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BEIS Consultation on Corporate Governance Reform

Response from the Employment Lawyers Association

17 February 2017

ELA: Response to Green Paper on Corporate Governance Reform

INTRODUCTION

The Employment Lawyers Association (ELA) is an unaffiliated and non-political group of specialists in the field of employment. Our membership includes those who represent and advise both employers and employees. It is not our role to comment on the political merits of proposed legislation, rather we make observations from a legal standpoint.

ELA's Legislative and Policy Committee is made up of both Solicitors and Barristers who meet regularly for a number of purposes; including to consider and respond to proposed new legislation.

A working group was set up by the Legislative and Policy Committee under the chairpersonship of Caroline Stroud of Freshfields Bruckhaus Deringer LLP to consider and comment on the Green Paper on Corporate Governance– draft regulations. *A full list of the members of the working group is set out at the end of this paper.*

What, if any, modifications should be made to the draft regulations? To inform our consideration of any proposed modification(s), please explain your response and provide supporting evidence where appropriate.

ELA has focussed its response on key areas within the draft regulations which have employment law implications as follows:

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?

1. ELA acknowledges that there is public disquiet about absolute levels of executive pay in the United Kingdom (and that it is part of the wider lack of public trust in business). However, outside the financial sector, the United Kingdom has some of the most onerous legal and regulatory controls on executive pay. Many of those controls have only been introduced relatively recently (2013/14) and remuneration arrangements in place at the time they were introduced are still working through – so it is ELA's view that it is premature to declare the current system (with its mixture of legislative control, extensive disclosure obligations, the pressure imposed by institutional investors and the flexibility provided by a "comply or explain" regime) completely broken. Adjustments to the existing regime relating to executive pay should therefore be made on a targeted basis and do not need to

fundamentally change the basic principles already in place.

2. We set out below our thoughts on the specific options described in the Green Paper.

Option (i): Make all or some elements of the executive pay package subject to a binding vote

3. We do not see any material benefit in introducing a mandatory annual vote on pay, either in relation to all pay or to some elements only (for example, variable pay). In order for the job market to operate effectively, it is important that both the executive –and the employer – have some certainty over pay. Requiring an executive to enter into a contract of employment (in which terms relating to pay are "conditional" upon shareholder approval) creates uncertainty on both sides, and may make it very difficult for an employer to recruit. This is particularly so if the appointment occurs a long time prior to the company's annual meeting at which any pay arrangements would be approved.[1] The executive may not be in a position to assess the likelihood that the pay package will pass a binding vote, and therefore would have no real way of assessing the "value" of any offer of employment. The employer, for its part, cannot plan effectively if it cannot be certain that a contract it has signed would not be overturned by a shareholder vote.

4. We are concerned that submitting the pay package to a binding vote annually would be unwieldy and could be practically unworkable[2]. ELA is not aware of any precedent for this approach in any of the markets in which UK businesses compete. If the pay package did not pass the binding vote, the employer would (presumably) have to reformulate the proposal and resubmit it. The employer and the executive will be concerned to understand the impact of a negative binding vote on remuneration paid to date. What terms should operate whilst approval is pending? There is clearly the risk that board pay would become a significant distraction from running the business. It could also potentially lead to short term success orientated decision making.

5. Subjecting all or some elements of the remuneration package to a binding vote only where there has been significant opposition to the remuneration report would give rise to the same practical considerations outlined above. Careful consideration would also have to be given to the trigger.

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

6. The current regime already allows for stronger consequences if shareholders are dissatisfied with executive pay. For example, the Corporate Governance Code requires all directors of listed companies to submit all directors for

[1] While a company could deal with this earlier by way of an EGM this seems an unnecessarily burdensome approach.

[2] Is there a resolution per director per item of remuneration? If a resolution to pay a director £X is voted down, does that mean the director gets nothing or remains at his existing remuneration level or does the company go back to shareholders with a proposal to pay £Y instead?

annual re-election. Aggrieved shareholders therefore have the power to vote to remove the remuneration committee chair (or other directors) if they are dissatisfied with the stance that is being taken on pay. In a recent letter written to the chairmen of all FTSE350 companies, Blackrock, the world's largest asset manager, reiterated their position that where "*executive pay is not aligned with the best long-term interests of shareholders, we will…consider this in our voting decisions for remuneration committee members' re-election*".

