

Business, Energy and Industrial Strategy Committee

Oral evidence: Corporate Governance, HC 702

Tuesday 15 November 2016

Ordered by the House of Commons to be published on 15 November 2016.

Watch the meeting

Members present: Mr Iain Wright (Chair); Richard Fuller; Peter Kyle; Amanda Milling; Anna Turley; Kelly Tolhurst; Amanda Solloway; Chris White.

Questions 1-72

Witnesses

I: Janet Williamson, Senior Policy Officer, Economics and Social Affairs Department, Trades Union Congress, Oliver Parry, Head of Corporate Governance, Institute of Directors, and Stephen Haddrill, Chief Executive Officer, Financial Reporting Council.

II: Alex Edmans, Professor of Finance, London Business School, Mike Everett, Governance and Stewardship Director, Standard Life Investments, Peter Montagnon, Associate Director, Institute of Business Ethics, and Jonathan Chamberlain, Employment Lawyers Association.

Written evidence from witnesses:

– [Add names of witnesses and hyperlink to submissions]

Examination of witnesses

Witnesses: Janet Williamson, Oliver Parry, and Stephen Haddrill.

Q1 **Chair:** Good morning. Thank you for coming to attend this Select Committee on corporate governance. We have an awful lot to get through today, so I am hoping to be as concise as possible, both in the questions and the answers. For the purposes of the record, could you each introduce yourself and tell us the organisation you are representing, starting with you Janet?

Janet Williamson: I am Janet Williamson. I am a Senior Policy Officer at the TUC.

Oliver Parry: I am Oliver Parry. I am Head of Corporate Governance at the Institute of Directors.

Stephen Haddrill: I am Stephen Haddrill. I am Chief Executive of the Financial Reporting Council.

Q2 **Chair:** May I ask each of you whether there is a problem with corporate governance in the UK? If there is, what particular aspects of governance are there problems with? Let us start with you, Stephen.

Stephen Haddrill: Corporate governance in the UK is strong in many respects and has worked well for investors. It is highly regarded internationally and the flow of international investment into the UK that we very much depend upon is some testimony to that. However, there is a problem and the problem is public confidence in business and the integrity of business. That needs to be addressed. The way it needs to be addressed is by invigorating the provisions in the Companies Act that ask directors or place a duty on directors to pay attention to stakeholders, other than the shareholder.

Q3 **Chair:** What does “invigorating” mean in that context?

Stephen Haddrill: First of all, companies should report on how they have gone about fulfilling their duties in that regard. They do not at the moment; there is very little in that respect in terms of reporting. That would give us, as the FRC, the ability to scrutinise what they have said and call them to account if we do not feel they have really justified their position. That would require some change in our powers, but it is really through a reporting mechanism that we think the first step could be taken.

Oliver Parry: Broadly speaking, corporate governance in the UK is pretty strong, especially in the listed sector. There are some concerns from investors and bodies like the IoD about high pay, in particular executive pay. Pay has clearly ratcheted up over the years. There seems to be a disconnect between those at the bottom and those at the top, and clearly for the vast majority of people in the country, when they look at what our highest paid CEOs earn, it seems quite extreme. If you



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look at the steps and the improvements that have been made in Government in the last decade through the code and the FRC, significant progress has been made. I would certainly say in the area of executive pay there is an issue.

On the unlisted sector, that is a little bit of an area that none of us know about. Clearly the issue at BHS and Arcadia has highlighted issues around corporate governance. That needs to be investigated further. I do not know how strong corporate governance is in the unlisted sector, which is why it is so important that we look at it.

Janet Williamson: There are strengths in the corporate governance system in the UK, but there are also significant weaknesses. Much of the focus of corporate governance in this country is on the relationship between the company and its shareholders. There is an insufficient focus on the relationship between the company and the rest of its stakeholders, and indeed on the interests and the success of the company over the long term. The problem we have seen of executive pay is part of a wider problem. The corporate governance system in this country also has contributed to endemic short-termism, which has affected our productivity, which is notoriously low in this country. It was low before the financial crash and has been low ever since. It has not recovered. One of the factors behind that is corporate governance.

Q4 Chris White: Good morning. What do you see as the direction of travel in terms of governance and in terms of culture? Do you see businesses becoming more interested in things like their corporate social responsibility and social value? Do you see these things becoming more important compared with just a money-making motive for a business? I would also be interested to know whether you think there should be legislation in place to speed up this shift.

Stephen Hadrill: You referred to culture in business. That is an element that has perhaps not been paid sufficient attention, because you can have an excellent regulatory regime but there will always be attempts to get around it. If the corporate governance code requires the board to set values and culture for the business, then we have to see that that is driven through the business. Particularly with increasingly large multinational businesses, where what is going on in the far-flung parts of the empire is not necessarily seen at the board, the board needs to establish a strong, consistent culture throughout the business that is there on behalf of the employees, consumers and stakeholders of the company in the round. We published a report recently on meeting culture and that has to be a big part of the message.

It is consistent with that for a company to be paying attention to the quality of its interaction and the contribution of its interaction with the community at large. If you are not doing that, you are probably not living a culture that is sensitive to the interests of a wide group of stakeholders.



Q5 **Chris White:** Before the other two come in, do you think that is a function of legislation or do you think this should be consumer-driven?

Stephen Haddrill: It should be driven by boards, respecting the provisions of the corporate governance code. We can look at whether the code needs to be strengthened in that regard. Legislation to drive culture is not something that would work. The other piece that can drive it, though—and we are starting to see this, though it is a slow burn—is the interest of investors in the culture of the business. Investors have increasingly seen that businesses with a bad culture lead to them losing money. Reporting to investors around the culture that the board is looking for is important and only a very small proportion of companies do report on what they are looking for in terms of their own culture, how they are measuring it and so on. That is another driver that ought to be explored.

Oliver Parry: This is a very important question. I find it curious that the regulatory system is now looking at culture; my view has always been that we should have looked at culture in 2008-09. Instead, what you found were regulators and politicians regulating. Suddenly, reports from HBOS and RBS come out and there is a big cultural issue at the top of the organisation. It is the wrong way round. It is certainly right what the FRC are doing.

Who should it be driven by? Primarily the power lies with shareholders. Shareholders have to apply pressure to the boards, engage with boards regularly, above and beyond their AGMs. Equally, it is a two-way street; boards should be doing exactly the same, living and breathing it. There is one underlying point. We have, certainly in the FTSE 100 at least, developed a very compliance-driven mind-set. You have a code system, you have mountains of regulations on companies—not just banks but all FTSE 100 companies have to deal with. You get the impression there is a lot of box ticking going on.

I would like to go back to what Sir Adrian Cadbury said 25 years ago: that governance is more about behaviours. It is quite possible that you can tick every box in the UK corporate governance code, which includes aspects about CSR, but still there can be massive corporate governance failing. That shows that it is beyond compliance. While the project on culture is absolutely welcome, we have a long way to go. It is much more than just ticking boxes.

Janet Williamson: There is a problem with the culture of corporate governance. I would agree with Stephen that, to some extent, the change there should be led by company boards, but I do believe that boards, in order to do that, should be differently constituted from how they are at present, and there should be a greater range of voices on company boards. Notably, workers should have their voice represented on company boards.



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That would be an excellent way of creating a different culture in the boardroom and one that is more long-term in its orientation, which is better equipped to promote good working relationships and which has been shown, time and time again, to be essential for raising productivity and profitability within companies.

Survey evidence from countries where worker board representation is in place show that worker representatives are more likely to have regard to CSR aspects, environmental impacts and that kind of thing. While you cannot legislate culture per se, you can use regulation to change the institutional framework within corporate governance in a way that would effectively bring around the kind of culture change we need to see.

Q6 Chris White: Would the workers on boards piece of legislation that you have mentioned be sufficient to create a paradigm shift in the way that businesses work?

Janet Williamson: If it was done properly it could make a significant contribution. Is it the only change that we would like to see in terms of bringing around that cultural change? No. We believe that regulatory change in terms of directors' duties would be extremely desirable as well.

Q7 Chris White: Would you suggest that a business that is seen and perceived by the public to be one that embraced corporate social responsibility would be a business that would be more profitable and more productive?

Janet Williamson: There is a strong case that by following what you can call the high road of business—investing in long-term relationships with your stakeholders, investing in training and in R&D—and not following a hire-and-fire low-skilled route, you can be a more successful company in the long term. Is that sufficient to mean that companies will always follow that road? No, it is not. We have the evidence before us. We have seen companies throughout a whole range of different sectors in the UK who do not follow that path. There is a very good business case to be made for following the high road and that the role of corporate governance should be to encourage companies to take that path, rather than the low road to profitability.

Oliver Parry: Dealing specifically with companies, I do not think you can necessarily legislate on CSR. It is really about engaging with powerful fund managers and the institutional guys that hold all the money in these companies. That is crucial. Most of the largest fund managers in the UK have pretty well equipped CSR and ESG functions that are able to engage with boards. I will say it again: it is a two-way street and you require dialogue from both sides.

Stephen Haddrill: I wanted to pick up on what Janet was saying towards the end of her remarks. She talked about corporate governance driving long-termism in addition to regulation. The corporate governance code itself does have a focus on the responsibility of the



board to work for the long-term success of the company. I know Janet has a concern that that comes across in the legislation as a secondary thing, but it is very much a primary thing in the corporate governance code. It is something we have driven into other parts of the corporate governance code, for instance in the remuneration section. Where we used to say that remuneration was about retention and recruitment, we are now saying it is about building long-term value. I will pick up on the workers on the board point, if you like. Do you want to come to that later?

Chair: Can we come back to that?

Stephen Haddrill: Yes, by all means.

Q8 **Chair:** Stephen, you have talked both in oral session and in your written evidence about having more stringent reporting requirements in the code. Why have you not done that yet? What has been holding you back?

