IoD Inspiring business

Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy,
3rd Floor Spur 1,
1 Victoria Street,
London
SW1H 0ET

5 February 2017

Dear Sir or Madam,

Response to the Corporate Governance Reform Green Paper (November 2016)

Thank you for giving the Institute of Directors (IoD) the opportunity to provide written evidence in response to your consultation into corporate governance. Issues of this nature are of considerable interest to the IoD and its membership and we are therefore pleased to present our views in respect of your proposals.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 35,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 71% of FTSE 100 companies and 51% of FTSE 350 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises (SMEs), ranging from long-established businesses to start-up companies. IoD members' organisations are entrepreneurial and growth-orientated, and more than half (57%) export goods and services internationally. Of particular relevance to the evidence we provide here, the IoD's Royal Charter tasks us ***"To promote the study, research and development of the law and practice of corporate governance, and to share findings." Furthermore this is to be done for the benefit of the business community as a whole and is not confined to the interests of IoD members.***

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Overall response

- This is a crucial and timely consultation and the IoD welcomes the government's desire to look at the effectiveness of the corporate governance regime for both unlisted and listed companies.
- Society's expectations of companies as well as companies themselves have changed dramatically in the last ten years. It is important to note that following the financial crisis of 2007 – 2008, several reports identified poor corporate governance as one of the causes of the crash. However, more focus at the time was given to regulating the financial services sector than looking to remedy some of the issues with our governance regime.
- Public trust in businesses remains very low. As our 2016 Good Governance Report showed, Britain's biggest companies face an uphill battle to win back the trust of the public after a series of business scandals, despite recent efforts to clean up corporate governance. Controversies ranging from zero-hours contracts to "dodging" global tax bills have bruised the public's faith in certain businesses.
- That said the UK's corporate governance system is the best in the world. The "comply or explain" principle is copied and replicated throughout the world. Had it not been for Sir Adrian Cadbury's ground breaking work over 25 years ago, our biggest companies would not be as well governed as they are today. Equally our UK Corporate Governance Code is held in very high regard and many countries (such as Japan) have simply copied our approach.
- According to Grant Thornton, more than half of FTSE 350 companies were fully compliant with the Code in their latest published accounts, with 90% of these companies complying with all but one or two of the Code provisions. There has also been a significant rise in the number of companies providing "good" explanations for non-compliance up to 70% in 2015.[1]
- British companies (especially those listed on the FTSE 350) have made significant improvements in the fields of boardroom diversity and providing more clarity on executive pay.
- The IoD does not advocate more regulation. The Code, which operates on a "comply or explain" basis and the Davies Review into diversity have both shown that considerable progress can be achieved through guidance and encouragement. That said much more can be done; we would advocate a general review of the Companies Act (2006). Again, with specific reference to section 172, we are broadly happy with these provisions but companies should be reminded of their obligations as set out in law. This could be achieved by the government consulting further on the specific nature of the Act or by the establishment of a "rapid response" committee to look at the effectiveness of the Act.

[1] Grant Thornton, *UK Corporate Governance Review*, 2015

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Executive Pay

- Executive pay within the FTSE 100 has risen considerably over the last 10 years. According to research carried out by the High Pay Centre, the median average pay of a FTSE 100 Chief Executive has risen by a third since 2010, when chief executives took home £4.1m on average. According to the data, FTSE 100 chief executives were paid 147 times employees' average wages in 2015, barely changed on the previous year, when they were paid 148 times.[2]
- Moreover, the FTSE is trading at broadly the same levels as eighteen years ago and 10% below its peak–however executive pay over the same period has more than trebled and as demonstrated above, there is an increasing disparity between average wages and executive wages. This misalignment has resulted in widespread scepticism and loss of public confidence. Failure has sometimes been rewarded, and use of median comparators has driven disproportionate rises in executive remuneration. This is ultimately damaging to the listed company sector. At the same time, Boards have sometimes outsourced remuneration to consultants, reducing accountability and creating unwanted outcomes.
- It is therefore clear that the current approach to executive pay in the UK needs changing. There are several reasons the IoD believes this to be the case:

  - Ratcheting of pay – Many boards target paying above the median, or there is a strong desire to pay a competitive wage. There is sometimes a perception that total remuneration is a reflection of talent, therefore boards want to be seen to be paying above average. Combined with increased transparency on pay this naturally leads to an increase in pay as companies compete with each other to remain above the average.
  - Short-term incentives – Many pay schemes contribute to short-term incentives either through the annual bonus or LTIP (long-term incentive plans). It was acknowledged this was part of a much broader problem involving short-term focused shareholders, and therefore blame could not be solely directed to executive pay structures.[3]
  - Disconnect between pay and social impact – The aim with most executive pay schemes is to align management interests with financial return and hence the shareholders. Arguably, this leaves no automatic connection between

[2] High Pay Centre, http://highpaycentre.org/pubs/10-pay-rise-thatll-do-nicely, 2016

[3] A long-term incentive plan (LTIP) is a reward system designed to improve employees' long-term performance by providing rewards that may not be tied to the company's share price. In a typical LTIP, the employee, usually an executive must fulfil various conditions or requirements to prove that he has contributed to increasing shareholder value. In some forms of LTIPs, recipients receive special capped options in addition to stock.

