Regulatory Policy Committee

Corporate governance reform

Department for Business, Energy and Industrial Strategy

RPC rating: fit for purpose

Description of proposal

Corporate governance refers to the system of rules and processes that determines how companies are directed and controlled, and defines the rights and responsibilities of the different stakeholders involved with a company. The current regulatory framework for corporate governance is largely embedded in the Companies Act 2006. This regulatory framework is complemented by voluntary measures, the Financial Conduct Authority's (FCA) disclosure and transparency rules and listing rules, and the UK Corporate Governance Code. The code is overseen by the Financial Reporting Council (FRC), which monitors compliance and reports annually on developments.

The Department states that the Government's present proposals for reform are intended to address corporate excesses and short-term thinking that go against the interests of shareholders and stakeholders such as the employees of companies, and that undermine trust in business in general. The Government published a green paper on corporate governance reform in November 2016. The Department states that the final policy package presented in its impact assessment is based upon 375 substantial responses to this consultation and on extensive ongoing contact with stakeholders. The policy package includes a number of proposals across the three themes set out in the green paper. These include:

Executive pay

- Requiring quoted companies with over 250 UK employees, which are subject to current executive pay reporting requirements, to report annually in their remuneration reports, the ratio of the CEO's total annual remuneration to the average of the company's UK employees' remuneration; to show in each subsequent year how this ratio changes over time; and to provide a short narrative explanation each year on how the ratio relates to the company's wider strategy and workforce pay and policies.

- Requiring companies to provide more clarity and explanation on the impact that share price changes have on executive compensation. For example, quoted companies will have to set out in their annual remuneration reports, the value of executive compensation packages for executive directors that result from share price changes, and whether their remuneration committees have used discretion when awarding pay packages.

Stakeholder voice in the boardroom

- Introducing new reporting requirements on all large[1] companies to explain how their directors comply with the requirements of section 172 of the Companies Act 2006; to have regard to employee interests and other factors. For example:
    - Large companies that are already required to produce a strategic report will be required to add a statement in the report describing how directors have had regard to wider stakeholder matters and interests set out in section 172(1)(a)-(f) of the Companies Act.
    - Building on the existing content of directors' reports, companies will be required to provide a summary of how the directors have engaged with employees and had regard to employee interests, and of the principal effects of that regard during the financial year.
    - Large companies will be required to report, as part of their directors' reports, on their engagement with suppliers, customers and others in a business relationship with the company.

Corporate governance in large private companies

- Companies of a 'significant size'[2] will be required to disclose their corporate governance arrangements in their directors' reports and on their websites, including whether they follow any formal code, or recognised set of corporate governance principles.

There are also a number of non-legislative initiatives across these three themes, such as inviting the FRC to revise the UK Corporate Governance Code and develop corporate governance principles for large private companies, and to encourage industry-led solutions by asking the Institute of Chartered Secretaries and Administrators and the Investment Association to complete and publish joint guidance on practical ways in which companies can engage with their employees and other stakeholders.

[1] As defined in the Companies Act of meeting at least two out of three criteria: turnover of more than £36m; balance sheet total of more than £18m; number of employees more than 250.
[2] a) have more than 2,000 employees globally; or b) have a global turnover figures over £200m and a balance sheet over £2 billion.

Impacts of proposal

The proposal is estimated to cost business £17.9 million in the first year and £9.8 million per year thereafter. This translates into an equivalent annual net direct cost to business of £9.0 million (2014 prices; 2015 base year for discounting). This consists primarily of the following costs:

Section 172 reporting for large companies (falling under the theme 'stakeholder voice in the boardroom' above)

The Department estimates, using FAME data, that the additional requirements will affect around 16,000 large companies. Although costs will vary significantly across businesses, the Department expects that the average costs per business to be in line with the costs of existing non-financial reporting requirements that are comparable in scope. In 2016, external research on the impact of the EU non-financial reporting directive produced an estimated first year cost of £951 per company, taking account of familiarisation, and annual costs after the first year of £455, based on 2 hours of 'director time', 6.5 hours of 'professional time' and eight hours of 'administrative cost'. The Department indicates that a large proportion of the 16,000 companies will be holding, or subsidiary, companies that are part of a wider group. Although these companies will need to include a statement in their own strategic reports, their costs are expected to be significantly lower. For example, large components of stakeholder statements may be developed jointly, or at group level, and applied with little variation across individual companies. Based upon FAME data, the Department assumes that costs overall could be up to 50 per cent lower, with 75 per cent as a best estimate. Overall, costs are estimated at £11.41 million in the first year and £5.46 million per year thereafter.