Stephen Haddrill: We have had a big wave of change in reporting. We introduced much fuller audit committee reporting about four or five years ago. We have had the introduction of the longer-term viability statement, very much to drive this long-term focus. Frankly, we have not given sufficient thought or appreciation to the company's wider responsibilities beyond the shareholder. We have been focused very much on their responsibilities to investors. Frankly, what has happened over the last couple of years and more recently is a bit of a wakeup call to all of us. We do need to focus on that stakeholder issue. Section 172 has been there, but it has not borne on thinking in companies and it needs to.

Q9 **Amanda Solloway:** Talking about Section 172 and thinking about intervention and non-intervention, I wondered to what extent the requirements influenced behaviour in practice and whether they are well known to directors.

Janet Williamson: There was a survey that was carried out a few years ago that showed a large proportion of directors were not particularly aware of Section 172 and that a lot of directors did think that their prime duty was to promote shareholder financial value. Clearly, to that extent, the duties have not fully worked in the way that they were intended. They were intended to bring around something of a paradigm shift. Directors' duties are not, as everyone will be aware, enforceable in any way. They rely on having an exculpatory effect on directors' behaviour, rather than being something that is easily challengeable within the law.

The other issue with Section 172 is that there is a hierarchy of interests. The stakeholder interests are there and clearly formulated, but they are clearly secondary to the interests of shareholders. This creates a problem. When that wording was being formulated, it was under the understanding that there was a convergence in the long-term interests between shareholders, the company and other company stakeholders.



We have seen in the last decade the increase in share trading as a way of generating money through the stock market. In that scenario, if you are a share trader—a short-term share trader—your interest is in raising the share price of the company over the short term rather than in promoting long-term organic growth.

In that scenario, there seems to be a problem with having shareholders, including short-term share traders, as the group whose interest directors are required to serve above all others. We would recommend a formulation where directors are required to serve the long-term interests of the company as their primary aim and were also required to deliver fair and sustainable returns to shareholders; however, that would be secondary to the primary aim of promoting company long-term value. That is much closer to what the original intention behind that formulation was.

Stephen Haddrill: Your question was about what level of awareness is there of Section 172. We often tend to focus on the major public companies, but the Companies Act in this regard applies to all companies. In the private company sector, there is clearly very little awareness. In the lower half of the listed company sector there is probably little awareness as well. I hear that when talking to people who run training courses for directors and so on. They do not feel there is a high level of awareness. At the top end it is different; you have a strong company secretary function. I have heard of companies who have directors' duties highlighted at almost every meeting, but that is not typically the case.

Oliver Parry: I would certainly echo what Stephen said. It is good practice if Section 172 is printed out at the beginning of all board papers. It seems quite a simplistic thing to do, but it reminds company directors about their obligations and the law. That is important. At the top end of the listed sector, certainly there is strong awareness because you have a greater compliance structure and legal framework at the top that enables board directors to be aware of their obligations.

Section 172 clearly talks about the company, then it specifies what directors need to give regard to, which includes shareholders and other stakeholders. It is more about the Government—and perhaps this Committee as well—highlighting the importance of Section 172, which is largely fit for purpose, as I have said in my written evidence. It is about good marketing more than anything else.

Q10 **Amanda Solloway:** On that point, do you think the absence of successful prosecutions might have an influence on the success of Section 172?

Stephen Haddrill: You are quite right. There is an absence of prosecutions. Enforcement of the law is required for there to be respect for the law but there is not really an enforcement mechanism here. Enforcement is through the action of the shareholders but why are the



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shareholders going to enforce something that is there for the benefit of people who are not shareholders? The enforcement mechanism needs to be thought about.

I come back to the Chairman's point. Under the corporate reporting regulations we have the power to scrutinise and seek changes to the financial statements and to the strategic report, but much of what is said by the company in relation to corporate governance is elsewhere, including remuneration. We have no powers to scrutinise those parts of the annual report. That is just ridiculous. That needs to change.

Q11 **Chair:** Would you like that power?

Stephen Hadrill: Yes, because we could try to do it on a voluntary basis but it only takes one company to turn around and say, "We are not giving you that information," or "We are not going to explain to you why we did it in that way," and our credibility is shot out the water. That is very important.

Q12 **Chair:** Oliver, can I invite you to embarrass the person sat next to you? Do you think it is appropriate that the FRC has that power?

Oliver Parry: I should declare an interest of course because I am a former colleague of Stephen Hadrill.

Stephen Hadrill: Former.

Peter Kyle: Soon to be former friend.

Oliver Parry: The FRC has organically developed over time and it has picked up a number of responsibilities through the Companies Act. Remember, back in the 1980s it was the auditing and accounting standards board. Over time it has developed. On the regulatory side that Stephen talks about on reporting, yes, we would welcome that. There is a broader question about whether or not corporate governance will not then be swallowed up with other regulatory responsibilities. That would be my only point there.

Q13 **Amanda Solloway:** Following on from your point, Stephen, about shareholders, how effective are shareholders in enforcing in practice and what is it that stops them from being engaged in the process?

Stephen Hadrill: Shareholders focus on those things where they think there is a direct link with shareholder value or with the sort of pay out they are going to get, such as the strategy of the company, how it is pursuing that, its market circumstances, its performance, remuneration—because that is money that is not going into the shareholder's pocket—and the dividend. Frankly, this is the impact of the company more broadly, which is not seen as a priority given all the things that they do want to talk about.

Q14 **Amanda Solloway:** I am afraid there are more questions for you. Thinking of the calls for more stringent reporting, I wonder why it has



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not been done already. Is it something you should be doing now?

Stephen Hadrill: As I said, in the way we are talking about reporting on corporate governance, our powers are not developed in that area. The Government have not given us the ability to do that. That needs to be addressed and the regulations need to be changed.

Q15 **Amanda Solloway:** So you think there should be tougher reporting.

Stephen Hadrill: Yes.

Q16 **Amanda Solloway:** In what way?

Stephen Hadrill: In our ability to scrutinise the statements in relation to governance, remuneration and so on made by the company, and if we feel they are incorrect in some way or do not properly reflect what the company is doing, to be able to challenge them and seek a correction of them. We cannot do that at the moment. The whole governance system depends on the code and on the principle of "comply or explain", so the quality of the explanations is very important. If we had the sorts of powers I was talking about earlier, we could challenge those explanations, we could name and shame in relation to those explanations, and that would give information to shareholders to do their own challenging on the back of that.

Q17 **Amanda Solloway:** You report 9% compliance for FTSE 350 companies for all but one or two code provisions. How robust do you think this assessment of compliance is and what are the main areas of non-compliance?

Stephen Hadrill: It is robust. A lot of work has been done by Grant Thornton and has been validated by them. The question, which is a fair question, is about what the quality of that compliance is. Is it compliance on the letter or in the spirit of it? Non-compliance generally arises in relation to board composition where you perhaps have fewer independent members of the board than is desirable. We should have a majority of independent members. That will arise where there are particular ownership issues. For instance, if there is a major family shareholding or something like that then the number of independent directors is sometimes fewer than is generally sought for by the code. It is that sort of area where there is usually non-compliance.

Q18 **Amanda Solloway:** What steps are you taking to address the areas of non-compliance?

Stephen Hadrill: The code is "comply or explain". If companies explain that they do not wish to comply for certain reasons and the shareholders support that, that is how the system is supposed to work. We would not take action and, indeed, we do not have any powers to take action anyway in those areas. It is important that the explanations are true and fair, to use accounting terminology. At the moment, we do not really have the ability to test that.



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Q19 Amanda Milling: Thank you. I want to go back to one of Oliver's opening remarks, which was about the difference between publicly listed companies and private companies. The code applies to publicly listed companies. Do you feel that should be extended to private companies as well? If so, what size of company and how do you do this in reality? It is a question to all the panel.

Oliver Parry: The UK corporate governance code could not easily be transmitted to the unlisted sector just like that. You cannot do it. Stephen has mentioned that a lot of the amendments made to the code in the last six years have been giving shareholders more confidence in how boards are running. Clearly there is a difference to how companies are owned in the unlisted market.

The Committee should very carefully look at whether or not there should be some guidance for the larger unlisted companies. Some people have bandied around the idea of those with £35 million turnover a year with X numbers of employees. I suspect it should be a little bit higher and you certainly need to look at the number of employees as well.

We have our own unlisted guidance, which we published in 2010, which rather cleverly splits the guidance into two phases. The smallest unlisted companies would focus on phase 1 and, as they go through their business life cycle, would move on to phase 2. When it came out in 2010 and we published it with Deloitte it was well received but, again, a bit like Section 172 it has been forgotten. A lot has happened in the last six years. What we will be doing at some point is amending that guidance and republishing it next year. That is a good place to start. It does not necessarily have to be used, but it is the groundwork for something more substantial for the larger companies.

Q20 Amanda Milling: You say it does not have to be used; this is the question of whether you have to have something that is more formal because we can look at BHS as an example. How can you get this right in terms of it being there but companies not having to adhere to it?

Oliver Parry: What I meant about it being used is that you do not necessarily have to use our guidance. You could use that as a basis. If some guidance is going to be adopted for the larger unlisted firms, then it should apply to all of those larger unlisted firms. The question comes to the reporting mechanisms. At the moment, how do we get those companies to report on their corporate governance? Is it as simple as asking them, through regulatory changes, to produce a corporate governance statement?

The problem then is that you will have a lot more than 350 companies that the code applies to dealing with this guidance. Which regulatory body is then able to check that? You potentially would have a few thousand that would come into that. The question is then about which regulatory body has the capacity to check that. The best solution we have at the moment is that you would sample each year, sample-



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checking maybe 10%, to see their general movement. That is a question that needs to be looked at.

Q21 Amanda Milling: What you are saying is that the barrier is capacity and resource.

Oliver Parry: Absolutely. You could not just stick that with another regulator, whether it be the FCA, the FRC or the Bank of England. You would need to think of a way to do it. As I said, we have the platform and guidance that can be used. That is step one.

Janet Williamson: There is a regulatory gap when it comes to private companies. I agree with Oliver that just extending the corporate governance code as it exists to the private sector would not address my concerns. One of the big gaps is going back to directors' duties. It is not just Section 172; it is also conflicts of interests and all of those elements that are not easily supervised, enforced or overseen in any way in a private company.