7. If there is to be further legislation in this area, it would be disproportionate to apply it to all companies; rather there needs to be an escalation point before those consequences are triggered.

8. The Government should take care to ensure that any structure does not give significant shareholders undue influence over directors. For example, if there was a requirement to obtain a 75% vote in favour of remuneration arrangements, a 25% shareholder effectively has a veto right on the directors' pay packages. This could be relevant for a company that has recently listed, having previously been owned by private equity. It is common for the private equity holder to retain a significant proportion of the shares – but with a view to exiting its investment in the relatively near future – and so their interests may not be aligned with those of other shareholders.

9. A final point is that shareholders may be less likely to vote against a remuneration report if the consequences of that vote may be damaging to the company (in which they have a vested financial interest).

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

10. To a large extent, this suggestion reflects the existing regime. The legislation requires companies to specify the maximum opportunity for directors under each element of the remuneration package and investors are increasingly requiring companies to state maximums that have teeth. As the Green Paper rightly acknowledges, if legislation were to be introduced to require an upper threshold, share price increases in share awards would need special treatment.

11. Companies need sufficient flexibility to hire new executives (for example, to replace an incumbent who has resigned to join a competitor): setting an upper threshold may bind the hands of the company and prevent them from doing so in certain circumstances. The same point arises in respect of termination payments, where companies need sufficient flexibility to make termination payments to resolve disputes and to avoid litigation.

12. Companies who compete for talent internationally would be substantially disadvantaged in comparison to those not subject to the mandatory cap.

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.

13. We do not see any significant benefit in requiring the existing binding vote on the executive pay policy to be held more frequently than every three years. In any event if the annual advisory vote does not approve the annual report on remuneration the binding vote on remuneration policy is brought forward. Indeed, we have concerns that it will potentially drive short termism – both amongst management teams and investors.

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

No comments on this proposal.

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?

No comment on this question.

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?

14. The widely held view is that high pay has got out of hand and that this is a worrying factor in increased social dissonance and reduced support for business. This supports the proposal that steps do need to be taken to improve the performance of remuneration committees. The only logical conclusion has to be that the existing guidance provided by the FRC and others has been ineffective and that steps do need to be taken to address the issue.

15. Government may wish to give consideration to the current drafting of s172 Companies Act 2006. There is academic opinion that as it prioritises shareholders over other stakeholder interests it may operate contrary to the thrust of a number of the recommendations in this paper.[3]

We turn to the specific Options in the paper.

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

16. As far as seeking to strengthen the guidance about obtaining shareholder support for proposed remunerating policy we agree this makes sense. There are many existing examples of channels for such communication and perhaps

[3] https://www.law.ox.ac.uk/business-law-blog/blog/2016/12/department-business-energy-and-industrial-strategy-corporate (accessed 31/01/17)

the real issue is the extent to which the shareholders actually engage with the issues and effectively communicate their views at the right time.

17. As far as communicating with the workforce is concerned our experience is that whilst some remuneration committees may do so effectively there is more resistance to communication with the workforce than with shareholders. We also observe that there are generally less well developed channels for such communication than in the case of shareholder groups. It is not our experience that it is common for there to be a NED 'responsible for representing the workforce' though we see no reason why this should not be encouraged. In addition any policy initiative will need to take into account all the categories of worker and employees within any individual organization. Given the variety in the makeup of individual workforces we suggest that any 'requirement' ought to be at the level of general guidance rather than being prescriptive.

18. There are within most companies others with responsibilities for communication such as the company secretaries, legal advisers, employee relations and human resource directors. It seems to us that these resources should be engaged to assist in the communication process. Those companies with experience of developing and running Works Councils will have knowledge and expertise that may assist improvement of communication and of developing mechanisms to enable remuneration committees to receive employee reactions to proposals for pay policies. It is not essential for the membership of the remuneration committees to be expanded if adequate and effective communication mechanisms can be put in place. Where trade unions are recognised plainly they could be involved but today that is the minority of companies in the private sector. Improved communications would at the least inform remuneration committees if their proposed policy would cause an adverse reaction from employees which could only be useful.

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.