Pay ratio reporting (falling under the theme 'executive pay' above)

Using the FAME database, the Department estimates that the pay ratio reporting requirement will apply to around 450 companies. Its estimates of cost per business are informed by consultation responses and discussions with stakeholders, and by the economic assessment undertaken by the US Securities and Exchange Commission (SEC) on its proposed rule for the forthcoming pay ratio reporting. SEC registrants identified inclusion of worldwide employees as a significant factor in the overall costs. The IA explains (paragraphs 82-85), however, that costs are likely to be lower in the UK because the requirement in the UK applies to UK employees only, and flexibilities will be incorporated into UK regulations (e.g. UK companies will be able to use existing pay data collected for 'gender pay gap' reporting purposes.

The Department assumes that familiarisation and transition costs will amount to £3,312 per company, based upon fifteen hours of a non-executive director's time at £150 per hour. Ongoing costs, relating to collecting and checking data and making the required calculations, are expected to amount to 110 hours per company at an HR director pay rate. In addition, it is assumed that companies will need to have discussions at board/remuneration committee level, equivalent to five hours at £150 per hour. Taken together, ongoing costs are expected to be around £5,700 per company. Over the 450 companies, the cost of the pay ratio requirement is estimated at £4.05 million in the first year and £2.56 million per year thereafter.

Other costs

The requirement to explain the impact of share price changes on executive remuneration (falling under the theme 'executive pay' above) is estimated at £1.18 million per year (600 businesses affected at an average cost of around £2,000). The requirement for companies of significant size to disclose their corporate governance arrangements (falling under the theme 'corporate governance in large private companies' above) is estimated at £1.23 million in the first year and £0.59 million per year thereafter (1,720 businesses affected at an average cost of around £710 and £340, respectively).

Benefits and wider impacts

The Department explains that it is not possible to monetise the benefits of the proposals. The IA does, however, helpfully provide a qualitative assessment of the benefits of each individual measure. Anticipated benefits include incentivising stronger stakeholder engagement, sustainability and long-termism; helping to reduce the risk of future governance failures, improve transparency and restore trust in business; and providing greater transparency to shareholders and others on how share price changes affect executive remuneration.

Quality of submission

The Department has provided a clear and detailed impact assessment. The Department's assessment is informed by responses to the green paper and engagement with stakeholders, making good use of available evidence, including from external research and literature, and from overseas. The IA includes a useful post-implementation review plan (pages 44-45).

The IA would benefit from addressing the following points:

- *Consultation evidence*. Providing further clarity on how much of the evidence from stakeholders is in relation to the specific proposals, as opposed to the broader themes set out in the green paper. The IA includes a useful summary of responses to the green paper (pages 47-51). In a number of areas, a large majority of listed companies' respondents appear to be opposed to additional action being taken. The IA would benefit from addressing this in more detail. The IA would also benefit from assessing how many companies already have systems in place for engaging with their employees (for example, through recognised trade unions), particularly through compliance with the information and consultation regulations, and how this might affect the estimated impact on business.

- *Rationale for intervention*. Given the levelling off of executive compensation since 2011 (pages 6-7) and the pay reporting reforms introduced in 2013 (page 9), the Department could provide a stronger justification for further intervention at this stage. In particular, the Department could provide more-specific evidence to support there being "…still significant concern about the level of pay and about its structure." (paragraph 25).

- *Impact of 2013 reforms*. The IA would benefit from a fuller evaluation of the 2013 pay reporting reforms.

- *Non-legislative initiatives*. The IA does not monetise the impact of non-legislative initiatives, on the basis that "*Code-based changes are though ultimately the responsibility of the FRC and that industry-led action is voluntary and non-regulatory by nature*." (paragraph 47, page 13) The IA would benefit from providing additional description of potential impacts, setting out how any subsequent measures taken by the FRC would be assessed and explaining further how such industry-led measures would remain voluntary despite encouragement from government.

- *Focus on share prices*. The IA would benefit from explaining the focus on share prices, as opposed to the other ways that equity holders benefit (dividends and share re-purchases at non-market prices), and addressing further the role of share options in compensation packages.

- *Explanation of how objectives/non-monetised benefits will be realised*. The IA would benefit from further consideration of how the reporting requirements will promote 'long-termism', given changing patterns of stockholding duration, and how greater transparency will 'restore trust in business', particularly in firms with 'lumpy shareholding' (where ownership is not dispersed relative to control).

- *Risk and uncertainty*. The IA includes a useful section on 'uncertainty' (pages 43-44). This section would benefit from additionally covering risks, putting more detail on the assessment provided in the summary sheet (page 20).

Departmental assessment

Classification	Qualifying provision
Equivalent annual net direct cost to business (EANDCB)	£9.0 million
Business net present value	-£92.35 million
Societal net present value	-£92.35 million

RPC assessment

Classification	Under the framework rules for the 2015-17 parliament, qualifying regulatory provision (IN). To be determined once the framework rules for the current parliament are set.
Small and micro business assessment	Sufficient

Anthony Browne, Chairman