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GREEN PAPER ON CORPORATE GOVERNANCE REFORM: CONSULTATION RESPONSE BY THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

"THE PLSA RECOGNISES THE VALUE OF INCORPORATING A STRONGER STAKEHOLDER PERSPECTIVE INTO CORPORATE GOVERNANCE STRUCTURES."

February 2017

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ABOUT THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION

The Pensions and Lifetime Savings Association is the national association with a ninety year history of helping pension professionals run better pension schemes. With the support of over 1,300 pension schemes with over 20 million members and £1tn in assets, and over 400 supporting businesses, we are the leading voice for pensions and lifetime savings in Westminster, Whitehall and Brussels.

Our purpose is simple: to help everyone achieve a better income in retirement.

EXECUTIVE SUMMARY

A number of high profile corporate governance scandals have hit major UK companies in recent years, while UK executives continue to enjoy excessive pay awards. As long-term investors in these companies, pension funds are concerned that this is doing serious damage to the stakeholder relationships that the companies depend upon to ensure their sustainable success.

We believe this necessitates a change in the approach taken by UK companies, from one too driven by short-term financial performance, to a more holistic understanding of their purpose and success in relation to their impact on a wide range of stakeholders.

We are therefore supportive of the Government's objectives in relation to more proportionate executive pay, and the incorporation of a broader range of stakeholder perspectives into corporate governance processes, but are unsure of whether the Green Paper proposals will achieve the cultural change we think is necessary.

Slight variations on the proposals in the Green Paper could make companies more accountable to engaged shareholders regarding their executive pay practices. A company's approach to pay ought to enjoy much broader support than a narrow majority of shareholders. