Department for Business,
Energy & Industrial Strategy,
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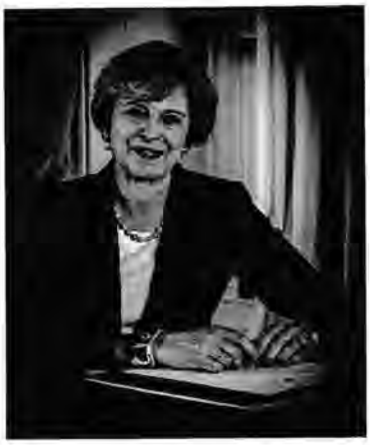
Department for
Business, Energy
& Industrial Strategy

CORPORATE GOVERNANCE REFORM

The Government response to the green paper consultation

August 2017

Introduction from the Prime Minister



As the United Kingdom prepares to forge a new role on the world stage as a global trading nation, the strength of our businesses are critical to our future success.

Our best companies are hard-working and responsible. They invest in their workforce's skills, and are a source of creativity and innovation, knowing that this is the way to succeed in the long term. A strong and effective system of corporate governance, which incentivises business to take the right long-term decisions, is key to that success.

Our system of corporate governance is rightly envied and emulated around the world, but we must continue to improve if we are to retain our competitive edge. We have also seen worrying evidence that a small minority of our companies are falling short of the high standards we expect. I want to tackle these problems and strengthen people's faith in a well-regulated free market economy.

That's why last Autumn, the Government began a discussion about where reform was needed. In some companies executive pay has become disconnected from the performance of the company itself. In others, some directors seem to have lost sight of their broader legal and ethical responsibilities. There is a worrying lack of transparency around how some large privately-held companies behave. A responsible government must recognise these problems, and show leadership to tackle them.

So we are now setting out a range of legislative and business-led measures which will improve corporate governance and give workers and investors a stronger voice. This will be good for business. Firms which listen to their workers and are responsive to their shareholders see the benefits on their bottom line. So by giving a stronger voice to those outside the boardroom, we incentivise businesses to take the right long-term decisions and help restore the public's trust.

As we leave the EU and chart a new course for our country, the economy we build must be one which truly works for everyone, not just a privileged few. Our measures to improve corporate governance will help ensure that British businesses can thrive in the future, and that all of us – customers, suppliers, workers and shareholders – share in the benefits.

PRIME MINISTER RT HON THERESA MAY MP

Foreword by the Secretary of State for Business, Energy and Industrial Strategy

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

One of the reasons why we have maintained this reputation is that we have kept our corporate governance framework up to date with reviews and improvements being made from time to time.

The Government's green paper of last November followed in that tradition, looking at specific aspects of corporate governance – executive pay, corporate governance in large privately-held businesses and the steps that company boards take to engage and listen to employees and other groups with an interest in corporate performance - where the Government saw particular scope to build on the current framework.

The green paper generated a wide debate and a big response from a cross-section of business and society. I am grateful to all those who responded. They have provided the Government with a solid basis on which to act. We have also benefitted from the work of the House of Commons BEIS Committee which published recommendations for corporate governance reform in April.

This document responding to our green paper consultation sets out a package of measures designed to:

- Address concerns that a minority of companies are not responding adequately when they encounter significant shareholder opposition to levels of executive pay. Remuneration committees will also have to do more to engage with the workforce to explain how top pay relates to wider company pay policy. And pay ratio reporting comparing the remuneration of the CEO with average UK employee pay will be introduced for quoted companies to help set executive pay in the wider company context;

- Drive change in how our largest companies engage at board level with employees, customers, suppliers and wider stakeholders to improve boardroom decision-making, deliver more sustainable business performance and build wider confidence in the way businesses are run; and

- Encourage large private companies to adopt stronger corporate governance arrangements, reflecting their economic and social significance, through the development of a set of corporate governance principles; and introduce new measures to require companies, both public and private, of a significant size to disclose the corporate governance arrangements they have in place.

These measures are in line with the UK's approach of strengthening corporate governance through non-legislative means: through changes to the UK Corporate Governance Code overseen by the Financial Reporting Council and voluntary industry-led action where possible, and legislating where necessary.