How do you enforce a requirement to act in good faith and put the success of the company before your own interests in the context of a private company? The lack of enforceability of Section 172 and all of directors' duties is a real problem when it comes to private companies—not all of them of course, but some of the egregious examples that have contributed to this inquiry. That has to be addressed in some way. It is not about the existing corporate governance code but there has to be some kind of regulatory oversight of private companies, particularly the large ones who have a very large social and economic footprint.

Owning a company should not be seen as being the same as owning a pen or a pencil that you can throw away without any cost to anyone else. If you asset-strip a company and throw it away, you are ruining the lives of thousands of workers and local communities. There are huge implications. With the privileges of limited liability and so on, there do need to be responsibilities and a way of managing that. A way of bringing it into the open and enforcing it needs to be found.

One of the things that should be considered is that certain behaviours ought to attract a higher regulatory level of scrutiny than they do at present—things like borrowing to pay dividends, paying dividends that outstrip profits or perhaps are very near to the level of profitability in a company, and the whole sale-and-lease arrangement that can be put in place—which so often do not seem to be for the long-term success of the company itself but in somebody else's interests to put those arrangements in place. You could devise a system where certain behaviours triggered some kind of regulatory oversight function. I do not say they are always the wrong thing to do, but perhaps they should trigger scrutiny.

Q22 Chair: Would Oliver and Stephen agree to that? Is that appropriate?



Stephen Haddrill: There is a gap in the Companies Act but I am not sure it should be filled through regulation. It could be filled through a code, which is what you are focusing on. There is a lot in the Companies Act about the actions a director must take. There is not very much about integrity, ethics or those sorts of things. That is good territory for a code to develop in. There is then a question about how you enforce that. You certainly need a good reporting regime so that people can see whether directors are doing what they are supposed to be doing or not. It would be a big step, but we ought to consider how integrity in the private sector as well as the public company sector can be enforced. At the moment, that is not a focus of the legislation.

Oliver Parry: Broadly speaking, absolutely. I would like to make two quick points. It comes down to a question of the professional development of directors, not just the professional development of directors serving on unlisted companies, but also in the unlisted sector. We have argued for some time that we would like to see more emphasis placed either through the code or other regulations on training and development of directors. I argued a very similar case to the Financial Conduct Authority when they were undertaking their changes to the senior managers regime.

That is quite important, to train and develop constantly, developing awareness of changing regulations, laws and even social aspects of serving as a board director. How do you deal with a very combative and difficult chief executive? You can have all the experience in the world but if you are not trained and developed, you are just not going to be able to do it. If you look at the cases we have had in the last 10 years, that has been one of the root causes.

Q23 **Chair:** We are looking at this through the prism of BHS. Some mistakes were made. There was a domineering individual who owned the business and a weak board. How could we have avoided that? How can we be wise after the event? Can some changes minimise the risk of BHS happening again?

Stephen Haddrill: We have taken successfully quite a number of cases in the last few years against accountants because that is what we are empowered to do. Most of those cases are not usually about some fault in financial statements; they are usually about an accountant not living up to the ethical requirements of the profession. We find ourselves in a slightly ridiculous position where something goes wrong in a company, there is the CFO who is an accountant—we can get them disbarred and fined as an accountant—but another member of the board has been equally culpable and we cannot touch them. That is not right.

You get a situation like BHS where you cannot find an accountant in the room and we cannot take any action. We are looking into it in other respects but I will not go into that. We need to recognise the role of the director as a professional role and think about the public interest responsibilities of professions that we see in other areas, build those into



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a code and then find a mechanism for holding that profession to account against that code.

Q24 Anna Turley: Janet and Oliver, you both mentioned executive pay in your introductory comments as one of your biggest concerns about corporate governance. We know that the gap between those at the top and bottom has increased from 50 times to 150 times in the last 20 years. Why do you think that is? What has driven that? What has caused it? Does it concern investors and shareholders? Is there any action being taken about it?

Janet Williamson: There are a number of drivers of the increase in that gap. Perhaps the main one has been the focus within public policy going back to the mid-90s on linking pay and performance for directors and putting an increasing proportion of remuneration into performance related pay. That has not really worked. You can do the graphs and see pay massively outstripping company performance no matter how you measure it. That kind of performance or incentive-related element has contributed most to the growing gap between the pay of the workforce and, indeed, workers throughout the economy and company directors.

Another factor has been the desire to pay the upper median or even upper quartile, which has led to a ratcheting up of pay for no reason other than someone else had a pay rise. There has been a lot of attention given, rightly, to the role of remuneration consultants and the advice that they give to remuneration committees. There is also an element of the fact that remuneration committees are all non-executive directors but that whole pool is drawn from a fairly narrow constituency, who are often pretty well paid themselves.

Regulating executive pay is being left in the hands of shareholders. Many people who worked in institutional investing are themselves highly paid and so may not see anything particularly strange about some of the levels of rewards. They look very different when you are looking at those levels from the shop floor, from the street, from wherever you are.

There is a problem. There is a lot of evidence that high inter-wage disparities within companies are detrimental to company performance. Quite apart from the impact that these very high wage gaps have on inequality, which should concern all of us, investors, companies themselves and the Government should be concerned that this growing gap is getting bigger and bigger and has a detrimental impact on employee morale, which has a direct impact on company performance. Something has to change.

Q25 Anna Turley: Do you think shareholders and investors are concerned about this? Are you seeing any challenge to this?

Janet Williamson: There has been a shift to some extent but not a sufficient shift. The TUC conducts a fund manager voting survey each year and we have seen increases in the level of voting "No" to



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remuneration reports among our respondents. Our respondents represent the bulk of the UK institutional investment organisations. It is not enough to have very much impact on the level of “No” votes across the board and it has not had a lot of impact on the level of pay either. Shareholders have had their chance to tackle executive pay and have not done so. It is time to try other means.

Oliver Parry: The vast majority of institutional investors that hold stakes in FTSE 100 companies are beginning to utilise their powers more and more. It is certainly a marked change to the situation four or five years ago, certainly post the shareholder spring, as everybody called it, back in 2012. We have seen significant progress in that regard.

To go back to the question that you asked of why it is happening, there are a couple of reasons. There is the focus on short-term profits each quarter, the ratcheting up of pay—that everybody either wants to pay the median or above the average. That pushes salaries up. Initially, yes, there was a lack of interest from the institutional funds, but that has significantly changed. I would remind the Committee that the three-year binding vote is a relatively new mechanism that is in place. We have only seen it tested a few times. We need to give it more time to bed in. Broadly speaking, shareholders are acting a lot better than they were doing.

Q26 **Chair:** Would an annual binding vote be more appropriate?

Stephen Haddrill: Yes.

Q27 **Chair:** Why is that, Stephen?

Stephen Haddrill: It is the key decision. The policy is setting out the way forward, but circumstances, particularly in fast-moving global markets, change and what any shareholder really wants to know is how the policy is going to be implemented.

Q28 **Chair:** I rudely interrupted Anna and I apologise. I am just going to ask one more question. Transparency has ratcheted up executive pay; should we have a bit more darkness and opaqueness when it comes to this? I now know that Richard is paid more than me and I want to say, “Hang on; I deserve more than that.” That is that constant ratcheting because it is constantly announced. That is the problem, is it not?

Stephen Haddrill: You are right that it is one of the causes of pay being ratcheted up, but we cannot rebuild confidence in British business by removing transparency. That train has left the station.

Oliver Parry: It is important that you distinguish between base pay and performance-related pay. Performance-related pay, as the code makes very clear, needs to be fixed on the long term with rigorously applied performance targets. That is crucial.

Q29 **Anna Turley:** Was there anything that you wanted to add about how



we got here, what you think has driven this and any other thoughts you have on how we could tackle it?

Stephen Haddrill: The other thing that needs to be explored is the link between dividends and pay because dividends have gone up quite a lot as well. Pay policies are often structured around returns to shareholders and so on. One of the things that bothers me a bit is that the pay element has gone up, on high executive pay, and the dividend element has gone up, so what is left for reinvestment in the business? That is a fundamental economic question that needs to be thought about.

Chair: Share buybacks as well, as part of that process

Stephen Haddrill: Yes, exactly. There are a couple of other factors. One is that these packages are not simple. It is very hard for people to understand what they really mean. That needs to be addressed, not least because it is sometimes rather hard for the shareholders to work out what the package is going to deliver and whether there is a risk, under the policy and the complicated system, of effectively being able to pay rewards for failure. That brings the whole system into disrepute.

Q30 **Chair:** Is executive pay warranted? Do superstar chief executives really make a difference, or is the long-term financial performance and success of a company based upon a number of different things? It is like football managers: is it really the case you are going to get a step change? I am not entirely convinced you are. You have these journeymen Premier League managers. Is that not the case with chief executives as well?

Oliver Parry: It is hard to give a direct "yes" or "no" answer, which I know is what you want. If you take a look at the former CEO of Thomas Cook, she resigned on one Tuesday morning at 7.30; by 8.00 the share price of Thomas Cook Group had dropped 20% or 30%. CEOs can affect share price. The other important thing to note is the jobs that they do are incredibly tough. They are running global organisations where their decisions from second to second can have lifelong consequences for the business. I go back again: it is about rewarding chief executives and other senior executive directors based on their performance over the long term. That is absolutely crucial. The FRC has made some very important steps there in amending the code to emphasise that. Ultimately, at the moment, the power does lie with shareholders. If shareholders deem performance not to have been good enough then they should vote pay down. It is as simple as that.

Stephen Haddrill: It is true that people who have come up through the business tend to not get quite such high rewards as people who are brought in from outside. That is something that is worth thinking about. Recently there has quite rightly been a lot about diversity in the boardroom and particularly diversity amongst the executive team. If companies were focusing more on how you grow that pipeline within, with a diverse group of people growing up the pipeline, you might find



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that the pay situation would look better and there would be a better focus on the longer-term strength of the business.