executive pay and positive social impact. For example, the public will show more outrage against a CEO who is being paid well while firing thousands of workers.
    - There is too little connection between pay and the specific strategy and purpose of a company. Too often LTIP schemes are solely based on relative TSR (total shareholder return) and EPS (earnings per share). The onus here is on shareholders to more closely scrutinise pay structures as opposed to regulation of further government intervention.
    - Executives are not incentivised to plan succession – Too often pay structures are designed only to incentivise an individual while they hold a job, rather than incentivising them to plan for succession and the long-term success of the company. CEOs should be incentivised to develop the next generation of leaders in the company, who can take over when they leave. CEOs should also be incentivised to pass the company on in a condition ready for long-term success.
    - Lack of transparency – Despite recent progress, there is too little transparency around executive pay, especially on the rationale for why an individual is paid a certain amount. This creates the public perception that executives are setting their own pay. Executive pay disclosure, while improving in recent years, still had a long way to go. For example disclosure generally explains the 'how' and ignores the 'why'.

- According to the UK Corporate Governance Code, "Executive directors' remuneration should be designed to promote the long-term success of the company. Performance related elements should be transparent, stretching and rigorously applied." However, this does not always happen. As such, we would recommend the following potential solutions to the government:
    - It could be argued that awards need to have a concrete value at the time the award is made. If the intention is to keep LTIPs, they need to be revised. In practice this would mean those shares given in 2016, whose value is determined by a 5 year cumulative performance against targets set 5 years ago, would then need to be held for another 5 years. This would ensure that the market is certain about the value of everything an executive is paid in 2016 and that the LTIP component is based on something that has actually been delivered. It is important to note that corporate performance is largely a by-product of the economic cycle. A 5 – 10 year period would normally cover part or all of an economic cycle and is likely to feature a difficult economic period which would of course effect the performance of listed companies.

- Annual bonuses should be based on metrics determined by the Board and agreed by shareholders on the basis that these awards represent the inputs that, if achieved consistently, are the key drivers of long-term sustainable wealth creation.
- We need to consider the origins of why bonuses and LTIPs are paid. Of course it should not be forgotten that the major reason for LTIPs was to link pay with performance. However, one of the underlying reasons behind the current incentive programme is that people are fearful that the base salary, which should be paid for the job, would be deemed as totally unacceptable to shareholders and the media. Consequently, companies have dressed it up as a bonus or LTIP. This has fuelled much of the public anger surrounding executive pay.

Strengthening the Stakeholder voice

Britain's corporate governance regime – indeed, good quality corporate governance across the piece – relies on active, engaged shareholders and high quality boards. The IoD exists in part to promote just those two outcomes. But we, too, recognise that corporate governance goes beyond simply those to whom legal obligations must be met, but also to stakeholders beyond that narrow group – stakeholders who include the public, of course, but most specifically employees of individual companies.

We have contributed to the Cabinet Office consultation into mission-led businesses, and indeed many of our younger entrepreneurs are actively considering 'B-corp' accreditation, to put their commitment to stakeholders at the very heart of their business offering.

- There has been much public discussion around the possibility of mandating that large listed companies must include an employee on their board. While we feel that direct employee representation is appropriate for some firms, and the Government should encourage *all* firms to investigate how appropriate such a move would be, we do not feel that legislation mandating such a significant change to board structures in the UK is needed at this point in time.
- This is a very important area and it is vital that the Government considers the ramifications of any path it chooses, and - with particular regard to the idea of employees on boards – this includes the legal dimension. [4]
- Broadening the pool of potential directors will always provide a useful antidote to groupthink, but the crucial question is: what will having worker representatives on

[4] A part of this, but also a separate topic is the requirement/practicality of a preventing an employee representative from representing/pushing sectional interests. By this, we do not just mean representing a union, but (perhaps) a geographical or trade bias.

the board achieve? There is little point in simply electing a "worker" to the board if they are subsequently cut out of all the strategically important discussions. Moreover, it is important that the principle of unitary boards is maintained. Collective responsibility is as fundamental to a company as it is to a cabinet. But it will be vital that employee board members recognise that their obligation is to the company and its stakeholders as a whole, not just to the sector from which they come.

- Over the coming months, corporates in particular must engage with the government to look at how this might work in practice and whether it would, crucially, create better engagement with the workforce, without limiting the effective functioning of the board. Currently, directors have a responsibility to consider all stakeholders, including suppliers and customers, as well as employees. The Government will, therefore, have to determine whether this responsibility also applies to employee representatives, or if they will have a different status. It appears that this idea is being driven in part by concerns about executive pay, so one place to start might be to introduce workers to the remuneration committees. If the initiative starts out voluntarily, this will help boards to adapt.
- It is important to remember that worker representatives are not a completely new idea. The two tier board system in Germany allows for worker representatives and has done for many years. If the decision is taken to support this initiative, it will be crucial for worker representatives to be given training before they take up their seat on how to be an effective and good director, and the way in which boards function. In this way, they can be prepared to make the transition from their day-to-day jobs to fully participating members of the board of their company.
- It is also worth remembering that what works abroad – such as Germany – may not necessarily translate to a different culture and different economy. The most obvious point which Government should be aware of is that while many unions are focussed explicitly on the welfare of their members and remain focussed on that task in an apolitical fashion – we have, indeed, worked with the TUC on a recent joint letter to the Prime Minister on a corporate governance topic which falls slightly outside the scope of this consultation – there are other unions who clearly have elected to be louder, less constructive, and often deliberately political. Such an environment does not necessarily suggest that a 'workers on boards' initiative would be as trouble-free as some may think.

