

# The long and winding road to corporate governance reform

A summary of the Government's response to reform the UK's corporate governance framework

## Introduction

On 29 August 2017, the Government published a response<sup>1</sup> to its corporate governance reform agenda. This long awaited response reflects wide-ranging feedback received from nearly 400 respondents to its Green Paper<sup>2</sup> of last November and also takes into account the recommendations of the House of Commons BEIS Select Committee inquiry which published its report<sup>3</sup> in April.

The package of measures to improve the UK's long standing corporate governance system are largely non-legislative in nature. They include changes to the UK Corporate Governance Code (the Code), voluntary industry led action, regulators improving their co-ordination and using their existing powers better and lastly, limited changes to secondary legislation only where necessary.

In order to provide companies with some clarity and a sense of direction about the changes that are still to come, this document summarises the Government's headline proposals across the three specific aspects of corporate governance which it consulted on:

1. Executive pay
2. Strengthening the employee, customer and supplier voice, and
3. Corporate governance in large privately-held businesses

## Headline reform proposals set out in the Government's response

### 1. Executive Pay

Despite the 2013 reforms to strengthen and increase transparency in the UK executive pay framework, executive pay has continued to be a key factor in public dissatisfaction with large businesses, and a source of continuing concern to UK investors. In the Green Paper, the Government invited views on a range of options to strengthen shareholders' ability to hold companies to account on executive pay, and to further enhance the transparency of pay at the top in comparison to the rest of the company and it has now set out which options will be taken forward.

<sup>1</sup> Department for Business, Energy & Industrial Strategy, Corporate Governance Reform: [The Government response to the green paper consultation](#), August 2017

<sup>2</sup> Department for Business, Energy & Industrial Strategy, [Corporate Governance Reform: Green Paper](#), November 2016

<sup>3</sup> House of Commons, Business, Energy and Industrial Strategy Select Committee, [Corporate governance](#) April 2017

Proposals included in the Green Paper	Government's response published on 29 August 2017
Increase shareholders' voting rights further	<p>The Government has decided not to proceed with the proposal to introduce an annual binding vote on executive pay. The majority of companies that put their remuneration policy to shareholder vote in 2017 have received significant (over 85%) support from shareholders. We have also seen the median FTSE100 CEO pay decrease year on year. Overall, the outcomes of the 2017 AGM season indicate that companies have listened to and increasingly engaged with investors prior to their AGMs. As a result of not proceeding with some of the potential measures mooted in the Green Paper, the measures contained in the response will still allow time for the 2013 reforms to be fully bedded down.</p>
Strengthen shareholders' engagement on pay	<p>The Government invites the Financial Reporting Council (FRC) to revise the Code to be more specific about the steps that companies should take when they experience significant shareholder dissent to executive pay policies and awards.</p> <p>Additionally the Investment Association will also oversee the creation of a new register of all companies that receive a negative vote on executive pay from at least 20% of their shareholders, along with a record of the measures companies are taking to address shareholder concerns.</p>
Require remuneration committees to consult with shareholders and wider workforce on executive pay	<p>The Government has asked the FRC to consult on a Code revision to give remuneration committees broader responsibility for overseeing pay and incentives across their company and require them to engage with the wider workforce to explain how decisions on executive pay reflect wider company pay policy (using pay ratios to help explain the approach where appropriate).</p> <p>The Government has also asked the FRC to include in its Code consultation a proposed new provision that chairs of remuneration committees should have served on a remuneration committee for at least 12 months, unless there is a clear and valid explanation why this may not be appropriate or possible in a particular case.</p>
Increase transparency in executive pay by disclosing CEO to wider workforce pay ratio and bonus targets	<p>The Government will introduce secondary legislation requiring quoted companies to publish annually the ratio of CEO pay to the average pay of their UK workforce. It is currently proposed that the ratio will compare total remuneration (as set out in the 'Single Figure' table in the Directors' Remuneration Report). A narrative explaining the year-on-year changes to the ratio should also be published.</p> <p>The introduction of pay ratios has been widely supported by the investor community and may provide them with some additional information. EY particularly welcomes the increased consideration of worker's pay in the context of executive pay. In EY's view, there should be an equal, or arguably greater, focus on the bottom quartile and how much a company's lowest paid workers are earning.</p>
Consider alternative long-term incentive models, in the form of restricted shares or introducing longer holding periods	<p>The Government is not convinced that Long Term Incentive Plans (LTIPs) should be abolished and sees them as powerful driver for long-term executive performance when they are properly designed.</p> <p>It has invited the FRC to consult on a proposal to extend the recommended minimum vesting and post-vesting holding period for executive share awards</p>

Proposals included in the Green Paper	Government's response published on 29 August 2017
	<p>from three to five years to encourage companies to focus on longer-term outcomes in setting pay.</p> <p>The Government will also introduce secondary legislation requiring companies to provide clearer explanation of the potential remuneration outcomes from complex LTIPs under a range of scenarios (including significant share price growth).</p>

## 2. Strengthening the employee, customer and supplier voice

Pockets of poor corporate practice where the views and needs of key stakeholders – employees and workers, suppliers, customers and pension beneficiaries – have not been given appropriate consideration, have given rise to concerns about how well directors of UK companies are taking into account the views of key corporate stakeholders. These concerns have in effect questioned how effectively directors have been discharging their 'section 172 duty' to 'have regard to' a wide set of stakeholders in performing their duty to promote the long-term success of the company for the benefit of its shareholders. The Government has now responded on the range of options as noted below:

Proposals included in the Green Paper	Government's response published on 29 August 2017
<p>Whether the voice of key corporate stakeholders at board level needs to be strengthened to enable directors to discharge their duty under section 172 Companies Act 2006 effectively. It sought views on the following three options:</p> <ul style="list-style-type: none"> <li>▶ Designate existing non-executive directors to ensure that the voices of key interested groups, especially that of employees, are being heard at board level;</li> <li>▶ Create stakeholder advisory panels; or</li> <li>▶ Appoint individual stakeholder representatives to company boards.</li> </ul>	<p>The Government invites the FRC to consult on the development of a new Code principle establishing the importance of strengthening the voice of employees and other non-shareholder interests at board level as an important component of running a sustainable business.</p> <p>The FRC has been asked to consider and consult on a specific Code provision requiring premium listed companies to adopt, on a 'comply or explain' basis, one of three employee engagement mechanisms:</p> <ul style="list-style-type: none"> <li>▶ a designated non-executive director,</li> <li>▶ a formal employee advisory council, or</li> <li>▶ a director from the workforce.</li> </ul> <p>The Government encourages industry-led solutions, including:</p> <ul style="list-style-type: none"> <li>▶ by asking the Institute of Chartered Secretaries and Administrators (ICSA: The Governance Institute) and the Investment Association to complete their joint guidance on practical ways in which companies can engage with their employees and other stakeholders</li> <li>▶ inviting the general counsels of the largest listed companies (GC 100 Group from the FTSE100) to publish new advice and guidance on the practical interpretation of the directors' duties in section 172 of the Companies Act 2006.</li> </ul>
<p>Whether company reporting requirements related to stakeholder engagement should be strengthened</p>	<p>The Government will introduce secondary legislation to require all companies of significant size (private as well as public) to explain how their directors comply with the requirements of section 172 of Companies Act to have regard to employee and other interests.</p>

### 3. Corporate governance in large privately-held businesses

The UK's more stringent corporate governance and reporting standards are currently focused on public companies where owners or shareholders are often distant from the executives running the company. However, the Green Paper set out reasons why similar standards might need to apply to privately-held businesses, including the point that good governance can go beyond the relationship between the owners and the managers of a company, and that there are other stakeholders, including employees, suppliers and customers with a strong and legitimate interest in the way a company is run. The Government's response to the options set out in the Green Paper is as noted below

Proposals included in the Green Paper	Government's response published on 29 August 2017
Whether, and to what extent, the UK's largest privately-held businesses should meet higher minimum corporate governance and reporting standards.	The Government has tasked the FRC to work with the Institute of Directors, the CBI, the Institute for Family Business, the British Venture Capital Association and others to develop a voluntary set of corporate governance principles for large private companies under the chairmanship of a business figure with relevant experience.
The Green Paper also invited views on which businesses should be within scope and on how any strengthening should be implemented and monitored.	<p>The Government will introduce secondary legislation to require all companies of a significant size to disclose their corporate governance arrangements in their Directors' Report and on their website, including whether they follow any formal code.</p> <p>The Government's initial view is that these requirements should apply to companies with more than 2,000 employees unless they are subject to an existing corporate governance reporting requirement. The Government will also consider extending a similar requirement to Limited Liability Partnerships of equivalent scale.</p>

### 4. Other issues

Proposals included in the Green Paper	Government's response published on 29 August 2017
<p>The Green Paper also provided an opportunity for respondents to make observations on the UK's governance framework as a whole and to suggest other themes, ideas and proposals that might be explored.</p> <p>Among the issues raised by respondents included:</p> <ul style="list-style-type: none"> <li>▶ Adequacy of the FRC's powers to oversee and enforce the corporate governance</li> <li>▶ Simplification of the Code with more focus on overarching principles</li> <li>▶ The importance of company culture and ethics</li> <li>▶ The lack of effective mechanisms for sanctioning directors when their conduct or competence fell short or where they failed to comply with their duties.</li> </ul>	<p>Overall the Government notes that action is already in train to address many of the suggestions but that the most relevant comments and, in some cases, concerns, relate to whether the FRC has the powers, resources and status to undertake its functions effectively.</p> <p>In this regard the Government has asked in the short term, the FRC, the Financial Conduct Authority and the Insolvency Service to conclude new or, in some cases, revised letters of understanding with each other before the end of this year to ensure the most effective use of existing powers to sanction misbehaving directors and ensure the integrity of corporate governance reporting.</p> <p>In recognition of the central role that the FRC plays in UK's corporate governance framework, the Government will give further consideration in the long term to whether it has the appropriate powers, resources and status to operate effectively.</p>

## Next steps

As noted above, the reform proposals will require the engagement of, and work by, several organisations. However, given the delay in the Government's response - most likely due, in no small part, to the outcome of the snap general election and the time demands of the Brexit agenda - the response provides business with some clarity and a sense of direction about the changes that are still to come.

The Government's intention is to bring the reforms into effect by June 2018 to apply to company reporting years commencing on or after that date. To achieve this deadline:

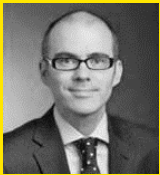
- ▶ The FRC will consult on amendments to the Code in the late autumn.
- ▶ The Government intends to lay before Parliament draft secondary legislation before March 2018. Where necessary, there will be consultation on the detail of this secondary legislation.
- ▶ The work on developing voluntary corporate governance principles for large private companies will commence in the autumn.

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