Chair: We will come on to diversity in a moment. Janet, did you want to add something?

Janet Williamson: On your question, chief executives clearly make a difference, but no chief executive can succeed without a dedicated, hard-working and talented team around them. The share price diving up and down is not always the best measure of how a company is doing over the long term. Long-term company success depends on far more people than one person at the top. Any good chief executive is absolutely aware of that as well. Executive pay needs to change to reflect that.

Could I make one more point that goes back to the original question? Remuneration committees have been required, since I think 1995, to be sensitive to pay and conditions elsewhere in the company. This is an element of decision-making that has simply not affected the outcomes on executive pay at all; it has taken a ratcheting up, up and up and legislation to try to get more disclosure on that area. Even now, with the most recent changes that have already been referred to and are a lot more detailed, companies are not fulfilling those changes in full. They are required to report upon their pay increases compared to those elsewhere in the workforce; often they only choose to look at salary, for example, despite the fact that the vast majority of the remuneration of executives is the incentive-related element.

That is an aspect of pay that has not been sufficient in the minds of remuneration committees, companies more broadly and arguably the Government as well until, perhaps, this Parliament.

Q31 **Anna Turley:** On worker representation on boards, which you mentioned earlier, Stephen, what difference do you think that might make and how do you think it would be best achieved? Is it with best practice and guidance or is legislation required?

Stephen Haddrill: It would make a difference. It would obviously introduce an employee voice into the boardroom. That is potentially very valuable. The board needs to be thinking about the interests of employees, the way they are being developed, the way they can add more value to the business and so on. It is also a link with the community that the company is part of. However, there are other ways of doing it than having employee-elected directors. This is a big change so those alternatives have to be considered. Another possibility is creating a committee chaired by a non-executive, where the committee perhaps has employees on it and the non-executive has a specific remit, like an audit committee chair for example, to represent that particular interest on the board. That is worth looking at as well.



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There are a couple of caveats. Whatever route one goes down, the unitary board principle serves us well: that all directors have the same rights, duties and responsibilities because then they treat each other with respect. If you have a second-class citizenry in there, there is not much point in doing it. The full-blown worker-elected director model should not be done through the corporate governance code. That is quite a big shift and requires parliamentary weight behind it to get it done. There is a risk if we try to do it through the code that we would have a very high level of non-compliance. That would cause the code to come into some discredit. We need to take care about how we do it.

Oliver Parry: The Institute of Directors are on record as saying that we are very open to having workers on the board. We need to increase the stakeholder voice around the board table and throughout the organisation. The question is whether this is the most effective way to do it. I do not necessarily think we are at that place right now. You could not introduce legislation and say to a company, "Go and do it tomorrow morning". That is simply because we have a unitary board system. Directors at the moment all have fiduciary duties.

Imagine a worker on the board of a bank, for example. Let us say, god forbid, we have another banking crisis and that bank fell over, under the SMR regime as it currently stands—the regulatory regime of the FCA—they could all be individually prosecuted. The workers need to be aware of that. For me, it comes down to appropriate training and guidance for all directors, but in particular workers. If you are going to put workers on boards, they have to be trained. We recently published something called the competency framework for directors, which can be used in the listed and unlisted sectors, and would be an appropriate step. However, you cannot just parachute somebody in there; it has to take time.

Q32 **Chair:** It always strikes me, in terms of what happens in reality on the ground, that the roles of directors are very different. Information asymmetry would mean that executives would be very different to non-executives. Should that not be reflected in what we term as directors' duties?

Oliver Parry: Absolutely. Any new law student, for example, turning to the Companies Act would find that it does not distinguish between non-executive and executive director. There should be greater distinction.

Q33 **Chair:** We could develop that further still in terms of making sure there was a workers' director, could we not? That would address the concerns that people have. We could still have a unitary board structure but just differentiate between different types of directors.

Stephen Haddrill: You have a differentiation now in the way that the Department for Business, for example, would proceed if something has gone wrong and somebody needs to be disqualified. In practice, they would look to find an executive director or a non-executive director who had had a very direct role in whatever had gone wrong. The law does



distinguish between them. Decisions are taken by the board as a whole. We have to be very careful about saying there are some people who are either lesser beings or cannot be held to account for the decisions of that board. You really want people there who are going to hold the board to account. If you are going to put workers on the board, what is their purpose? The purpose is to challenge. Yes, some of the non-executives do not know as much about things as the executives, but if you let them off the hook too much then their challenge is not going to be as strong.

Oliver Parry: As a point of clarification, because I do not want what I said to be misconstrued, I am making a policy point there. There is a difference between a non-executive director and an executive director in the sense that a non-executive director attends a board meeting maybe once a month; the executive directors are there running the business on a day-to-day basis. There is a difference.

Q34 **Anna Turley:** Could I hear from Janet Williamson because I am particularly interested in where the role of the trade union would sit with this potential shift?

Janet Williamson: The workers' voice is really the missing element in UK corporate governance. It would make a key difference to the culture of boards and the quality of decision-making. There are several reasons for that. First, the interests of workers are very well correlated with the long-term success of a company. Having workers in the boardroom would encourage boards to focus on the long-term success of the company rather than being distracted by financial engineering, as did occur in the run-up to the final crisis. In addition, there is a lot of consensus now that diversity enhances decision-making. That has come out of the Davies review, the Hampton review and so on and so forth.

Bringing workers into the boardroom would substantially increase diversity in terms of background and experience. That would increase the challenge that would be available in boards. In addition, workers are very well placed to encourage boards to take the high road to success, rather than the low road, to ensure that boards understand relationships with their workforce, which is a key stakeholder relationship, which has a direct impact upon company success, profitability and so on and so forth.

There are a lot of reasons why workers' voice can enhance the quality of board decision-making. I believe that is what we see in other countries where it is in place. Survey evidence from those countries shows that other board members do value the input of the worker representatives, particularly on those elements guarding against group-think, being able to feed in on how the workforce might receive decisions going forwards, and in terms of the CSR element and having a better grasp of how the public would perceive things like executive pay.

In terms of how it should come about, I agree that this is not something for the corporate governance code. Apart from anything else, we believe that it should apply in the private sector as well as in listed companies.



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We would support it being mandatory in companies with 250 staff or above. We would like to see, though, workers constituting a substantial part of the board so you would guard against the lone voice phenomenon. We have suggested a third of the board, with a minimum of two.

I agree with Oliver and Stephen on the unitary board and directors' duties. It is very clear from other countries that worker representation can work well on the unitary board as well as on a supervisory board. It does not have to be in one or the other form. Indeed, there are a growing number of countries where companies can choose between a unitary board and a two-tier board. In those situations, the workers' representation element generally applies regardless of which one is chosen. The unitary board, which is clearly very much valued here, would not be compromised.

We absolutely agree that worker directors would be subject to the same director duties as every other director on the board. There are parallels for this. For example, in trust-based pension schemes you have employer-nominated trustees working alongside member-nominated trustees, nominated by different groups but working under the same fiduciary duties, which is to serve the long-term interest of the beneficiaries of those schemes. There are parallels where you have this model of people coming from different groups then working under one set of duties.

Stephen Hadrill: On this expertise point, one of the key things with the worker representative is that the person is elected by employees of the company. That does not necessarily mean that person has to be an employee of the company. In Holland, they often elect people from elsewhere. Someone might stand for election because of their empathy with the worker community but they might have great skills that are relevant to the business. They do not necessarily need to be an employee of the company.

Q35 **Richard Fuller:** Just to draw attention to my entry in the register of interests, I am a director of one private company and a non-executive chairman of a second. Oliver, talking about the diversity of non-executive directors, is there a problem with the availability of a diverse range of candidates to be non-executive directors? If so, how would you look to solve it?

Oliver Parry: Yes, I do. The issue really lies with the head-hunters and recruitment consultants that operate within this market. My view has been for a long time that if you say to a head-hunter, "We want a diverse portfolio of non-executives for our board", what they will typically do is come back with the same names that you see churned out day after day. We need to encourage the head-hunters in this world to think about a more diverse portfolio of individuals, with different backgrounds, different cultures and different understandings of the business environment, for example. One example I draw the Committee's



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attention to is cyber-security. There is clearly a desire in the marketplace at the moment to find non-executive directors with an understanding of cyber. There is a problem but you cannot legislate on it.

Q36 Richard Fuller: You are fingering the recruitment consultants—I should not name brands—but the ones that go around a bit. That is where you think the problem is in terms of opening up this pool of talent. It is not the fact that the talent is not there; it is just that they are not looking hard enough for it.

Oliver Parry: That is 90% of it, absolutely. There is one additional point, which is that the way one becomes a non-executive director is through training, understanding and development. It is also about professional development, ultimately.

Q37 Richard Fuller: Janet, when we are looking to improve the diversity of boards, should we focus on expanding the pool and diversifying the pool, or should we put in targets and quotas?

Janet Williamson: Quotas have been used successfully to increase the diversity of boards in terms of gender in Norway. They have worked well there. Whether you could use quotas for other elements of diversity, though, is a lot more questionable. Increasing the pool of talent is vital but I would also draw attention to the need to focus on the pipeline within companies and make sure you have a more diverse workforce reaching the very top of the corporate sector.

Richard Fuller: On the executive side.

Janet Williamson: On the executive side, yes.

Q38 Richard Fuller: Would it be fair to say that under the coalition Government and under this Government they have been nudging companies to hit quotas for gender equality on boards and potentially now with representation of people from various ethnic minorities, rather than looking at the harder work of expanding the pool both in the executive branch and in the NED pool. Should we not really be looking for new initiatives on the second level?

Janet Williamson: We do need new initiatives on the second, absolutely. We need to increase the focus on the pipeline and on the pool. The pool is out there in terms of non-executives and diversity. You may need to look in slightly different places; you do not always have to look within the corporate sector. There is the voluntary sector, there are charities, there is the public sector and there are trade unions. There are a lot of different people out there who can make a useful contribution to the board.

