Working Group highlighted as one of its recommendations that consultation must focus on material issues and that companies should not enter into the consultation process with the expectation of automatic shareholder support. Consultation on remuneration must also take place with regard to the wider business context and must be demonstrated to be strategically important.

Another factor which needs to be considered is that the volume of consultation on pay, where not all of it is meaningful, crowds out other types of engagement and allows less time to engage on other important governance issues, such as strategy, board effectiveness, succession planning, risks and controls, diversity, social and customer relations, and environmental issues. Investors have been clear on the need to focus on the important issues, whether on remuneration or broader governance issues. We reaffirm the expectations of investors on consultation in the Investment Association Principles of Remuneration.

Investors believe that remuneration committees need to do more to consider the context in which they set executive remuneration, which means that they should have a deep understanding of the pay and conditions in the wider workforce. It is important to investors that remuneration committees justify the pay of the executive in relation to the rest of the workforce. This is particularly true where the executive has received a salary, pension or other remuneration increase where the rest of the workforce has not received similar treatment. Additionally, shareholders want to know why some companies operate a separate system of remuneration for executive directors from the rest of the workforce.

A requirement to discuss the remuneration committee's approach to the pay and conditions of the rest of the workforce, and whether and how they have consulted the workforce on executive pay, is clearly set out in paragraphs 38 and 39 of the 2013 Reporting Regulations. We think that more should be done to improve the quality of these disclosures, rather than imposing new regulations.

While consulting the workforce could be one way for a remuneration committee to gain this insight, there are other information flows that could also be used when the remuneration committee exercises their duty to consider this wider context. We have covered some of these possible mechanisms in our answers to Section 2, regarding stakeholder voice in the boardroom.

<u>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</u>

We support this requirement, which we included in the Investment Association Principles of Remuneration in its most recently updated form in the autumn of 2016.

We believe that it is important that remuneration committee chairs have extensive knowledge of the company in order to carry out the role. Investors have seen too many instances of NEDs who are brought into a company and immediately appointed as remuneration committee chairs. Remuneration committee chairs need time to understand the Company strategy and what drives performance, culture of the company, the shareholder base and the wider employee population. They also need to build their relationships with the management team in order to effectively discuss these often emotionally-charged performance-related issues.

The workload of the remuneration committee chair is significant. It is important that any new committee chair has sufficient time for induction into the role. A year's experience on the committee could form part of this induction.

Investors understand that sometimes a sudden change in chairmanship is necessary for personnel or wider board governance reasons. We advocate that this be implemented on a 'comply-or-explain' basis, publicised through market-based initiatives such as the UK Corporate Governance Code and the Investment Association's Principles of Remuneration.

The Corporate Governance Code could also be amended to include this requirement. This could take a similar form to the 'recent and relevant experience' requirement for audit committee chairs. Additionally, if the FRC were to consider implanting this change in the Code, a similar requirement could be considered at the same time for the other heads of committees (audit, nomination).

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.

The Investment Association supports the introduction of requirements for companies to disclose the pay ratio between the CEO pay and the median employee, and CEO and Executive Committee. Our members are of the view that boards are not sufficiently justifying the level of remuneration they give to their executives. This is left to investors who are having to explain to their own clients why they support the remuneration packages.

This was recognised in our Principles of Remuneration in October 2016. Members believe that it is the board and remuneration committee's responsibility to set the appropriate level of remuneration. This level of remuneration should be explained and justified by the board using internal and external relativities.

The Investment Association Principles of Remuneration are clear that remuneration committees should be "cognisant of pay and conditions elsewhere in the Group and take them into account when determining executive remuneration" and that pay ratios should be used to justify the level of pay chosen for the executives. Investors consider that companies need to do more to show that they are indeed taking the wider workforce and context into account, and to justify why they have chosen particular levels of remuneration. Discussions on workforce pay certainly take place in the boardroom, however they need to be better explained and disclosed, so that shareholders can ensure that there are robust processes in place for this, and so that it is clearer for employees and wider stakeholders.