19. This can only be a benefit if practically achievable so it seems to us that this ought to be a general rule but one that provides for explainable exceptions. Any such exceptional case ought to be one where the proposed chair has at least 12 months' experience of administering remuneration issues elsewhere if not within the business where he or she is to be chair.

20. We are asked if we have other suggestions and we support the observation made by others that it is important that the remuneration committee is very conscious of its duty to make its own decisions and does not hand this power to external consultants advising on the basis of comparable rates of pay which process tends to ratchet up pay.

21. Also the issue of not rewarding failure is bound to continue to occupy the minds of shareholders and other stakeholders. One mechanism that might be used to assist this process is to incorporate a contractual term in executive service contracts entitling notice periods to be reduced if performance targets

are missed or in the case of other elements of poor performance. This may work as a contribution to providing executives with early warnings and also to reducing the payments received on termination.

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.

22. The principle reason for introducing a pay ratio is as an additional transparency measure. From a data protection law perspective, all information gathered for the exercise ought to be anonymised, particularly where information is transferred across jurisdictions and covers an entire corporate group. The CEO's expectation of privacy in relation to his pay is reduced by the current reporting requirements and therefore we do not see a data protection issue in relation to the CEO's pay.

23. The complexity of introducing pay ratio reporting should not be underestimated. Although the Gender Pay Gap Information Regulations 2017 will require the publication of employee pay data we do not think that it would be possible for there to be a direct use of the information gathered under those regulations and the calculations that would be needed to undertake a CEO pay ratio exercise (for example, in relation to share plan entitlements). In addition, if the pay ratio is a group-wide exercise, employees working outside the UK would not be included nor would information across multiple group payrolls (given the regulations focus on individual companies rather than corporate groups).

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?

No comment on this question.

6. How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

24. A number of plcs have already moved towards a five-year deferral period following sustained pressure from investors to do so, therefore, query whether it is necessary for the government to codify longer deferral periods where it is already being implemented in some plcs.

25. Increasing LTIP holding periods above three years would be a step that mirrors those taken within the financial industry for individuals deemed to be

material risk takers / senior managers accountable for key decisions within an organisation. To this end, the move could ensure that the LTIP incentivises long-term strategy and well-being of an organisation rather than a short-term outlook. However, if LTIPs are awarded on an annual basis then after a few years, the effect of the longer holding period will be smoothed and negated and the existing issues will continue save for those individuals who are introduced to the plan. As a result, it may mean that individuals are less likely to leave an organisation particularly if it results in losing the LTIPs as it will be a minimum of a five year wait before they are back to the same level of incentive.

26. Is there a risk that the introduction of the longer holding periods will result in arguments that they prevent/put off employees from moving between organisations and therefore, are a restraint of trade? This argument could be made at the moment on a three year holding period, but the longer the holding period, the more likely such arguments may be run. (Although this would only be in relation to LTIPs that were forfeited on resignation.)

27. To the extent that longer holding periods were required, would this begin a culture of buy-outs in organisations where LTIPs forfeit on termination? Would a more effective solution (rather than longer deferrals) be to require a more consistent approach to *malus* and clawback in such LTIP provisions?

28. One area where Government could assist is by providing greater legal certainty over the circumstances in which clawback provisions (which operate to ensure decisions are taken in the long term) can be enforced. It is currently unclear whether s15 Employment Rights Act will restrict companies' ability to claw amounts back if they do not have express agreement from an employee to that claw back. Such agreement can be difficult for companies to obtain in practice and so hampers the usefulness of clawback. Clarity would also be desirable as to the tax consequences for companies and individuals where pay is clawed back. There is currently some limited guidance from HMRC arising from Julian Martin v HMRC but it only addresses the income tax consequences of cash payments and does not deal with NICs or corporate tax consequences or what the position might be if it is non-cash assets (eg shares) that are clawed back.

Strengthening the employee, customer and wider stakeholder

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.

29. The response is focused on how the interests of employees, rather than customers or wider stakeholders, can be taken into account at board level in large UK companies.