Richard Fuller: Entrepreneurs, too. Yes, there are plenty of people out there. Sorry, did you want to say something?

Oliver Parry: No, I was just completely agreeing with Janet.



Q39 Richard Fuller: Can I just change topics to advisers, because I am conscious of time, and maybe ask Stephen a couple of questions? In the experience of British Home Stores, which I guess is a situation of an acquisition, there are a number of advisers who created credibility for the acquirer and who facilitated the transaction. Do you think there is an argument that there should be much more transparency about the role and the fees that are paid to advisers in mergers and acquisitions or takeovers?

Stephen Hadrill: Yes, I do, particularly in the public sector but obviously in the big public interest situations as well. That is important. We can take action against advisers, again if they are accountants and breach their ethical code, but you have to find out whether that has happened. More information in the public domain would make it easier for us to do that.

Q40 Richard Fuller: To be clear, are you suggesting that if it is a private-to-private transaction there should still be the same requirements for transparency in disclosures as there would be in a public company?

Stephen Hadrill: You have to have some thresholds there and some proportionality. Going back to the earlier conversation about the private company and whether a code should be applied to it, if you think that that private company is a matter of public interest and therefore caught by that code then, yes, what is going on in major transactions and so on is of public interest and should perhaps also be covered by such a code. We should think about whether a code around ethics, integrity and so on should apply to the people advising the company as well as the company itself.

Q41 Richard Fuller: Oliver, in the IoD's evidence there was some reference to this issue. What specific guidance would you provide in terms of additional control or effectiveness for advisers in M&A?

Oliver Parry: Our position on this is that it is one of these unsighted areas that needs to be looked at more closely. There is clearly a part to play for advisers in all M&A activity. Our views are on record with respect to the advisers, and on BHS our letters were published accordingly on this matter. It is an area that the Committee needs to look very strongly on because they have a very sensitive and privileged position in all of these activities and there needs to be more transparency around their role.

Q42 Richard Fuller: To go back to British Home Stores, there was one adviser who said they were not an adviser but they were the one whose advice was listened to most intently. How are you going to stop non-advisers being the most influential advisers in the room?

Oliver Parry: During the time of the collapse of BHS, I was asked this question a number of times when I was doing media interviews and having conversations with stakeholders. My answer remains the same,



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unfortunately: I am not entirely sure how we do that or go about that, which is why we ask for clarification on the regulatory parameters of the current regulatory system. There does need to be a question about the role of regulators in this.

Q43 Richard Fuller: I have one final quick question to you, Janet. Perhaps you can come back but I want to ask you a specific question. You implied earlier on, going back to the issue of compensation but also diversity on boards, that the shareholders had had their go at doing this. One suggestion that is in some of the evidence before the Committee from one of our colleagues is to adopt a shareholder committee structure as they have in Sweden. That shareholder committee would comprise the largest institutional shareholders and certain responsibilities on the board would be under their control, the first of which would be executive compensation. They would be the ones to affect a vote.

The second would be that they would be responsible for the nomination of NEDs so you do not get the chums of the CEO coming on, but you get NEDs who can contribute to the wellbeing. Has the TUC looked at that model of shareholder committees and do you have any thoughts about that and how it might contribute?

Janet Williamson: Yes. We have looked at it. It is hard to see how that would work well in the UK context because most companies listed here have very diversified shareholdings. There are hundreds of shareholders who hold their shares. If you want just to take, say, the 10 largest, what you would then find is that is often the same 10 largest investors across the whole FTSE 100, more or less. You would be putting an awful lot of pressure and an awful lot of power into the hands of quite a small number of institutional investors. The whole structure of the equity market in Sweden is very different: a lot of the companies have maybe one or two investors who own a substantial proportion of shares and then you can maybe bring in a couple of others as well to people the committee. I do not see it translating easily to our situation within the UK. Could I come back on the question about BHS very briefly?

Chair: Very quickly if you can, Janet, because I am conscious of time and I want to bring Peter in.

Janet Williamson: One question to ask about the advisers is if the advice had been much, much better quality or there had been much better reporting on the demise—had we all known what the fees were, and so on and so forth—would that have changed the outcome of the decision that was made? Would it have stopped the sale taking place or not? Would it have gone ahead because you had somebody who wanted to buy and somebody who wanted to sell? That transaction was deemed to be a private matter between individuals rather than being something that was a matter of public interest and therefore should be open to public scrutiny. I wonder if perhaps the transaction itself and then some



of the behaviours that followed should be under scrutiny, rather than focusing primarily on the advisers.

- Q44 **Peter Kyle:** Thank you. I am Chair of Governors at a secondary school. When Ofsted come in and do their inspection, a large section of Ofsted is now about governance: testing very proactively and assertively whether the board scrutinises, challenges and supports in the right way, and also the depth of knowledge of the operations of the organisation in a hands-on way. Oliver, you mentioned avoiding tick-boxing earlier on and how to incentivise professional development. There is nothing that incentivises those things, challenging tick-boxing and investing in professional development, than knowing you are going to be tested on it at some point in time by some pretty rigorous inspectors.

In the city that I represent, Brighton and Hove, CQC came in recently to health institutions in the city. Within a couple of days of both of those inspections, the chair of the board departed. In one case, up to half a dozen non-executive directors departed as well because they were inspecting the quality of governance. Is it not time, now we know the consequences of when collective governance fails for a sector, subsector or part of the private sector, that we start inspecting in a proactive and rigorous way the governance of these organisations in the FTSE 250?

Oliver Parry: Stephen has already mentioned getting greater regulatory powers in this space and we would welcome that. There is a massive gap in the market. The short answer to the question is yes, absolutely, we would like to see that. That is one of the reasons why in the last four to five years the IoD, under its Royal Charter obligation, has been quite outspoken on corporate governance failings because we do not feel—apart from the shareholders who have become a lot better in the last couple of years—that is happening. If you look at the Financial Conduct Authority that deals primarily with financial institutions, they have become more outspoken because they have the powers to do so. They will name and shame companies and bang naughty bankers up if they misbehave. The FRC, unfortunately, does not have that ability at the moment. That is one of the reasons we have been seen to do that.

- Q45 **Peter Kyle:** Until very recently I was a non-executive director of a bank and an FCA regulated director. I took the test to become a non-executive in that subsector, the financial services subsector, and was aware that should there be a stress test on the bank that I was on the board of, an element of that stress test would involve a governance review as well. It never happened in the years I was there in terms of me being interviewed. We are halfway there but not the whole way there. Do the other two want to comment because this is really important. Unless we are inspecting, rolling our sleeves up and understanding how these organisations and big private sector organisations work, which we now know if they fail have a profound impact on the workers, consumers, but also the economy at large—is it not right that we roll our sleeves up, understand how they are being governed and the quality of governance in a hands-on way?



Stephen Haddrill: There needs to be greater transparency about that so the shareholders can do their job properly. That is step one. The regulator, the FRC in this case, needs to have the power to interrogate the company in relation to its compliance or explanation with the corporate governance—

- Q46 **Peter Kyle:** How can you provide the reliability of information unless you have these people being interviewed by an independent inspector who can provide independent information to the shareholders that non-executives are doing the job, functioning, understanding, putting the time in and understanding the regulatory environment they are operating within? How can they have that?

Chair: This will have to be the final answer.

Stephen Haddrill: The other regulatory bodies you are talking about—Ofsted, the CQC and so on—are protecting really quite vulnerable people: people in care homes, children and so on.

Peter Kyle: The banks?

Stephen Haddrill: People who have no ability to come back. What we are talking about is providing a regime where people who can exercise their rights—the shareholders, and pretty major shareholders very often—giving them the information to exercise their rights and responsibilities effectively.

- Q47 **Peter Kyle:** They are not doing it—BHS, Sports Direct, the banks.

Stephen Haddrill: Right. I was talking about public companies. In private companies, you have a different situation. You do not have the shareholder there. There, the directors who act without integrity do need to be held to account through direct enforcement action.

Chair: Thank you very much for your time. We really appreciate that. Thanks again.

Examination of witnesses

Witnesses: Alex Edmans, Mike Everett, Peter Montagnon and Jonathan Chamberlain.

- Q48 **Chair:** Gentlemen, good morning. Thank you for coming to give evidence. We have a lot to get through, so if I could ask you just to introduce yourselves briefly and the organisations that you represent.

Jonathan Chamberlain: Jonathan Chamberlain from the Employment Lawyers Association. I chair the working committee that produced the written evidence, which you have already seen.



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Mike Everett: Mike Everett. I am a Governance and Stewardship Director at Standard Life Investments.

Peter Montagnon: Peter Montagnon. I am Associate Director at the Institute of Business Ethics.

Alex Edmans: I am Alex Edmans. I am a Professor of Finance at London Business School. I am also on the steering group of the Purposeful Company project with Andy Haldane, trying to promote long-term plans within organisations.

Q49 **Chair:** May I ask each of you two very brief questions? I would like brief answers, if I may. What is wrong with corporate governance in the UK and if there are any problems, what do we need to do to fix them?

Jonathan Chamberlain: ELA is a technocratic organisation. We comment on policy rather than lobby on it. In terms of the remit of the inquiry, I would say that there is clearly an issue as to whether Section 172 of the Companies Act has the teeth that some would like it to have. There are a number of options that might be taken to give it some teeth. ELA's view is that fresh primary legislation is probably not one of the better ones.

Mike Everett: The structure of corporate governance and the way it works and the mechanisms that allow the challenge of boards is there. The quality of that challenge has still some way to develop. Some investors do challenge and hold to account. We need to continue to encourage large asset owners and large asset managers to really focus on holding directors to account according to the framework we have.

Peter Montagnon: I would be wary of starting off by asking what is wrong because there is a lot good about corporate governance in the UK. That does not mean we do not need to change quite a lot to adapt to the circumstances in which we find ourselves. Over the years, governance has evolved continuously through the voluntary codes and the "comply or explain" process. It is worth recalling that, although we have had problems during the financial crisis of 2007-08, there was an extraordinary resilience by non-financial companies in the face of a very steep recession. That owes something to the strength of our governance.