Industry has a key role to play in encouraging and driving further improvements. I therefore particularly welcome the contributions that the Investment Association, the Institute of Chartered Secretaries and Administrators (ICSA), and the Association of General Counsel and Company Secretaries working in FTSE100 Companies (GC100) will make. The Investment Association, for example, will be establishing a public register to ensure that there is greater visibility for quoted companies who encounter significant shareholder opposition to levels of executive pay. ICSA, with the Investment Association, is producing practical guidance on ways that company boards can engage with employees and other stakeholders.

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

Greg Clark

RT HON GREG CLARK MP

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1.43 A substantial minority of respondents who considered this question (in particular respondents from wider civil society, some think-tanks and academia) argued that there should be a rebalancing of executive remuneration towards fixed salary and away from share-based variable pay. A common argument was that this would enable CEOs to take longer-term decisions without wondering how they might impact on LTIP or other variable pay targets over the next three years. Against this, other respondents argued that CEOs and other executives should be required to build up shares of at least twice their basic salary, in order to give them a potentially long-term stake in the company's future. One think-tank said that this could be augmented by annual reporting of the impact of share price movements on a CEO's total share wealth in their company, providing a clear demonstration of the CEO's performance and the impact of her or his performance on their own wealth over the long term.

1.44 On the specific question of holding periods for shares granted to executives, almost two thirds of the respondents who addressed this question agreed that the UK Corporate Governance Code should provide for vesting and post-vesting holding periods of at least five years, compared to the current three years. Several of these respondents also proposed that the Code should set out a minimum period of time that executives should hold their shares after they have left the company.

Government conclusions

Addressing significant shareholder dissent on executive pay

1.45 The Government accepts the concerns raised by a majority of respondents that shareholders need an enhanced ability to hold to account the small minority of companies that experience significant investor dissent on executive pay. A shareholder vote of 20% or more against the Directors' Remuneration Report (DRR) is a rare occurence and can indicate that the remuneration committee has substantially misjudged one or more elements of the DRR; for example, by failing to exercise sufficient discretion when executive pay outcomes do not align with shareholder expectations based on company performance over the past year, or are not clearly in line with the company's executive remuneration policy.

Action 1

To provide greater confidence that companies experiencing dissent will take visible and effective remedial action, the Government will:

> ***(i) Invite the FRC to revise its UK Corporate Governance Code to set out the steps that companies should take when they encounter significant shareholder opposition to executive pay; and***

(ii) ***Invite the Investment Association to implement a proposal it made in its response to the green paper to maintain a public register of listed companies encountering shareholder opposition of 20% or more to executive pay and other resolutions, along with a record of what these companies say they are doing to address concerns.***

1.46 The FRC will need to consult on the new measures in the UK Corporate Governance Code, and the views of companies, investors and other stakeholders will be important in shaping the final set of provisions. They might include, for example, provisions for companies to respond publicly to dissent within a certain time period, or to verify that dissent has been sufficiently addressed by putting the company's existing or revised remuneration policy to a shareholder vote at the next AGM. The FRC's consultation will also provide an opportunity for stakeholders to comment on the scope of application of new measures covering shareholder dissent on executive pay; for example, whether they should apply to all premium listed companies or only to FTSE350 premium listed companies.

1.47 The Government will monitor the impact of both measures carefully once they are in place. The Government will consider further action at a future point unless there is clear evidence that companies are taking active and effective steps to respond to significant shareholder concerns about executive pay outcomes.

Broadening the role of remuneration committees

1.48 The UK Corporate Governance Code already asks premium listed companies to "be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual [executive] salary increases". However, as flagged by many green paper respondents and the BEIS Committee, this existing principle of good corporate governance is not in most cases driving meaningful engagement by remuneration committees with the wider workforce, nor ensuring that wider pay and conditions are taken properly and demonstrably into account in the setting of executive remuneration.

Action 2

The Government will invite the FRC to consult on a revision to the UK Corporate Governance Code and its supporting guidance to give remuneration committees greater responsibility for demonstrating how pay and incentives align across the company, and to explain to the workforce each year how decisions on executive pay reflect wider pay policy. This consultation will provide an opportunity to seek best practice examples from those remuneration committees that already proactively engage with the wider workforce, while enabling current work in this area by a number of prominent think-tanks to be taken into account.