Options for reform in the green paper

30. ELA considers that the four options advanced in the Green paper should be retained. ELA agrees with the comments made in the Green Paper that the options are not mutually exclusive and considers that many of them could (and in some cases should) be used together. ELA considers that companies should be given flexibility as regards which option (or combination of options) they choose. This will enable organisations to decide which option(s) is best suited to their particular organisation, having regard to important considerations such as: size of the organisation; complexity of corporate structure; existing governance arrangements; make-up of workforce (e.g. homogenous, flat structure or complex matrix structures with multiple layers and functional constituencies); geographic spread of operations/workforce; existing industrial relations landscape (including Trade Union recognition, Works Councils or other employee representative groups). ELA considers that a "one size fits all" or overly prescriptive model would be unhelpful.

31. ELA makes the following comments in relation to each of the proposed options for reform:

(i) Employee Advisory Panels (EAP)

32. Consideration will need to be given as to nomination and appointment of employees to the EAP (election mechanism or appointment mechanism). A variety of options could be used in this respect and ELA considers that companies ought to be given flexibility around how employees are appointed to the EAP (although it would be extremely helpful for guidance to be published in this respect).

33. There is a risk of the EAP not being able to establish a common position if there are conflicting interests between employee groups and any EAP would need to be truly representative of any diversity within the workforce.

34. Time may need to be allocated for employees to carry out this role (potentially including reducing the hours in their substantive role). This may require amendments to be made to employment documentation such as contracts and/or policies. It may also be necessary from a policy perspective to provide statutory protections to employees in this regard (for example in relation to the right to reasonable time off and protection against retaliatory treatment). Without these protections employees may feel exposed and therefore unwilling to take on an EAP position.

35. It is almost certainly the case that the EAP will require access to confidential information in order to operate effectively. In practice, the provision / disclosure of such confidential information by the board would need to be carefully managed.

36. There will need to be a reporting mechanism to the board. In addition to the suggestion in the Green Paper for EAP members to be invited to full board meetings to offer views whenever relevant agenda items are scheduled, a reporting mechanism could involve having a non-executive director liaising with the panel (see option ii below) and/or for board members to attend EAP meetings.

37. A critical aspect of this option would be the ability of the EAP to report publicly on the extent to which it considered that the board was having due regard to the EAP's views. For example the EAP could have the right to publish an annual report on the key issues identified and raised with the Board (including for example executive pay). This statement could be published on the Company's website and/or included in the Annual Report.

38. There will need to be enhanced disclosure from the board as to the ways in which the views of the EAP has been taken into account. To ensure this is effective, this could involve a greater role for the FRC.

(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.

39. Time would need to be given to non-executive directors to ensure they can liaise with interested groups (including employee advisory panels). It would also be necessary to consider whether employees or designated employee groups (of course this could be members of an EAP) would need to be afforded additional time off and training for the purposes of engaging with the NED. This could require amendments to be made to contracts and/or policies (see also section on EAPs above).

40. There exists the risk of (i) tokenism and (ii) conflicts of interest arising between the non-executive's commitment to the board and the NED's reporting obligations to/from any interested groups.

41. Whilst this is a useful option, in many organisations there is already a perception that NEDs do not have the same influence or level of input (in practice) as the executive directors (for example in relation to strategic decisions which are often perceived to have been presented to NEDs as a fait accompli). Given this perception, there are obvious drawbacks, at least optically, to a NED acting as the bridge between the employee population and the Board. Consideration should therefore be given to an Executive Director taking this role, particularly someone from an HR / Operations background.

(iii) Appoint individual stakeholder representatives to company boards

42. Given the focus of the ELA response, this section looks only at the potential for employee representatives on company boards ("**Employee Directors**")

43. Consideration would need to be given to how many Employee Directors should be appointed to the board. With very large and diverse employee populations there would be an obvious desire for more than one Employee Director to be appointed (in order to ensure effective representation of the wider workforce). However it would be difficult, in most circumstances, to justify more than one Employee Director (from a sound governance and logistical perspective). These issues would need to be carefully considered and balanced appropriately.

44. There would need to be a mechanism for nomination and appointment of Employee Directors. It is likely that a variety of options could be used in this respect and ELA considers that companies ought to be given flexibility around how Employee Directors are appointed (although it would be extremely

helpful for guidance to be published in this respect). Examples could include (i) election by employees; (ii) nomination through any EAP; or (iii) representative of an employee ownership Trust.