Disclosure of a pay multiple of CEO pay relative to median employee pay is just one part of greater explanation of remuneration committee decisions and processes. Moreover, any data point will not be illuminating in isolation, and would need to be accompanied by a full contextual explanation of why the remuneration committee considers that particular ratio to be right for their business. In addition, investors believe that there should be a wider discussion by Remuneration Committees of how they assess executive pay in the context of remuneration paid to the wider workforce. At the current time this is often minimal and boiler plate in nature.

Members are also interested in the ratio between the pay of the CEO and the executive team or next layer of management below the board. This can help shareholders to understand the dynamics within the management team and whether there is a dominance of particular individuals. It can also highlight companies' approaches to succession planning (or lack thereof). Some members have also expressed an interest in the ratio between the CEO and the bottom decile of employees, to focus on the issue of low pay in large companies as well.

Investors are clear that this piece of data is important as a tool for understanding the remuneration in a particular company, and due to varying methodologies, pay ratios may not be comparable between companies. Nonetheless, investors think it is an important piece of data, and that they will value the insight as to how the ratio changes within a particular company over time. Therefore we would suggest that companies are required to provide multi-year information on how their pay ratio has changed over time, and whether the methodology used has remained constant.

We are aware that effective implementation of this ratio will depend on both the data being easy to collect and present on the company side, and useful and meaningful for the users of that data (shareholders, employees, and the general public). Linking the production of the ratio to current and future reporting obligations, such as the Gender Pay Gap Disclosures which come into effect in April 2017, would be an efficient means to introduce this. The Gender Pay Gap Disclosures (in their provisional form) appear to also have the advantage of having several data points to avoid a single point being viewed in isolation.

Various methodologies for disclosing this ratio need to be explored to find the best format and understand any issues that may arise. It is worth noting that one limitation of using the Gender Pay Gap Disclosures as a starting point is that they only refer to UK-based employees.

We acknowledge that there are some limitations to the use of pay ratios. There are some concerns that pay ratios may provide a perverse incentive for companies to outsource low-paid workers to external agencies, or that the use of UK-only employees will not provide an illuminating picture for many global companies. To combat this we would suggest that the pay ratio is not measured on a 'full time equivalent' basis as this could drive moves to zero-hours contracts or outsourcing. However, we believe that if companies take the decision to outsource their workers in response to such pay ratio regulation, it would signal corporate governance concerns about the company and the board.

An additional approach would be to require companies to outline the full extent of any increase in remuneration. For example, if an executive received a 3% salary increase, this should be presented as an absolute monetary amount. The company should also include the impact of the increase in monetary amount for all benefits, pension, bonus potential and LTIP grant. This will mean that investors and other stakeholders can see the full monetary increase impact of any salary or variable pay increase.

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?**

   Investors are fully supportive of increasing transparency around annual bonuses, and this is something that investors have been advocating to companies for many years. In the most recent review of its Principles of Remuneration, the Investment Association wrote to all FTSE 350 companies outlining that investors expect full retrospective disclosure of target ranges and outcomes when a bonus is paid.

This has been monitored by IVIS (Institutional Voting Information Service), the Investment Association's corporate governance research provider, who have "red-topped"[2] any companies that have provided no disclosure of bonus targets, or have not committed to disclose the targets at a specified time in the future if those targets are deemed to be commercially sensitive. During 2016, IVIS red topped over 25 companies for failing to provide any retrospective bonus disclosure, or committing to provide disclosure in the future. Over 90 other companies have been amber topped as they only provide partial or relative disclosure of their bonus targets.

The success of this market-led approach to improved disclosure is reflected in the data used in the Green Paper, which reveals that all FTSE 100 companies now disclose retrospective measures relating to their bonuses.

Investors would, however, support greater clarification of the commercial sensitivity definition as used in the 2013 Remuneration Reforms. The current form allows companies, particularly smaller companies, to use it as a catch-all defence to avoid disclosing details of their remuneration in their annual report. While investors understand that there may be some specific examples where targets are genuinely sensitive, many bonus targets are linked to company financial metrics which are either disclosed publically in the annual report, or are linked to figures in the statutory accounts.

Therefore, investors support efforts to make companies better explain why a target is commercially sensitive, and to introduce a time limit on when the performance metrics will be disclosed, if not currently disclosed. A suggested period for this limit would be two years.