Corporate Governance in large, privately-held companies

Clearly, the recent highly-publicised scandals at BHS has shown that there are, in some cases, privately-held firms who are not governed in a way that the public expect and employees deserve. We would urge Government to carefully consider the IoD's already-existing guidance for unlisted companies, which recognises principles of good governance that can be applied to firms of different sizes in different fields. We have submitted our *Corporate Governance Guidance and Principles for Unlisted Companies in the UK* to this consultation under separate cover, and would be keen to discuss with Government whether the code could be adopted on a UK-wide, Government-backed level.

- There needs to be greater focus on the governance of unlisted firms, but you cannot easily create a one size fits all approach for both private and public companies. Any additional guidance or regulations introduced for the unlisted sector must only apply to those companies above a certain size, but this needs to be considered carefully and engagement with a range of stakeholders must take place before anything is adopted. **The government should be wary of developing a code for *all* private companies that would force small and micro-entities to adopt a governance model. This would not be right for their business model.**
- It is of course important to note that of the UK's millions of registered companies, most are not listed or quoted on tradable equity markets. The overwhelming majority are SMEs or start-up companies that remain under the ownership and control of the founder or founding family. Such unlisted enterprises are of course the backbone of the UK economy. They account for a significant proportion of its GDP and employment. Furthermore, they are a key source of dynamism and entrepreneurial spirit. Their potential contribution to any economic recovery should not be underestimated. The financial crisis provided a stark reminder of the need for a robust governance framework in the global banking sector. However, good governance is not only relevant for financial institutions and large listed companies. The IoD is convinced that appropriate corporate governance practices can contribute to the success of UK companies of all types and sizes, including those that are unlisted or privately held.
- In 2010 the IoD published *Corporate Governance Guidance and Principles for Unlisted Companies in the UK*. This document includes fourteen principles of good governance and is presented on the basis of a dynamic phased approach. This takes into account the size, complexity and level of maturity of individual enterprises. Unlisted companies – such as founder and family-owned businesses – can utilise this stepwise framework to ensure their long-term sustainability, to bring external parties to their boards, to attract funds, and to solve issues between shareholders and other stakeholders.

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?*

This is a very important question and it will be imperative the government strikes the right balance between giving shareholders more say over pay and not creating further unnecessary regulatory burdens for companies. It is important to note that the current pay policies (applicable to the FTSE) have only been in place for a few years and have not been given enough time to take effect. Whilst one or two bad cases are shining a light on the current system, it is important the government does not overreact. I would therefore advocate 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*). Companies need to do more before a pay vote and when a significant majority vote against pay policies.

That said it is important companies are reminded of their present obligations as set out in both the Code and in the law.[5] Should we see further cases of CEOs receiving relatively large salaries despite poor company performance and shareholder disquiet, the Government would then be within its right to look at whether more can be done.

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?*

There is no doubt that engagement between investors and boards have improved over the last 5 years. However, it is crucial that the government does more to promote the effective stewardship of companies by institutional investors.

As such, Option iii seems the most appropriate choice at this stage. It is important both the government and the Financial Reporting Council consider ways to facilitate or encourage

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[5] In particular we would refer the government to Section 172 of the Companies Act (2006) which states: A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to— (a)the likely consequences of any decision in the long term, (b)the interests of the company's employees, (c)the need to foster the company's business relationships with suppliers, customers and others, (d)the impact of the company's operations on the community and the environment, (e)the desirability of the company maintaining a reputation for high standards of business conduct, and (f)the need to act fairly as between members of the company.

individual retail shareholders to exercise their rights to vote on pay and other corporate decisions. In particular, it will be imperative the FRC immediately reviews the effectiveness of the UK Stewardship Code and the recent decision to tie signatories. More needs to be done by the FRC to encourage greater dialogue between investors and boards ahead of AGMs and on crucial pay votes. [6]

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?*

Much has been written in recent years about the effectiveness of remuneration committees and their relationships with advisers. Investors need to be confident that remuneration committees have the ability to make the right long-term decisions for the company.

To do this the chairman and members of the remuneration committees need to have the appropriate knowledge of the business. Committees should also think about appointing members that have a more diverse background and are prepared to challenge the status quo. Remuneration Committees need to be more accountable for the decisions they take. They need to ensure that remuneration outcomes are fully aligned with overall business performance and strategy. Discretion should be used, both upwards and downwards rather than committees relying on formulaic outcomes. Company Annual reports should include the total payment to the firm that provides advice to Remuneration Committee, not just the payment for advice on remuneration – this follows the practice used for auditors.

Companies should move away from a “one-size fits all” remuneration model: remuneration structures should be more tailored to the individual needs of the business and company strategy, moving away from the use of median comparators and “remuneration creep”. Remuneration Committee areas of judgement and discretion would include the required percentage share ownership for executives – e.g. 100% of annual total remuneration, including bonuses and LTIP’s, which could be 500% or more of base pay – and the division of remuneration between fixed salaries, short-term bonus (where appropriate: these are not especially closely-aligned to shareholder interests) and long-term restricted shares.

[6] Many institutions vote on the advice of their proxy advisor. As the UK is a “comply or explain” regime, this is arguably dysfunctional. Some large advisers (a) mechanically apply a tick box methodology and (b) will not engage in a dialogue with target companies.