Now we are facing a different situation where we are looking at issues around long-termism and corporate impact on society. We have to find a way of continuing this evolutionary process to bring those into the picture. That requires work on culture and the way people behave. That is quite difficult to regulate. However, there is one thing that is a problem, which is that our system of executive remuneration is not working properly. Most people privately admit that, but it is very difficult to deal with.



Alex Edmans: I largely agree with Peter. There are many positive aspects of governance that do lend the UK to be superior to other countries. However, to the extent to which it can be improved, I agree that the focus should be more on long-term value. This involves stakeholder capital, employees, customers and the environment rather than short-term earnings. Note this is an idea of making the pie bigger for everybody. Some of the concerns with governance are about some stakeholders taking a greater slice of the pie than other stakeholders. The more important question is how we can encourage managers to create a larger pie so that everybody—shareholders, workers, customers and society—can be better off.

Q50 **Chris White:** To what extent do you think the corporate governance in a business is a function of its culture or its values?

Alex Edmans: These things are certainly very important because you can look at some explicit measures of corporate governance; you can look at, say, the diversity of the board or the long-term nature of compensation. Those are things that are absolutely important, but there are implicit aspects that are also important. These are things such as corporate culture. Indeed, why is it that some firms significantly outperform their competitors? It is due to their culture element.

One of my own studies looks at firms that treat their workers better, looking at 28 years of data. Firms that treat their workers better outperform firms that do not by 2% to 3%; that is 90% to 184% compounded. That is something that is within an organisation. That is something we cannot legislate; it is something we need to improve from within. Most importantly, companies that treat their workers better then perform well. The causality is not the other way round. It is not that a firm is performing well to begin with and then decides that they can spend more on employee wages.

Peter Montagnon: One of the problems with the existing system is that there has been a tendency in some quarters to see governance as just complying with processes that are laid down. It has been a procedural thing. That has been quite useful in many cases because it has allowed us to have independent audit committees and structures within the boards that have generally been beneficial. It has detracted from the important point that companies and boards need to look outwards more. They need to look at the impact their company is having on society and they need to look at the way the employees are behaving and feeling. This is a new challenge to bring these behavioural issues into the picture and move us a bit beyond simply complying with the processes and procedures that are laid down in the code.

Q51 **Chris White:** I will come on to you gentlemen in a second, but the impact on society is important. It affects us all. How a business behaves affects everybody in society. Do you think that is something that calls for legislation? Alex, you said that legislation or regulation did not work. I would like to come back to both of you.



Peter Montagnon: Section 172 goes into this. We had a discussion about this with the previous panel. There is a problem that not enough directors are properly aware of Section 172 and take it into account when they make decisions. That is a very important part of the issue. However, there are some signs in larger companies that boards are beginning to understand they have to look wider. We did some research earlier this year that showed that 57 companies in the FTSE 350 have board-level committees that look at sustainability, behaviour, ethics and values. This is not a requirement of the code. These things have come about because the boards themselves have realised that they need to go further, look at the quality of behaviour, look at what is driving behaviour and look at their impact on society more than they perhaps thought they had to do in the past.

Chris White: That is very helpful.

Alex Edmans: You used the word “compliance” in the earlier discussion. Regulation can certainly lead to compliance but what we would like is for companies to have full commitment to this. One way to do this is show that it is in companies’ best interests to treat society well. One of the hallmarks of the Purposeful Company project is gathering systematic evidence, so not anecdotes but looking at hundreds of companies in different industries, which shows that different dimensions of purpose improve the long-term stock price and performance. It is not just employee satisfaction; it is treating customers better, adopting sustainability policies and reducing your environmental footprint.

What is being done about that? Do companies realise this? Yes, things are changing. Think of the number of companies that are engaged with the Purposeful Company project, with Tomorrow’s Company, and with the Blueprint for Better Business. Lots of firms are taking this seriously. Could this be much faster? Absolutely. There is far more to be done but there are companies now that are embedding purpose within the c-suite and recognising that this is something that improves long-term shareholder value in addition to being good for society.

Q52 **Chris White:** How do you make it faster? How do you move this on faster?

Alex Edmans: One thing that has led to this is that shareholders have made many proposals themselves. You can look at shareholder proposals to change, as Peter talked about, the long-term dimensions of compensation. You can study the effect of these proposals and those proposals have led to not only long-term improvement in terms of shareholder value, but also various measures of corporate social responsibility and various measures of innovation. What we have seen over the past couple of decades is a rise in shareholder activism. One myth is that the shareholders are short-term and they are all about increasing buybacks and maximising short-term stock price. The evidence does not show this at all.



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One thing that people found is that some of these firms and activists do reduce the level of research and development, but the output of innovation is much higher: they produce more patents and the patents are more highly cited. Interestingly, we just looked at the level of investment. One might think this is something that is negative, but it is really the output of investment that we want purposeful companies so they do not just spend willy-nilly but spend in the correct areas. There is a lot of evidence now suggesting that shareholder-motivated changes do have positive effects on society.

Mike Everett: We would look at culture and values as a result of corporate governance, not the other way around. When we engage with companies, we would be speaking to the board increasingly about how they have defined the purpose of the companies and therefore what the driving and expected values are. How the culture comes out of that is important to us as an investment. As Alex was saying, this is not because this is a nice thing to do; it creates a better investment if we can understand how a company deals with it. That could be culture and values, but the environmental efforts of an oil company are obviously a financial aspect for us as an investor. We will talk to boards on all of these aspects. Culture and values are something we are increasingly trying to talk to them about.

Jonathan Chamberlain: It is a business truism that culture eats strategy for breakfast. Culture does not eat governance for breakfast; as Mike has said, the two are absolutely entwined. The role of law in supporting or changing that is complex. It is not the case, if I may disagree with Peter, that directors are not properly aware of their responsibilities under Section 172.

The general scheme of company law as it relates to the decisions of directors is about the director's subjective knowledge and belief at the time in accordance with their own duty of care and skill. There is no mechanism for challenging the process, as it were, that the directors went through before they made a particular decision. What might be interesting, though, and what might accelerate things as you were suggesting earlier, is along the lines of what you have already heard this morning, in terms of requiring companies to report on how they have taken those interests into account in their decision-making.

As we have mentioned in our written evidence, that could be something along the lines of what they are required to do in the context of modern slavery, making statements as to how they have made sure there is no slavery present in their supply chain. A statement explaining how they have complied with their duties under Section 172 would, one would hope, have the result of making those thought processes transparent and open to shareholder comment, public comment and intervention.

Q53 **Chair:** Alex, briefly before I bring Peter in, you have mentioned a number of times that treatment of workers affects long-term company performance and maybe shareholder activism does too. Do you want to



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name and praise some companies where they are treating their workers properly and their performance is improving? Which ones are they?

Alex Edmans: I am happy to do this but what I would like to say before I do is that this is something that is large-scale; it is not just focused on a couple of firms. We can think of companies such as Unilever. They treat their workers fairly. Again, it is not just a worker thing. They are thinking more long-term about society. When we think about things such as workers on boards later, which I know will be a topic of discussion, we would like to encourage firms not just to think about workers but society generally. That starts from the incentives; that starts from increasing the incentives. We can think about those.

We can also think about companies that used to treat their workers extremely badly, like Walmart, Starbucks and JP Morgan. Over the past year or so, they have announced significant increases in the pay of the lowest paid workers. Interestingly, this was not prompted by legislation but by a recognition that, "We know we have treated our workers badly in the past. We see the evidence." In Walmart's case, their per employee profitability was lower than costs by significant margins. They recognised that was something that they wanted to change.

Q54 **Peter Kyle:** Jonathan, what gives a board teeth? What creates a board that has teeth that the executives have respect and sometimes the odd bit of fear for?

Jonathan Chamberlain: That is a very difficult question to answer in the abstract. In my experience, it is a board—and I realise this is circular—that is doing its job properly. A board that is properly informed, is asking the right questions at the right time, and is accustomed to and has the mechanisms in place to make sure that it gets the right answers. That is a function both of internal processes and external scrutiny, but also, as has been mentioned, of culture.

Q55 **Peter Kyle:** Peter, how do we move to a point where more companies have what we have just described? We all know what a good board looks like; we just do not have it across the board at the moment.

Peter Montagnon: We have some very high-profile cases where things have gone wrong, but I would contest that the bulk of boards are functioning reasonably well to very well.

Q56 **Peter Kyle:** Do you have evidence for that?

Peter Montagnon: The assumption we must not make is that everybody is like BHS or Sports Direct. The evidence that we have, also, is there are a lot of healthy companies growing and generating profits out there where things are functioning alright. I cannot give you statistics on that but there is a slight danger here that if you see one or two catastrophes, which are appalling and there is lots of bad practice behind them, you assume everybody is failing. That is not the case.

Q57 **Peter Kyle:** Because we have no inspector, we do not have evidence to



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say that is all good. If I might put this into context as well, we also have a country that has quite spectacularly low productivity for an economy of our size. Surely our corporate sector, our private sector, is not performing to the same levels as other comparable countries. I assume we can lay some of that blame at the door of governance.

Peter Montagnon: We quite possibly can say that, but I want to come back to the point about how we can find out and how we can improve it, because that was the question you asked. There is a lot of mileage in proper board evaluation. This is a relatively new thing in this country. It started, by the way, in a very light-touch way through the code and has been ratcheted up. We need to go further than that; we need to ensure the quality of the independent board evaluations is higher and people are learning properly from that. Also, to say that all the failure of Britain in productivity is due to weak governance—

Peter Kyle: I did not say that.

Peter Montagnon: Okay. In that case, I would not accuse you of saying that, but it is quite important to realise that you did raise the question of productivity and it is not only going to be a factor of governance; there are also lots of other things, like our levels of skills and education.

Q58 **Peter Kyle:** I asked whether some of the responsibility should lay with corporate governance. All I am saying is that the majority are fairly well governed. We do not have any evidence to say that our sector is spectacularly well governed across the board. The majority is fairly well governed, which is the same for most organisations in every sector. I spent six years helping to run Acevo, the umbrella body for the voluntary sector where we developed a governance tool, which had a pretty low take-up across the board. The organisations that did take it up saw a rise in their productivity, achievement and attainments.

Peter Montagnon: I come back to what Alex said earlier about some of these companies like Walmart, which are beginning to understand if they adopt the right culture, develop their workforce in the right way and perhaps pay a bit more, they progress as companies. The thing that is difficult about this is that a lot has to come from within the companies. We have to persuade them that this is the right thing to do, that it is in their interests, in society's interests and then help them do it. It is difficult to lay down a rule that says, "You must behave better", in a rather vague way, and then enforce it.

Q59 **Kelly Tolhurst:** Fundamentally, we have seen failings with what has happened with BHS. I started work in the late 1990s. That is 20 years ago. I understand where you say that it needs to come from the companies within but we have had a couple of high-profile cases. Ever since I have been in the world of work, I have seen what has happened with BHS happen in a number of organisations over those 20 years. Things do not seem to have changed. It just so happens that these



particular cases are high-profile.

What can be done? Not to see the improvement in 20 years that I would have liked to have seen—not necessarily just with big organisations but with some of the smaller, private organisations where things have happened that have been detrimental to the workers and the environment in which they operate—in my view means that business or the industry has not done enough at this moment in time. How do we improve it in a quicker way?

Peter Montagnon: First of all, we need to raise awareness. One of the things I fully support, which is what Jonathan was saying, is that companies should be obliged to disclose publicly how they carried out their duties under Section 172. Build that awareness and public awareness is going to focus in on this. People are going to change their behaviours accordingly.

It is also quite important that the Financial Reporting Council, which was here just now, has run a very big project this year with a very wide range of stakeholders, looking at corporate culture, looking at corporate responsibilities for their relationships with society, looking for the identifiers of a well-run company that will not fall into the category of those you describe. We need to promote this. We need to promote this public awareness and discussion. Where the facilitation comes in is ensuring the transparency about the right indicators.

For example, it is quite clear that a company that has a very high turnover of staff and a high level of customer complaints is doing something wrong. What we do not get in the disclosures mandated by the laws and regulations is enough information about those sorts of things. We need to recast the information we are getting and the way we look at it. There is a role for regulation and legislation in that.

Alex Edmans: One reason why we have been so slow to make improvements is that there was a myth about pie-splitting and that caring for stakeholders was at the expense of society. For many years, Costco was seen to be the bane of the stock market. There was a *Wall Street Journal* headline: "Costco's Dilemma: Be Kind To Its Workers, Or Wall Street?" This is a trade-off. There were analysts saying that Costco has given too much to customers and employees at the expense of shareholders. While there was some evidence trying to suggest that social responsibility does benefit long-term shareholder value, that evidence was typically weak and did not distinguish causation from correlation.

As a result, it inoculated many business people against social responsibility. Like a vaccination, you put in a little thing that is weak that causes the body to respond. Now what we are seeing are much more systematic studies with large datasets taking causality seriously. That is why we see initiatives such as the Purposeful Company project on the way with this new evidence. It will take time before this fully sinks



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in but now we have the evidence things will change. Why do people eat healthily or take exercise? It is not because of government regulation, but when there is evidence showing that this is good for people they will start to adopt this voluntarily.

Q60 Amanda Solloway: Do you believe the reporting requirements around compliance with directors' duties are sufficient at present?

Jonathan Chamberlain: It is not for my association to take a view as to whether they are sufficient, but they are not really there in terms of Section 172. There is in our members' experience something of a box-ticking approach. Minutes of board meetings will say that Section 172 has been complied with, but the extent to which that is genuine or real is uncertain. In any event, it is not open to scrutiny, hence our suggestion, which seems to be widely shared, that companies are required to publish their compliance and make a statement of their compliance.

Picking up on some of the things that were said earlier, in relation to modern slavery, for example, the practice that companies are adopting is to encourage whistleblowing at points in the supply chain. That would be a very good way—indeed it has proved to be a very good way, if you look at previous inquiries into the effect of whistleblowing—of bringing misdemeanours into the public eye and to the attention of the board who may not be aware of them.

Mike Everett: In our submission we said that perhaps "having due regard" could be changed to say, "They must consider and report how they have achieved Section 172". In order to be able to hold boards to account, we need them to communicate to us in a detailed manner how they have achieved all of those. I have a slight problem with the words, "report how they have complied", because if it is just about compliance you get boilerplate. There needs to be a real feel for how they have done it and how they have considered the interests of employees and wider stakeholders. Yes, that could be improved.

Peter Montagnon: I absolutely agree fully. We have also suggested this. Mike makes an important point about compliance. Our formula is how they have taken into account Section 172 in their skills development, which is very important because it brings in the diversity element in a broad sense, in their decision-making and in their setting of priorities. I would prefer them to make a discursive statement, which would be very public and for unlisted as well as listed companies, rather than to have some lawyer sign off saying, "They have complied", because that is very difficult and not very meaningful.

Alex Edmans: My expertise is in large-scale evidence; this is something that is more of a judgment call, so I will defer to the others on this.

Q61 Amanda Solloway: Going back to talking about Section 172, I am wondering how effective it is in governing behaviour, how well known it



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is to directors and how they find out about it in the first place.

Jonathan Chamberlain: There is no evidence as to how effective it is in governing behaviour. Under the current state of the law, there are no penalties for failing to comply with it. There are no reported cases of any shareholders having brought derivative actions against the board where they cite failure to comply with Section 172 or its predecessor, Section 309. That would suggest either it is working brilliantly because no actions have ever been brought or the cynical view would be that it is not working at all. I am not sure that is right. In my experience as an adviser, boards do take that duty seriously but we have no way of evaluating that.

Q62 **Chair:** So it is not worth the paper it is written on in terms of legislation.

Jonathan Chamberlain: I would not say that. Very few boards in my experience—and I appreciate that is a subjective experience—would disregard a section of legislation simply because they could get away with it. That is not how, in my experience, directors exercise their duties. We are all in agreement that, to put it at its lowest, it is very difficult to evaluate the operation of Section 172 in the absence of any real disclosure as to how it is working in practice.

Mike Everett: Your question was whether boards and directors know about it. Particularly at the top end, I cannot believe they would not. They have very well trained company secretaries whose job it is to do that. All the way down the listed companies, right down to the bottom of the FTSE 350, I would find it hard to believe they are not aware. They have advisers; they have company secretaries. In the private sector, I have less knowledge but in a company the size of BHS, I would find that hard to believe as well.

Peter Montagnon: I am not sure. This is anecdotal. We do not know definitely if they know about it or how much attention they pay to it. What is very clear is if they are required to report against it in some way it will bring the whole thing to life. It certainly should be worth something then. That is worth trying before we do anything more radical because we have seen situations before; the Modern Slavery Act has been mentioned. If you go back in time to the end of the last century when the New Labour Government required pension funds to make just a very light-touch statement about their attitude to corporate responsibility and their investment principles, that had a profound impact on behaviour. Tailored and carefully, carefully crafted, these disclosure requirements can have a very big impact on behaviour. It is a much simpler way than trying to rewrite the law.

Q63 **Amanda Milling:** One question I asked to the last panel was about the difference between publicly listed companies and private companies in terms of which codes they have to consider. This is a question for Mike. Do you feel that the private companies need to also be governed by the



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same requirements as those that are publicly listed?

Mike Everett: Particularly when they get of a sufficient size to be of an interest to the public. Stephen Haddrill mentioned the public interest test. If they are big enough, I would expect them to be able to meet the same requirements around environmental, social and those sorts of aspects. As companies get smaller, they maybe would have a reduced requirement but they should have similar standards applied to them. The difficulty then is how you make them adhere to those standards and what the mechanisms are by which that happens. With public companies you do have people to hold them to account; that is less easy with private companies.

Q64 **Amanda Milling:** What would your views be on that in terms of how you would hold them to account?

Mike Everett: In considering that, the only mechanism is somehow having a regulator who can inspect and challenge that, which was mentioned. We on public companies do meet boards. We try to understand the quality of the directors. We try to understand how good the chairman is that is running the board. We try to understand how they nominate people and the skills they want. That is less easy to do with a private company. The only concept I can think of is to have an entity that would do that as a regulator in some way.

Peter Montagnon: In one of my other activities I am a member of a board of an organisation in Dubai called the Hawkamah Institute, which promotes good governance in the Middle East, which is an interesting challenge sometimes. I came across a company there called Majid Al Futtaim Holdings, which has one shareholder and is not listed. It has an independent chairman and its board processes follow entirely the UK governance code. The chairman, by the way, is Sir Mike Rake who is also chairman of BT. The owner of this company clearly finds that the UK governance code is a very good starting point for getting together a board capable of delivering independent challenge and advice, and follows this.

My point in raising this is we must not assume that just because the code is directed at listed companies, it is almost wholly irrelevant to unlisted companies. We must start with high expectations for the unlisted sector and bear in mind that a lot of the structures that are mandated by the code can be made to apply in unlisted companies. In the case of Majid Al Futtaim Holdings, clearly the owner finds this greatly beneficial to his business.

Q65 **Amanda Milling:** If that is the case, surely it should be therefore expanded out to private companies, particularly based upon size. What are the risks of doing that?

Peter Montagnon: I do not think there are risks. The problem is this is voluntary. In the case of Majid Al Futtaim, it is entirely voluntary. The problem really is the "comply or explain" process: who you are



explaining to and how you react to challenge from outside. There is a task for the FRC to get on top of this and find a mechanism of promoting this process in the unlisted sector. The unlisted sector should be required to make statements under Section 172, which they should be required to push actively at stakeholders, employees, customers, suppliers and so on. The FRC should certainly be monitoring that process very carefully and be prepared to sanction directors and boards who do not deliver. You could apply something similar to the governance code if you wanted to.

Q66 Richard Fuller: I would like to ask questions about advisers. One of the most significant roles that boards contain, particularly around transactions, is the hiring of advisers. They are, in effect, an extension of the corporate board at that time. There is very little in the way of regulation or oversight of advisers. Perhaps I could start with you, Peter. In answer to one of my colleague's questions, you talked earlier on about the power of transparency and nudging to get better behaviour rather than taking a sledgehammer. Do you think we have a problem with knowing what advisers do? Do you think we ought to be looking to take some action, nudging or otherwise, around their responsibilities?

Peter Montagnon: Broadly speaking, I agree with what Stephen Haddrill said earlier about transparency. I think it was him who said there should be more transparency. There is a bit of a risk that you might then have some unofficial advice below the radar that never gets disclosed. We have not thought a great deal about this beyond that, so I would defer to my colleagues on the panel.

Alex Edmans: I used to be an adviser. My former life was at Morgan Stanley in mergers and acquisitions. When you would pitch for a business what you would quote is a league table showing your market share: how many deals you have done in the past in that industry. This is actually systematically negatively correlated with the performance of merger transactions. What we are disclosing is irrelevant information.

Instead, if you were to look at the value created by mergers, that is a persistent characteristic. We know that in many areas of finance past performance does not predict the future, but in M&A it does predict the future. We should try to skew or change the disclosures that we make based on value creation in M&A, so either in short-term or long-term shareholder value creation, rather than just looking at the number of deals that you do.

Q67 Richard Fuller: I am not sure how that would help. Just because you have done well in the past does not mean you are going to give good advice here, does it? I will give you an example. In the example of British Home Stores, two advisers were brought onto a board. They represented very senior positions in advisory firms and they provided—many of us think—a veneer of respectability on an otherwise entirely unsuited purchaser from one of our country's major enterprises. There is nothing that stops that happening.



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Alex Edmans: You are correct in one particular example.

Richard Fuller: I am not sure that what you are suggesting would have the slightest impact on that.

Alex Edmans: What we have done is a systematic study looking at whether the quality of advice that had been given in the past is linked to the quality of advice in the future. In some cases it will not be linked, but systematically it does seem to be linked. Therefore, at least basing your decision on which adviser to hire on the quality of deals done in the past is a better metric than the number of deals you have done in the past; otherwise, advisers have the incentive to do as many deals as possible regardless of the outcomes for society and shareholders.

Mike Everett: We think that, overall, there are too many advisers. A lot of advisers get between us as shareholders and the company. That does not improve communication. From the side of corporate finance, when we made a reply to the Kay review we questioned that as well and suggested a couple of things: first, the code of conduct but also that the incentivisation of these advisers is to do the deal, not the outcome of the deal. One of the things that could be considered is whether the incentivisation should be aligned with the outcome rather than the fact that a deal was done. In a listed company, if they got paid in shares of the new company that was created, there may be an alignment.

Q68 **Richard Fuller:** Should the fees be made public in a transaction?

Mike Everett: Transparency is always good, as Peter said. It brings some scrutiny to it. Boards, whether they use an adviser or not, are still required to be transparent about how their decision has considered those sections of Section 172, the employees and the wider aspects in the long-term success of the company. That needs to also be part of the transparency. Yes on using advisers, but also how they have used that advice to come to the decision is very important.

Q69 **Richard Fuller:** We have talked a lot about Section 172 responsibilities; in my experience, they really come to pass when you are doing a transaction. That is when the different interests of different participants become much more focused. Will the employees, suppliers, customers and shareholders be better off by merging with another company, being acquired by another company or acquiring another company? At that point, the people who are really giving the influence are the advisers. Should there be an equivalent to the Section 172 requirement on advisers or around people advising on a transaction?

Mike Everett: As I said, we suggested that there should be a code of conduct that has something around that, whether it is some sort of requirement for them to disclose how their advice had been aligned to that, but the board should still be reporting. They are making the decision at the end of the day based on the advice. They need to be able to say why their decision has considered all those aspects as well.



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Jonathan Chamberlain: As the adviser sitting on the table now, I have to be very careful because it is beyond the remit of my association to comment on advisers' roles in M&A transactions. What I would say in reply to your last question is that it would be very difficult to impose a Section 172-type duty on the advisers because different advisers will have different pieces of information. For example, as a lawyer it is sometimes said there are three kinds of lawyer: those who can count and those who cannot. We are not going to understand the financial implications of a transaction. We are not qualified to do so. It might be very difficult for us to be able to have a similar duty.

On the role of employment as advisers, we are—as solicitors anyway; not all employment lawyers or advisers are solicitors—regulated by the SRA. We are under a duty not to take advantage of our position as lawyers. In relation to issues around governance in the workforce, there may be problems as reported in the press. For example, as has been reported, some couriers have clauses in their contracts that they are not allowed to bring claims before an employment tribunal.

I am speaking for myself rather than the association when I say that it is questionable if solicitors were involved in drafting those clauses that do not work. There is no ambiguity about that. They absolutely do not work. A solicitor who put that into a contract knowing that it did not work, knowing that it could only be for the purpose of intimidating the worker from bringing a claim before a tribunal, may already be in breach of their existing obligations. That is a question, then, of, first, them understanding those obligations and, secondly, an effective regulator giving them the resources and priorities to focus on things like that.

Q70 **Richard Fuller:** Is there a role for expanding the professional code of conduct and the teeth that they have in the various professions and bodies?

Jonathan Chamberlain: I can only speak as a solicitor. I know that any solicitors who practise in M&A are always very cognisant of their professional codes of conduct.

Q71 **Richard Fuller:** Back to you, Peter, if I may. There was one adviser. You talk about below-the-radar advisers. In British Homes Stores, there was one adviser who was the only unpaid adviser. Their advice was the only advice that seemed to count. It is human nature to trust people when you might not want to hire them but just listen and give them a call. Is there anything unethical about that sort of behaviour?

Peter Montagnon: Are you asking me?

Richard Fuller: I am.

Peter Montagnon: I am afraid I do not know enough about it. It sounds as though there is possibly quite a lot that is unethical about what went on, but I really would not wish to comment.



Q72 Anna Turley: Chief executive and executive remuneration has been talked about a lot this morning as one of the key issues of corporate governance. We have heard about some of the reasons why we have got to where we are: ratcheting up, a failure of the link with performance, a short-termism rather than a commitment to the long-term sustainability of an organisation and the complexity of the packages. What I am really interested in is where we go from here and some solutions. Is this for Government to intervene in? What sort of regulatory or legislative models do you think could tackle this? How do we get shareholders interested in this and seeing it as a core part of their job? Can I focus on Alex and Peter specifically?

Alex Edmans: Sure. Thank you. One of the things that you mentioned in your question was the lack of link between pay and performance. This is not the case. This is a myth that is perpetuated; what people look at is how salary and bonuses change year-to-year as performance changes. The vast majority of an executive's wealth comes from all of the shares that she was given in the past. What you want to look at is not pay performance sensitivity, but wealth performance sensitivity.

Because CEOs in the UK have large shareholdings, a 10% fall in the stock price leads to effectively a pay cut of £1.5 million. There are negative effects of poor performance. What is important is to look at the change in the entire wealth rather than the change in pay. I certainly agree that that pay is a social issue. The public, quite rightly, gets upset where CEOs still get paid their salary despite poor performance. One of the suggestions that I had in the written submissions was to look at the changes in wealth, not just the changes in pay. This is something that should be very easy to disclose because firms know how many shares an executive has. They can look at the change in her shareholdings.

We start from that side but it is important to start with the problem and to diagnose the problem before we look at the solution. In terms of the solutions, a lot of the measures currently proposed are looking at the quantum of pay or the ratio of pay to median worker pay. There is not much evidence that this is correlated with long-term performance. For example, it was mentioned in the earlier session that there is evidence that high ratios lead to bad outcomes. Actually, the paper, if you read the executive summary, finds: "We do not find a negative relation between relative pay and employee pay... We find that firm value and operating performance both increase with relative pay."

What is going on here is that there are so many academic studies out there and many of them are poor. Some of them do not distinguish causation from correlation. Some of them do not control for other factors. It is popular nowadays to state a position and then state a study that has found something supportive. You will always find a study that supports something. What is really important is to look and distinguish between the evidence. What was quoted in one of the written testimonies was a working draft of the paper. That paper then goes



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through peer review, and then after peer review, controlling for the factors that they omitted, it led to a very different conclusion.

From that premise—that just the long-term elements are what has been linked to superior performance—actually making the CEOs' pay more sensitive, not less sensitive, to performance has been shown to lead to a causal effect of four to 10 percentage points per year in terms of long-term shareholder returns. Back to one of the earlier questions in the earlier session, do CEOs really have an effect on firm value? This is only changing the CEOs' contracts, nobody else, but this leads to 4% to 10% of long-term shareholder returns. There is an earlier study I talked about on extending the horizon, again improving shareholder returns, innovation, and corporate social responsibility.

Chair: I am very conscious of time.

Peter Montagnon: We have some basic principles behind our approach to this. Executive pay should be simple, which it is not; transparent, which it is not, despite disclosure; fair, which does not always appear to be the case; and should give an incentive towards a long-term approach to running the business, which relates to the cultural questions we mentioned earlier. Our fundamental problem is that this remuneration as delivered is impossible to value. It is too complicated, the share schemes cannot be valued, the executives do not know what they are getting and, indeed, because they do not know what they are getting and are suspicious of it, they always ask for more. The people who are handing it over do not really value it or cannot easily value it. The shareholders are voting on the outcome from an even greater distance.

We need to go back to a much simpler process that starts with cash because you can value that—you can see what people are getting—and then insists that some of that cash is transferred into long-term shareholdings that then bring in the wealth factor that Alex is talking about. We need to stop doing sticking plaster stuff, stand back and work out a better system. It is not necessarily wrong to pay people who are delivering a lot of money; it is wrong to pay them in a way that generates distrust amongst the general public and which they do not understand.

Chair: Thank you, gentlemen. We are very grateful for your time. We really appreciate the evidence you have given us. Thank you again.