As recommended by the Executive Remuneration Working Group, it would be helpful for shareholders to understand not just the targets, but also the process for setting bonus targets. Our members feel that companies could improve how they demonstrate that the performance metrics chosen are aligned with the implementation of the company's long term strategy, and how it links to long term value creation for shareholders. Specifically investors want to know:

- Any assumptions or adjusted measures used for remuneration targets;
- Any adjustments made to measures during the performance period;
- How metrics differ from KPIs used elsewhere in the report, and reasons for any differences.

Investors will continue to push for these improvements through market-led initiatives such as the Principles of Remuneration, however we believe that the definition of commercial sensitivity in the regulations could be amended to help clarify market expectations and require disclosure of performance targets within two years. Additionally, investors would like to see the introduction of a reporting requirement on whether and how performance conditions have been adjusted from the statutory numbers or KPIs elsewhere in the Annual Report, as outlined above.

[2] IVIS does not provide voting recommendations, instead it highlights issues or concerns through the use of blue, amber and red 'Colour Tops'. Red indicates the strongest level of concern.

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.

In recent years, investors have become increasing concerned with some of the unintended consequences that have resulted from the widespread use of LTIPs. Their growing complexity is viewed as one of the contributing factors to growing quantum, and there is scepticism about their effectiveness in driving long-term value creation in businesses. The problems with LTIPs were highlighted in the recent report of the Executive Remuneration Working Group, which was set up by the Investment Association in the autumn of 2015.

However, as the Executive Remuneration Working Group highlighted, there is no one-size-fits-all solution to better alignment of long-term variable pay. Investors want remuneration committees to create the right remuneration structures for their businesses, which will clearly link pay to the long-term success of the business. As investors, our members signal their expectations in terms of remuneration structures and approaches to remuneration through the Investment Association Principles of Remuneration, which provide an annually updated, market-based source of guidance on best practice. This guidance is set on a comply-or-explain basis and can be amended to reflect changes in the market environment.

We are opposed to any particular remuneration structure being mandated in law, as we have seen that strict guidelines on the remuneration structures that companies should adopt can have unintended consequences, as it is difficult for one structure to address the needs of all companies.

Restricted shares are noted as a particular alternative in the Green Paper. There are mixed views on the use of restricted shares. Some of our members see restricted shares as a way of reducing the leverage of executive remuneration packages, and a possible way of reducing quantum by scaling back awards in return for certainty. However, some investors have concerns with restricted share awards and would not support them, due to the long-held view about the primacy of pay for performance. These investors are also concerned that restricted share awards would not be appropriately discounted and may end up at the same value as the current LTIP awards.

This variety of views highlights the difficulty in finding consensus on what the "right" structures are in the market. Certainly the market has evolved such that certain mechanisms and structures are considered best practice, but this has developed over time and remains fluid. It is important that the market is able to react to the changing environment and views of participants on the appropriate structures.

On holding periods, it is already considered best practice for LTIPs to have a minimum two-year holding period following a three-year performance period. This is reflected in the Investment Association's Principles of Remuneration. Since mid-2016, IVIS has been highlighting any companies that do not do this on an 'amber top' to reflect member sentiment on this.

Section 2 – 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.

We believe that current director duties are appropriately drafted and they sufficiently balance and take account of the interests of the differing stakeholders. Directors' duties as set out in Section 172 of the Companies Act 2006 clearly set out the groups of stakeholders that all directors should be taking into account in their decision making. Investors, however, believe that more can be done to ensure that directors are truly acknowledging and fulfilling these duties.

With regard to the specific options presented in the Green Paper we have summarised our position as follows:

- We support the use of any of these following options, except the use of a stakeholder director. We are concerned that there is an inherent conflict in the idea of a director simultaneously representing a particular stakeholder group, while observing their directors' duties, which requires them to give weight to the views of all stakeholders. We also have concerns about the impact on the unitary board principle which is a key feature of the UK corporate governance framework.

- We support the Government's comments in the Green Paper that mechanisms for stakeholder engagement should not be mandated. We prefer a flexible approach to allow the Board to choose the best approach for the company and its stakeholders.