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.*

We are broadly supportive of pay ratios: companies are clearly going to have to get used to more transparency around executive pay. Publishing the ratio alone will tell investors and other stakeholders little and the key thing will be to agree the formula used to calculate it and provide an adequate explanation around what the figures mean. Companies are clearly going to have to get used to more transparency around executive pay, and pay ratios will be a part of that increased transparency. **However, publishing the ratio alone will tell investors and other stakeholders precious little; such a hard-and-fast calculation, producing a single number, could also produce perverse incentives to scale pay up or down depending on the individual circumstances.** Much, too, has been made of the fact that large retail firms – particularly the supermarkets – will appear to be 'worse' at controlling executive pay than, say, investment banks, where the average salary is higher.

That does not mean that either is better or worse, but by publishing a single number, that is *precisely* the media narrative that will be created. It is inevitable that 'league tables' and other such rankings would be produced, which would move us further away from the executive pay principles as listed in the Corporate Governance Code.

If the Government continues on this path, we would urge a significant period of consultation to agree the formula used to calculate the pay ratio, and to allow firms the space to explain what the figures mean.

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?*

It is important to note that the disclosure of performance targets alone, no matter how detailed, will not in itself rein in bonus payments. It is more important to focus on the performance targets themselves ensuring they are high achieving and rigorously applied, as required by the UK Corporate Governance Code. Focus should be given to ensuring shareholders engage more directly with boards on performance targets in advance of them being disclosed.

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?*

LTIPs are intended to motivate executives to achieve certain goals over the long term. They are designed to provide long-term alignment between executives and shareholders. Setting long-term (usually three year) performance targets is intended to incentivise management to ensure they are implementing the chosen business strategy and taking the right long-term decisions. The payment of LTIPs in shares also aligns the executive's interests with shareholders and requires them to think like owners.

The IoD believes that companies should move to a more flexible executive remuneration structure. A company's remuneration structure should be considered on the basis of suitability for that business. The company will then have to explain and justify why a different approach is appropriate to shareholders. Flexibility means that boards are expected to use their knowledge of the company to choose a structure which will act in the long-term interests of the company.

According to the Investment Association, a consensus is forming around greater flexibility. According to the IA, *"increased flexibility in the system would be beneficial, as the consequences of companies using inappropriate remuneration structures have been the growing complexity of performance targets and rising quantum."*[7]

Strengthening the employee, customer and wider stakeholder voice

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?*

This is a very important question and the government may find it appropriate to look at ways to ensure the views employees, customers and other stakeholders are represented at board level. Broadening the pool of potential directors will always provide a useful antidote to groupthink, but the crucial question is: what will having worker or customer representatives on the board achieve? For example, there is little point in simply electing a "worker" to the board if they are subsequently cut out of all the strategically important

[7] Please refer to the earlier points made in this paper for clarification about LTIPs.

discussions. Moreover, it is important that the principle of unitary boards is maintained. Collective responsibility is as fundamental to a company as it is to a cabinet. But it will be vital that employee board members recognise that their obligation is to the company and its stakeholders as a whole, not just to the sector from which they come. Over the coming months, corporates in particular must engage with the government to look at how this might work in practice and whether it would, crucially, create better engagement with the workforce, without limiting the effective functioning of the board.[8]

Currently, directors have a responsibility to consider all stakeholders, including suppliers and customers, as well as employees. The government will, therefore, have to determine whether this responsibility also applies to employee representatives, or if they will have a different status. It appears that this idea is being driven in part by concerns about executive pay, so one place to start might be to introduce workers to the remuneration committees. If the initiative starts out voluntarily, this will help boards to adapt. It is important to remember that worker representatives are not a completely new idea. The two tier board system in Germany allows for worker representatives and has done for many years.

If the decision is taken to support this initiative, it will be crucial for worker representatives to be given training before they take up their seat on how to be an effective and good director, and the way in which boards function. In this way, they can be prepared to make the transition from their day-to-day jobs to fully participating members of the board of their company.

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?*

N/A

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.*

The IoD would strongly caution against introducing further legislation or codes in this area. Companies must strive to increase the voice of employees and other stakeholders but this must be encouraged on a voluntary basis, along the lines of the government's approach to women on boards. We support option iv (strengthening reporting requirements related to stakeholder engagement). Should explanations not meet requirements, further action by regulators and government could then be introduced.

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[8] Irrespective of what solution is advocated by the government all board members must comply with the requirements as set out in Section 172 of the Companies Act 2006.

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?*

There needs to be greater focus on the governance of unlisted firms, but you cannot easily create a one size fits all approach for both private and public companies. Any additional guidance or regulations introduced for the unlisted sector must only apply to those companies above a certain size, but this needs to be considered carefully and engagement with a range of stakeholders must take place before anything is adopted. Developing a code for all private companies would not be appropriate and would force small and micro-entities to adopt a governance model which would not be right for their business model.

It is of course important to note that of the UK's millions of registered companies, most are not listed or quoted on tradable equity markets. The overwhelming majority are SMEs or start-up companies that remain under the ownership and control of the founder or founding family. Such unlisted enterprises are of course the backbone of the UK economy. They account for a significant proportion of its GDP and employment. Furthermore, they are a key source of dynamism and entrepreneurial spirit. Their potential contribution to any economic recovery should not be underestimated. The financial crisis provided a stark reminder of the need for a robust governance framework in the global banking sector.

