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BEIS SELECT COMMITTEE'S REPORT ON CORPORATE GOVERNANCE

The BEIS Select Committee (the **Committee**) published its report yesterday following its inquiry on corporate governance launched in September 2016 and BEIS's green paper published in November 2016. The inquiry focussed on three key areas: directors' duties, executive pay and composition of boards. The Committee does not believe that a radical overhaul of the law in relation to directors' duties or a change to the "comply or explain" approach under the UK Corporate Governance Code (the **Code**) is necessary but it does believe that there is scope for "significant improvements in order to address the changing nature of company ownership in a globalised economy".

Key issues

- Key Committee recommendations include:
  - new narrative reporting requirements relating to how directors have fulfilled their statutory duties
  - additional powers for the FRC to bring action for breach of a statutory duty by a director
  - greater board diversity
  - reform of executive pay, including the phasing out of LTIPs
  - the introduction of a corporate governance code for large private companies
  - greater disclosure of asset management voting

The Committee believes that more specific and detailed reporting on how boards have fulfilled their duties together with robust enforcement by regulators will ensure directors take seriously their legal duties and the provisions of the Code. This includes the requirement to have regard to other stakeholders and the long-term consequences of decisions. In light of this, the Committee makes the following recommendations to the Government:

- **Reporting on the section 172 duty** – The Financial Reporting Council (the **FRC**) should amend the Code to require informative narrative reporting on the fulfilment of the section 172 Companies Act 2006 duty (duty to promote the success of the company for the benefit of the members, having regard to various factors, including amongst other things, the interests of certain other stakeholders (including employees) and the likely long-term consequences of any decision). This reporting should include an explanation of how boards have considered each of the different interests and how this has been reflected in financial decisions. The Committee is not proposing any amendments to section 172 itself.
- **Giving additional powers to the FRC** – The Government should give the FRC additional powers to engage and hold directors to account, including public reporting to shareholders of any board or individual director failings and the authority to initiate legal action for a breach of the section 172 duty.
- **Introducing an annual rating system** – In order to encourage greater compliance with best practice, the FRC should work with business to develop appropriate metrics for an annual rating system on corporate governance. This should publicise good and bad practice using a simple

and easy to understand red, yellow and green assessment system. These ratings would be included in annual reports.

- **Introducing a corporate governance code for large private companies** – The FRC, Institute of Directors and Institute for Family Business should develop, with private equity and venture capital interests, an appropriate corporate governance code for large private companies to be overseen by a new body. It should be a voluntary regime but if it fails to raise corporate governance standards after three years, or reveals high rates of unacceptable non-compliance, it should become a mandatory regulatory regime.
- **Creating more transparency on advisers** – The Government should consult on new requirements for listed and large private companies to provide information on advisers engaged in transactions above a reasonable threshold, including amount and basis of pay, and method of engagement.
- **Encouraging more effective engagement and disclosure of asset management voting** – The Committee recommends that the Investor Forum seeks to become a more pro-active facilitator of a dialogue between boards and investors and that companies consider establishing stakeholder advisory panels. It also suggests that the FRC includes in its revised Stewardship Code stronger provisions to require the disclosure of voting records by asset managers and undertakes to name those that subsequently do not vote.
- **Addressing concerns about executive pay** – Greater control should be exerted on executive pay with reforms on the structure of executive pay, the process by which it is agreed and pay reporting. LTIPs should be phased out as soon as possible (with no new LTIPs agreed from the start of 2018) and deferred stock should become best practice for incentivising long-term decision making. The FRC, in consultation with stakeholders, should develop guidelines for the structure of executive pay, including simplification and clear criteria for bonuses. The FRC should also revise the Code, and legislation should be passed, to require a binding shareholder vote on executive pay the following year if there has been a vote against executive pay of over 25% of votes cast. The chair of the remuneration committee should normally have served on the remuneration committee for at least one year previously and should resign if remuneration proposals do not receive the backing of 75% of voting shareholders. The Code should also be amended to require publication of pay ratios between the CEO and senior executives. Employee representation on remuneration committees is also encouraged and should be reflected in the Code.
- **Improving the composition of boards** – The FRC should have the issue of board diversity as a key priority in its revised version of the Code, it should embed the promotion of ethnic diversity in the Code (giving it as much prominence as gender diversity) and require detailed narrative on board diversity in annual reports. The Government should set a target that from May 2020 at least half of all new appointments to senior and executive management level positions in the FTSE 350 and all listed companies should be women. The Government should legislate for all FTSE 100 companies and businesses to publish their workforce data, broken down by ethnicity and pay band. The Committee also recommends that companies are encouraged to recruit directors from the widest

possible net of suitable candidates but does not recommend any compulsory requirement to include "worker" representatives on the board.

At this stage these proposals are presented as recommendations of the Committee to the Government and the FRC in light of the responses to the Committee's inquiry. Some of these recommendations would require legislative change (such as the binding vote on executive pay) and others represent significant changes to current practice (such as the abolition of LTIPs).

The BEIS consultation on its green paper on corporate governance reform closed in February and we expect BEIS to publish the outcome of the public feedback it has received in due course. Also in February, the FRC announced that it would undertake a fundamental review of the Code prior to a formal consultation later this year. A response from the Government is also expected in due course.

If you have any questions or would like to discuss this report or corporate governance issues further, please contact your usual Clifford Chance contact or David Pudge or Robert Crothers.

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