- A flexible approach to better board engagement with stakeholders should be implemented through a change to the Corporate Governance Code to require companies to ensure they have appropriate mechanisms to hear the views of their stakeholders, so that they can fulfil their directors' duties and take long-term decisions.

- This should be underpinned by a reporting requirement, which requires boards to outline how they have received the views of their stakeholders, and how these views have affected their decision-making processes. This disclosure should form part of the Governance or Strategic Report in the annual report.

As announced on 13th January 2017, the Investment Association and ICSA: The Governance Institute have established a joint project to draw up practical guidance on how boards can enhance their understanding of the interests of employees and other stakeholders, in accordance with their duties.

<u>Option i) Create stakeholder advisory panels</u>

Investors support initiatives which will improve the channel of communication between company boards and their stakeholders. Stakeholder advisory panels would mean that a formal channel could be set up between directors and stakeholders which could be used for both generic discussions relevant to board strategy, as well as a forum to discuss particular strategic issues and allow directors to receive the information they need to carry out their duties as set out in law.

These panels could take the form of an annual consultative presentation from the board to a representative group of employees, in which board-decision making is explained, remuneration payments are justified, and employee or other stakeholder representatives have the opportunity to pose questions to the board directly.

Investors would want such stakeholder panels to provide reports on the scope of what discussions were had during these meetings. Many companies may already have extensive engagement programmes with employees in particular, but this is not always communicated externally to stakeholders such as shareholders, nor is it often apparent how boards are incorporating such feedback into their decisions.

The 2005 Information and Consultation of Employees Regulations may mean that larger companies will have formal consultation agreements with their employees, but these agreements are not externally visible, meaning that investors cannot assess whether these agreements are broad enough to cover the breadth of issues that should be fed to directors to fulfil their duties.

It is important that such stakeholder consultative groups or forums are tailored to suit the individual company, which may require a different composition and format. Therefore, we do not believe that such panels should be strictly mandated. Indeed, given the potential costs of setting up a prescribed system of engagement, we think there is a need for companies to tailor engagement systems to their individual needs.

Instead, guidance needs to be provided by the relevant industry bodies to help companies set up these groups. This guidance is necessary to address some of the obstacles that companies may identify to having these groups, such as identifying the correct balance of representation, the frequency of the engagement, any possible confidentiality and conflict of interest issues, as well as the expectations from the wider market on how the panels should be conducted.

The Investment Association/ICSA project mentioned above is an example of an industry-led response to this issue, in order to help companies identify practical steps to improve the stakeholder voice on the board.

<u>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</u>

This option would allow a formal channel of representation for stakeholders within the current system of the unitary board. Investors envisage that a designated non-executive director would have similar responsibilities towards stakeholder engagement that audit and remuneration chairs have towards their respective functions. This system would also have the advantage of providing accountability, through the re-election of the designated non-executive director.

This would need to be facilitated by an amendment to the Corporate Governance Code to outline the expectations of the role of the designated non-executive director. As pointed out in the Green Paper, it is important that, while an individual would be nominated to coordinate stakeholder views, this does not detract from the duties of all directors on the board to take note of, and acknowledge, the interests of all stakeholders. It would however, allow the board and non-executive director to decide which is the best approach to gathering stakeholder views. Some investors have concerns that this non-executive director could become a scapegoat for these issues, or become separated from the decision-making of the rest of the board.

An alternative suggestion would be that the Chair is required to address the stakeholder advisory groups as set out in option i, and is required to bring this feedback to both the board and to shareholders. This would fit more naturally with the Chair's role as the contact point for shareholder and stakeholder relations.

Option iii) Appoint individual stakeholder representatives to company boards

Investors support the approach of the Government in not mandating the direct appointment of employees or other interested parties to company boards.

The UK has a unitary board system whereby directors all owe the same duties to all stakeholders as set out in section 172. If stakeholder representatives are appointed to a board, they must fulfil the role of a director and therefore refer to the views of all stakeholders, not just a particular representative group. Therefore, this representative must be selected on their ability to fulfil the role as director of the company first and foremost, rather than as a representative, as this would disrupt the unitary board model.

The current unitary board system is designed such that directors are appointed to manage and control the company's business. The primary responsibility of the board is, through its senior management, to promote the success of the company over the long-term. When discharging this responsibility, directors have a duty to take into account a range of factors which are set out in the Companies Act. All directors owe the same duties to the company, including the duty to exercise independent judgement.