However, good governance is not only relevant for financial institutions and large listed companies. The IoD is convinced that appropriate corporate governance practices can contribute to the success of UK companies of all types and sizes, including those that are unlisted or privately held.

In 2010 the IoD published Corporate Governance Guidance and Principles for Unlisted Companies in the UK. This document includes fourteen principles of good governance and is presented on the basis of a dynamic phased approach. This takes into account the size, complexity and level of maturity of individual enterprises. Unlisted companies – such as founder and family-owned businesses – can utilise this stepwise framework to ensure their long-term sustainability, to bring external parties to their boards, to attract funds, and to solve issues between shareholders and other stakeholders.

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?*

This is a fundamental question and one that requires careful consideration by the government. It is important that additional regulatory burdens are not placed on firms, especially those smaller companies looking to grow. That said government has an obligation to highlight the importance that high standards of corporate governance plays for all businesses throughout their life-cycle.

The IoD supports a phased approach. Reflecting the diversity of unlisted companies, this approach takes into account the specific nature of a company in terms of size, complexity and maturity.

Based on our guidance for unlisted companies, phase 1 would apply to all kinds of unlisted companies, regardless of size or level of complexity. Comparatively, phase 2 principles are more sophisticated corporate governance measures that are relevant to larger or more complex unlisted companies. They may also be considered by unlisted companies that are seeking to prepare themselves for a future public listing.

Any guidance or code for the unlisted sector should only be introduced on a voluntary or "comply or explain" basis.

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

We would urge the government to approach any governance reform, in the unlisted sector, on a voluntary basis rather than legislation.

Compliance could be monitored by way of a corporate governance statement, based loosely on what is required within the FTSE 350. Private companies would be required to produce an annual statement on governance which sets out which governance principles they have complied with.

A regulator or review body would then be tasked with reviewing the statements in order to check on compliance levels. As the green paper explains, the approach undertaken by the BVCA with respect to disclosure and transparency in private equity is one such example of how this might work.

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?

This is a crucial question which will require considerable thought. The IoD believes that all non-financial reporting requirements should not create additional burdens on firms but that greater consideration of governance by unlisted companies is important. Broadly speaking we would wish to see both turnover and employee numbers considered.

Other issues

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?

The government and the Financial Reporting Council both have an obligation to ensure that non-executive directors at our largest listed and unlisted companies are adequately trained. Little credence has thus far been paid to this matter and yet it remains a crucial issue. At the moment, the UK Corporate Governance Code pays little attention to the importance of this and merely states that all directors should “regularly update and refresh their skills and knowledge”. Regardless of their years of experience all directors should have their skills regularly refreshed, which will help them to understand the latest legal and regulatory parameters as well as understanding their role, responsibilities and limitations at board level.

We have called on the Financial Reporting Council and the Bank of England to place more emphasis on the professional development of directors, which the IoD can of course support. Regulators have paid little attention to this important topic; however, we would urge the committee to consider the benefits of regular training and development for NEDs.

The IoD can provide particular guidance here in the form of our recently published Director Competency Framework. This framework outlines the knowledge, skills and mind-set we believe to be the essential requirements for effective board performance, and which every director can use to guide their professional development.

We believe this framework is a significant contribution to establishing a recognised set of professional standards for directors, and is particularly notable for its broad application across sectors and industries and to any role on the board. It incorporates knowledge of director duties and compliance but goes beyond this in recognising the importance of interpersonal skills, ethical behaviour and a professional mind-set in delivering good governance.

The government can gain enormous benefit from utilising the guidance that can be provided by professional bodies such as the IoD, which are dedicated to and experienced in working with directors and which understand what directors need to effectively fulfil their responsibilities.

We hope you have found our comments helpful. If you require further information about our views, please do not hesitate to contact us.

Kind regards,

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SECONDARY EVIDENCE

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Department for Business, Energy and Industrial Strategy
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15th February 2017,

To whom it may concern:

Thank you for giving the Institute of Directors the opportunity to respond to this consultation. We have submitted a formal response to the Consultation from an IoD perspective. We felt it worthwhile however to submit secondary evidence, taken from recent IoD surveys, to provide quantitative information on corporate governance which may help to inform the review.

Each month, the IoD surveys members through our online Policy Voice panel. The panel is an opt-in group of around 3,500 members with a response rate of around 25-33 per cent. We survey on a number of business issues, including a series of tracking questions.

In December 2016 and January 2017, we surveyed on questions around corporate governance. A précis of the results of these surveys is below.