45. Time will need to be allocated for employees to carry out this role (potentially including reducing the hours in their substantive role). This would require amendments to be made to employment documentation and employment policies. It may also be necessary from a policy perspective to provide statutory protections to employees in this regard (for example in relation to the right to reasonable time off and protection against retaliatory treatment). Without these protections employees may feel exposed and therefore unwilling to take on a Board position.

46. Training would need to be provided to the Employee Directors, including their responsibilities and liabilities as a director.

47. Consideration will need to be given to whether an Employee Director is independent for the purposes of the make-up of the board. Further, consideration will also need to be given as to whether the board has the appropriate balance of skills, expertise, independence and knowledge in accordance with the Governance Code.

48. There would need to be a process for communication and consultation between an Employee Director and employees. This would need to be managed without raising a conflict with their duty to the Company as a board member and with clear guidance on what board information can be communicated.

49. There is a practical risk that having an Employee Director on boards could result in substantive business and strategic decisions being discussed and substantively agreed at other meetings (i.e. not in the presence of the Employee Director(s)). Any such situation, where matters come to the board having already been discussed or dealt with when the representatives are not present would defeat the purpose of having Employee Directors and safeguards would need to be put in place to prevent the board paying lip service to the inclusion of an Employee Director.

(iv) Strengthening reporting requirements related to stakeholder engagement

50. This is likely to be an enforcement mechanism for options (i) to (iii). Enhanced disclosure requirements could be placed on boards to confirm how employee's views have been taken into account. This could include an expansion of s.456 requirements (Application to court in respect of defective accounts or reports) or a greater role for the FRC.

51. Employee advisory panels could produce an annual report and/or periodic reports on key agenda topics which could form part of the Company's annual report and/or be published on the Company's website. They could also play a role in the AGM.

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?

52. ELA's view is that the definition of who will be included in an employee number should be clear and certain. The government might consider the definition of "*relevant employer*" in the Equality Act 2010 (Gender Pay Gap Information) Regulations 2016. This means a firm who has 250 or more relevant employees. A relevant employee is a person who can bring a claim in respect of their employment under the Act, and so will either ordinarily work in Great Britain or work overseas in a context where there is a "strong connection" to Great Britain.

53. The definition should be consistent regardless of how the company is owned (for example whether the company is private or listed) and / or whether it is a subsidiary of a multinational company.

54. UK representation in a multinational company may not be appropriate at Group level and imposing the obligations across a multinational company could be burdensome and may deter companies from registering in the UK.

55. The level and structure of representation will therefore inevitably differ depending on the size of the UK Company and the number of UK employees.

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.

56. ELA considers that large UK companies should be given a choice on the approach they take regarding their governance structures. The structure of any approach will depend on and ought to take into account the following:

- The diversity of the workforce;
- Whether the workforce is unionised and/or has existing employee representative bodies, if so, what relationship the company has with them. In particular, the structure should be such so as to not interfere with the work / ethos of the union or other body;
- The number of staff in the Company;
- Whether the Company is a multi-national with a UK subsidiary;
- If the Company is a multi-national, the number of UK staff compared to the number worldwide.

57. To allow this flexibility ELA considers that any reform should be largely Code based, rather than legislative. There are however aspects which we consider should have legislative force, for example the right of the EAP to make public statements. Without this there is the risk that some companies would not comply. We consider that this 'industry led' approach is in line with trends thus far in UK corporate governance (and we agree with the statements made to this effect in the Green Paper).

Corporate governance in large, privately-held businesses

10. What is your view of the case for strengthening the corporate

governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

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

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

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

58. In relation to questions 10-13, if there is to be guidance or new regulation with respect to pay ratios or the extent to which boards should consider employee interests then these should be consistent across both public and private 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 have no further suggestions.

ELA Committee Members:

Chair: Caroline Stroud, Freshfields Bruckhaus Deringer LLP
Patrick Brodie, Reynolds Porter Chamberlain LLP
Steven Cochrane, Pinsent Masons LLP
Alice Greenwell, Freshfields Bruckhaus Deringer LLP
Stephen Levinson, Keystone Law Limited
Jane McCafferty, 11 Kings Bench Walk Chambers
Julie Morris, Slater Gordon (UK) LLP
Tom Ogg, 11 Kings Bench Walk Chambers
Tim Poole, Clifford Chance LLP
Andrew Sutton, UBS AG
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