Boards are expected to come to collective agreement on issues, so that decisions are that of the whole board in the interest of the whole company. This means that decisions should not be made to favour any particular select group of shareholders or other stakeholders.

Investors expect boards to ensure that they have a diverse membership who are able to reflect employee and consumer perspectives during their discussions as well as other important stakeholders such as the environment and society at large, as it is the duty of directors, as set out by law.

However, the degree to which this is applied in practice varies across the range of companies that members invest in. These duties are clearly set out in law but whether stakeholder views and needs are fully taken into account in board decision-making is not certain. While it is clear that some boards are adhering to best practice, many others show room for improvement. Investors are keen to ensure that directors are fulfilling their duties and that these issues are taken into account by boards.

Shareholders have suggested a number of ways in which companies can ensure these relationships and interests are managed effectively:

- **Improve the diversity of perspective on boards,** ensuring that non-executive directors are drawn from the widest pool of talent and experience that can reflect the needs of consumers, employees and other stakeholders. The nominations committee has an important role to play in making sure there is sufficient diversity to reflect on the wide range of stakeholder perspectives.

- Ensure that **existing director duties are promoted** and directors are held to account where they are not effectively carrying out these duties. It has been suggested that training for new directors could be improved to ensure that directors understand the full fiduciary responsibilities of a board.

- Improve the **mechanisms for incorporating employee and consumer perspectives** into board debates, as suggested in the options set out in the Green Paper.

  Another method of improving information flows not included in the Green Paper is for the board to make use of qualitative and quantitative KPIs on employee engagement and performance. Investors have been asking for better acknowledgement of the role of human capital in board strategies, and therefore better disclosures on how the board manages the workforce. Indeed, this forms one of the recommendations of the Productivity Action Plan[3]. These mechanisms for understanding stakeholder views need to be reviewed at board level regularly, and evidence of these activities should be published so that shareholders can hold boards to account. Boards could facilitate this review through the annual board effectiveness review.

Investors have not always had a positive experience in other markets where such representation is mandated. For example, in Germany where the Supervisory Board consists of equal proportions of worker and shareholder representatives, investors have found it more difficult to engage with the Supervisory Board on management and board issues, as they are both further away from the management decisions taken on the management board, but also they tend to focus more on employment issues rather than oversight of management. Additionally, the size of these boards, once employee representatives are taken into account, can make it more difficult for boards to function as effectively, as decision-making can take longer and accountability is diminished.

Investors note that companies are still free to appoint employees under current legislation, as shown by companies such as First Group. Where companies do decide to include a formal stakeholder representative, there are a number of practical difficulties that would need to be addressed, such as choosing which type of employee or stakeholder to include and implementing a selection process which would ensure that any candidates for board membership have the appropriate skills and experiences to make decisions on the board. Conflict of interest and confidentiality systems and controls would also be a potential issue for many companies when including a stakeholder representative on the Board.

While companies may choose to implement this system, investors still believe that it is paramount that the board manages and incorporates the views of all stakeholders, as set out in s.172. Having representatives of particular groups on the board could impact the ability of boards to represent the company as a whole, and disrupt the functioning of the unitary board system. Additionally, investors have found in the German model that having particular stakeholder groups involved in boards could lead to decision-making being made by a small number of Directors outside the board, who then use the board meetings to ratify their decisions.

Option iv) Strengthening reporting requirements related to stakeholder engagement

Investors believe that reporting on engagements with stakeholder engagement is vital to allow investors and other stakeholders to assess how effectively boards are taking into account their perspectives. We have heard examples from many companies on how the board and management hear from differing stakeholders which hereto have not been publicised outside the company.

[3] The Investment Association's Productivity Action Plan, March 2016

This option should be considered in combination with any of the other options, or as a stand-alone point for improvement. Companies need to do more to demonstrate how they interact with their employees, customers, and other stakeholders as part of their commitment to the long-term success of the company.

Members are, however, keen to stress that reporting (in any form) is only useful when it is meaningful disclosure and the explanation is company-specific. Investors are wary of reporting requirements which lead to boilerplate disclosures from companies, as these will not add to stakeholder understanding of board decision-making.

Investors want any disclosure on this issue to help them to understand how the directors are discharging their duties. Investors want these disclosures to include:

- The approach the board has taken to gathering and understanding shareholder views, and taking these into account in their board decisions (the input); and

- The impact these views have had on the board decision-making process (the output).

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?

Directors' duties under s.172 apply to all directors of all companies. Investors expect that directors are already taking these duties seriously, and taking steps to understand stakeholder views. There needs to be improvement across the board.

A different approach will be needed for different types of companies. Companies with listed securities have shareholders or bondholders to monitor them, whereas private companies do not. As the Investment Association, our focus lies primarily with the listed sector, and improving the channels for stakeholder voices to the boardroom in these companies.

Nonetheless, as we outline in Section 3, the present crisis in public trust in business means that we are also concerned that private companies improve concurrently with listed entities. This will, however, require the Government to consider how this can be implemented, as private companies do not have the same oversight that investors provide to companies with listed securities.

We need to be conscious of the burden of regulation on listed companies. For the growth economy as a whole, and particularly to allow people to save for the future, we need a good supply of high-quality listed companies which channel the savings of today into returns for pensioners in the future. If companies are unwilling to list a company because of a perceived regulatory burden for listed companies, it will impact on the economy and the returns of pension savers.

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.

As far as listed companies are concerned, we think the best approach would be to introduce a change to the UK Corporate Governance Code underpinned by a reporting requirement. All companies need to act to better recognise the voice of stakeholders, but the approach to implementation needs to be voluntary to allow boards to choose the approach that suits the company and its stakeholders. A comply-or-explain Code requirement would provide this flexibility, and the reporting requirement underpins this requirement so that investors can assess how effectively they are exercising their duties.

We envisage that reform could take the following format:

- Amendment to the Corporate Governance Code such that boards are required to have mechanisms to hear from their material stakeholders;
- Reporting requirement to explain how they have operated these mechanisms and thus fulfilled their directors' duties.

We hope that the Investment Association/ICSA project mentioned earlier will help companies to identify such mechanisms and to provide examples of best practice for reporting. We also think that the government needs to review the current enforcement regime of s.172. Where there have been clear breaches in the past, there has not seemed to be processes used for investigation or sanction. The Government should make it clearer which government bodies are responsible for this issue.

As shareholders, we already have a role in enforcement, either in terms of engaging privately with companies where directors are not seen to be working in the interest of the company, which can lead to directors being removed. This can also be done publicly through the investor right to re-elect directors. We do not feel that it is solely for the shareholder to enforce the provisions of s.172, and it would be beneficial for both companies and investors if the formal process of enforcement by the relevant bodies was clarified by the Government.

Section 3 – 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?

Our members are predominantly interested in public listed companies, as that is where their investment focus lies. However, public listed companies do not exist in a vacuum, and high-profile business scandals such as the collapse of BHS have a resounding impact on public trust in business as a whole. Very few members of the general public could identify whether a particular business is a public or private company, but incidents of mismanagement erode trust in the whole business community. Private companies also have obligations to society and should not use their legal status to avoid this.

We would therefore welcome further industry-led initiatives that encourage private companies to consider their licence to operate, to build trust amongst stakeholders, and to ensure that they are managing risk in line with good corporate governance principles. Private firms have the same duties to stakeholders, and the same obligation to generate long-term value from the firm. They should therefore consider the adoption of best practice from public companies where appropriate. For example, it could be helpful for some private companies to undertake external performance evaluations of their boards.

We acknowledge that the reason listed companies are subject to a heightened level of scrutiny is because they are the entities in which the general public are able to invest their savings. It is also important to note that not every private company behaves in the same manner as BHS. We believe it is important to focus attention and pressure on the minority of offenders, rather than constrain all companies by imposing significant additional regulatory burden. There would be significant challenges with directly replicating current corporate governance approaches from the public company sphere to private companies, therefore there should be careful consideration of any new regime for private companies.

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

Any companies with public listed securities should be within the scope of existing corporate governance frameworks (this includes private companies with debt securities).