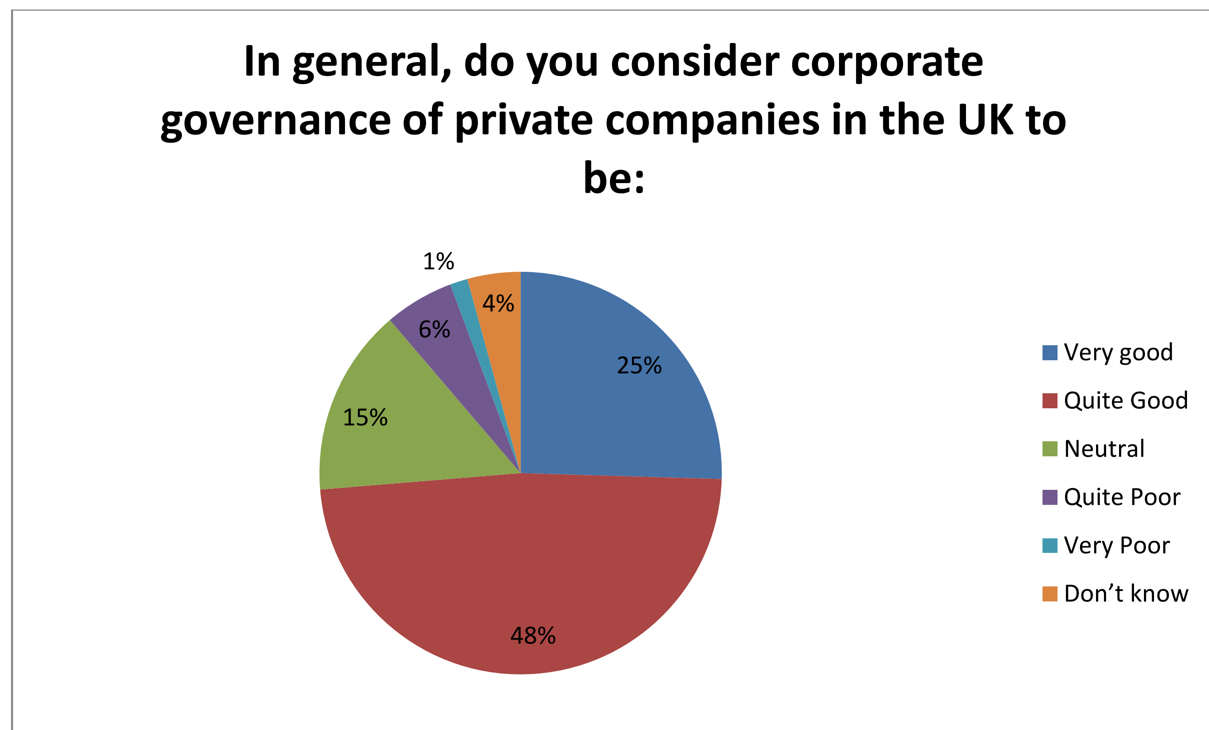
The key findings can be summarised as:

- Just under three-quarters (73%) of IoD members believe UK corporate governance, in comparison with other developed countries, to be either 'quite' or 'very good'; only 7% feel it is poor
- Out of four options proposed which could have a material impact on corporate governance in the UK, two were felt to enhance governance significantly, one was felt to be broadly balanced, and one would diminish the quality of corporate governance
    - A statutory requirement to give one Director responsibility for employee engagement (+44 rating) and a code of conduct for large unlisted companies (+63) were both felt to be significant boons
    - Placing an employee on remuneration committees in large listed and unlisted companies had a small (-2) negative rating
    - Compulsory workers on boards was felt to diminish corporate governance (-28 rating)

- More than half micro-sized firms do not follow any formal corporate governance code, and almost half of small- and medium-sized firms are in a similar position. In general, there is a greater prevalence of formal corporate governance guidelines and adherence to a formal code amongst larger companies.

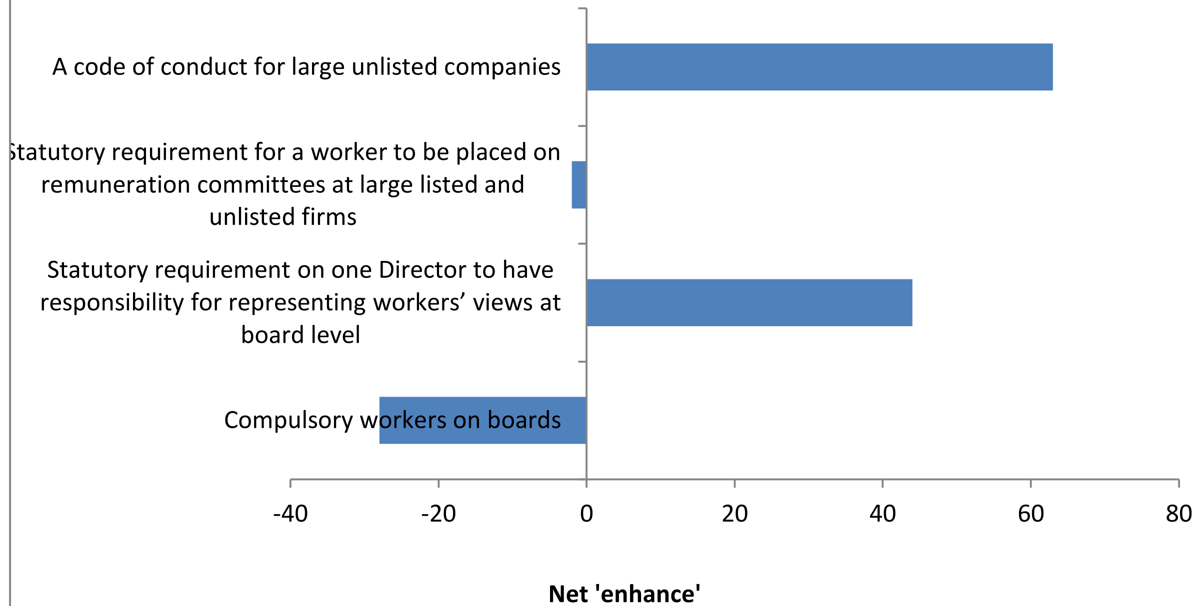
In comparison with other developed countries, in general, do you consider corporate governance of private companies in the UK to be:

Very good	25%
Quite Good	48%
Neutral	15%
Quite Poor	6%
Very Poor	1%
Don't know	4%
Total responses	844



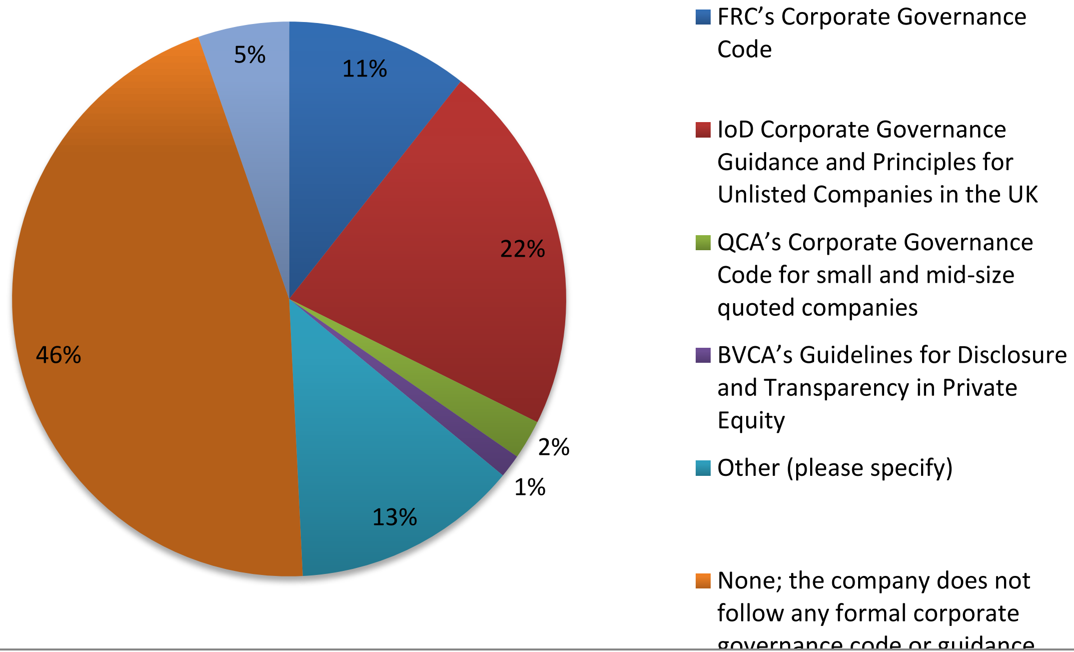
Do you think the below measures would enhance, diminish, or make no difference to the overall quality of corporate governance of private companies in the UK?

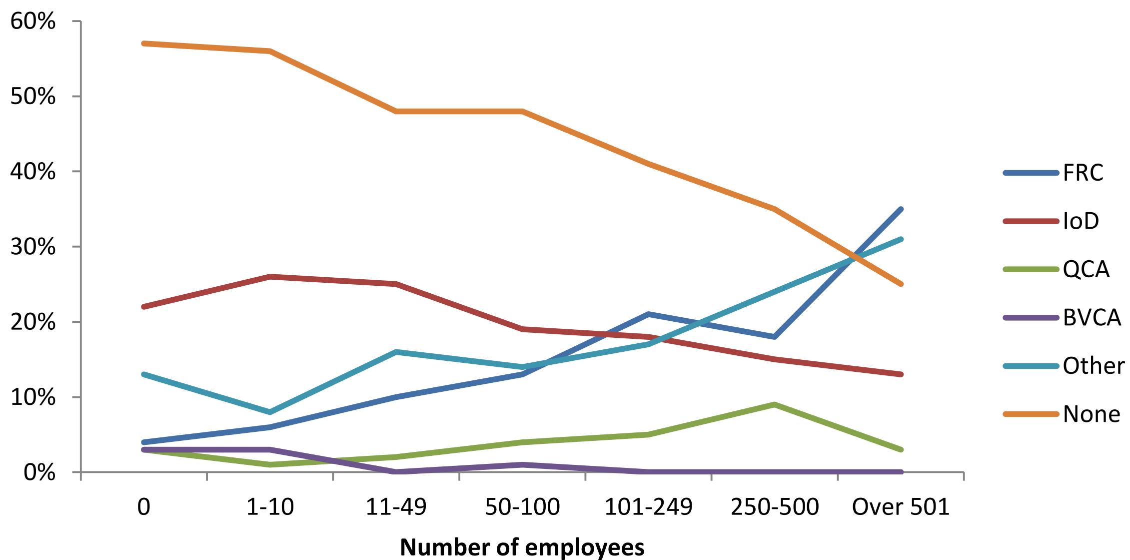
	Compulsory workers on boards	Statutory requirement on one Director to have responsibility for representing workers' views at board level	Statutory requirement for a worker to be placed on remuneration committees at large listed and unlisted firms	A code of conduct for large unlisted companies
Enhance	19%	52%	28%	67%
Diminish	37%	8%	30%	4%
Make no difference	39%	36%	32%	25%
Don't know/Not applicable	6%	3%	10%	4%
Net Enhance	-28	44	-2	63



Do you follow any formal corporate governance code or guidance?