There are a range of different types of privately-held businesses, and arbitrary size thresholds may not be appropriate. Similar thresholds should be used to other reporting requirements that cover large companies, both listed and unlisted, so that definitions are consistent.

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

    The Investment Association would prefer any strengthening to be done through a voluntary system, similar to the Corporate Governance Code for listed companies which is applied on a 'comply-or-explain' basis. This recognises that companies differ widely from each other and that an overly restrictive approach can mean that companies simply follow the letter rather than the spirit of the rules, and treat corporate governance purely as a compliance exercise.

    Adherence to standards should be monitored in some form, however private companies do not have the same monitoring pressure as public companies receive from their shareholders. We note the current application of the Walker Guidelines for Transparency and Disclosure in Private Equity, and the annual monitoring of the Private Equity Reporting Group. Any extensions to such a regime would be a significant burden for an industry body/regulator to take on in the absence of shareholders.

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?**

    As investors in companies with listed securities, our primary focus is on these companies. Where we are able to express a view on this question it relates to these companies. Indeed, we support the requirements for non-financial reporting for companies with any listed securities (including listed debt). There could be more consistency in the size thresholds used for non-financial reporting requirements that apply to both public and private companies.

    Further, the extension of the voluntarily applied Walker Guidelines could be considered to help encourage leadership and to help restore trust in all UK businesses, in both private and public ownership. Currently inclusion in the voluntary regime is only triggered after a company is acquired, so many larger private companies are not included within the provisions. We believe the application of the Guidelines could be extended in order to capture all large privately held companies.

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?

We propose the following additional issues that should be considered to improve the corporate governance framework in the UK:

Information on Directors - There could be greater information provided on the skills, experience, and other relevant information to inform the re-election of Directors. Investors would also like companies to outline the key reasons why the Chairman and the board believe that the Director should be re-elected, with an explanation of the attributes and skills which the Director has brought to the board discussion during the year, as well as other board positions held.

Disqualification of directors – Investors are concerned that there is currently no clear and consistent regime for disqualification of directors and sanctions for ignoring the duties set out under s.172. There is a mismatch of sanctioning regimes that are held between the regulators, government departments, courts and other bodies. The Investment Association believes that the Government should reassess the current framework for the disqualification of directors and investigate which single body should hold responsibility for this process. Given the resources and insight required to effectively carry out this role, we would question whether existing bodies would be best placed to undertake this position.

Cost of shareholder resolutions – Investors would like to highlight the barriers to shareholders bringing resolutions to a company's AGM, which is one means of shareholders being able to escalate their engagement or concerns with board governance. In order for the cost of tabling the resolution and distribution of the requistionists statement to be covered by the Company, the resolution must be tabled prior to the release of the Annual Report and Accounts of the company. Consequently those investors who want to bring a shareholder resolution to the AGM, as a result of information that has come to light in the Annual Report and Accounts, find that the costs and logistics associated with doing so can be prohibitive.

Board effectiveness reviews – Investors would like there be more scrutiny of the board effectiveness review process. Companies are required to have board effectiveness reviews under the Corporate Governance Code, however investors are concerned about the range of quality provided by these reviews, and question whether they provide the right level of challenge to board practices. Investors would like there be a Code of Practice which is adopted by the Board Review industry and for the Company to disclose more information on how they select their service provider and any conflict of interest procedures that are in place to ensure that the board reviewer is effectively challenging the board.

Protections for minority shareholders - In 2013 the FCA changed the listing rules to introduce protections for minority shareholders in premium listed companies, in the form of additional voting rights on independent directors. However, recent examples have shown that the independent director vote can still be overruled by the controlling shareholder when re-election is brought to a general meeting, leaving these protections ultimately ineffective. The FCA should review whether the provisions in the listing rules and the regime governing controlling shareholders in premium listed companies is sufficient.

Poll Voting – Most companies now use poll voting to decide voting at a general meeting, however the default position in the Model Articles of the Companies Act for Articles of Association is for votes to be decided on a show of hands. We propose that this should be changed to voting by poll, meaning that the number of votes given is proportional to the number of shares held. This would be consistent with the 'one share, one vote' approach in the UK, help to strengthen accountability, and would help shareholders to reconcile their votes cast against the votes reported by the company.