Number of employees		0	1-10	11-49	50-100	101-249	250-500	Over 501
	Total							
FRC's Corporate Governance Code	**11%**	4%	6%	10%	13%	21%	18%	35%
IoD Corporate Governance Code	**23%**	22%	26%	25%	19%	18%	15%	13%
QCA's Corporate Governance Code for small and mid-size quoted firms	**2%**	3%	1%	2%	4%	5%	9%	3%
BVCA's Guidelines for Disclosure and Transparency in Private Equity	**1%**	3%	3%	0%	1%	0%	0%	0%
Other	**14%**	13%	8%	16%	14%	17%	24%	31%
None: the company does not follow any formal corporate governance code	**49%**	57%	56%	48%	48%	41%	35%	25%
Don't know	**6%**	6%	5%	5%	8%	8%	9%	7%


Do you follow any formal corporate governance code or guidance?
5%
11%
22%
2%
1%
13%
46%
FRC's Corporate Governance Code
IoD Corporate Governance Guidance and Principles for Unlisted Companies in the UK
QCA's Corporate Governance Code for small and mid-size quoted companies
BVCA's Guidelines for Disclosure and Transparency in Private Equity
Other (please specify)
None; the company does not follow any formal corporate

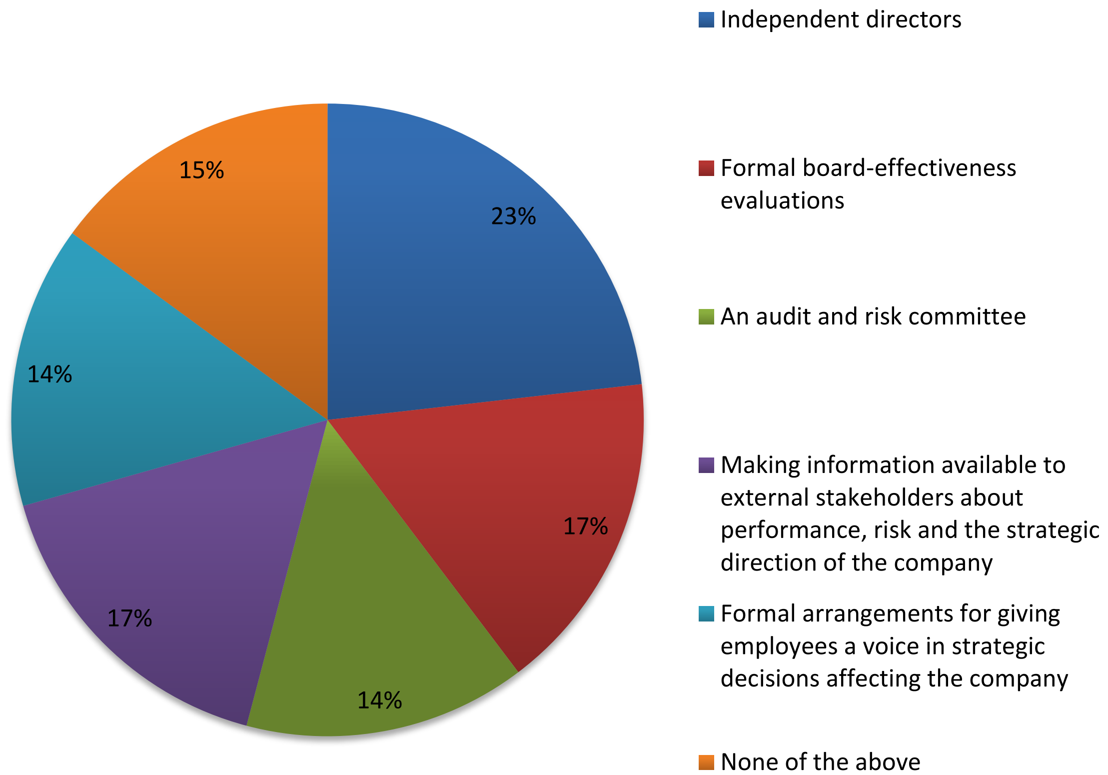

Do you follow any formal corporate governance code or guidance
60%
50%
40%
30%
20%
10%
0%
0
1-10
11-49
50-100
101-249
250-500
Over 501
Number of employees
FRC
IoD
QCA
BVCA
Other
None

IoD Inspiring business

Which of the following do you consider to be important corporate governance features that help support the success of your company?

Number of employees	Total	0	1-10	11-49	50-100	101-249	250-500	Over 501
Independent directors	**45%**	37%	40%	41%	52%	50%	65%	64%
Formal board-effectiveness evaluations	**32%**	25%	24%	35%	40%	33%	41%	47%
An audit and risk committee	**28%**	27%	20%	19%	32%	36%	59%	55%
Making information available to external stakeholders about performance, risk and the strategic direction of the company	**32%**	25%	26%	23%	46%	39%	59%	63%
Formal arrangements for giving employees a voice in strategic decisions affecting the company	**28%**	10%	27%	34%	27%	23%	29%	32%
None of the above	**29%**	49%	34%	29%	21%	23%	9%	9%

Which of the following do you consider to be important corporate governance features that help support your company?



We hope this evidence is useful as part of the policy formulation process and are happy to discuss the findings in greater detail.

Yours sincerely,

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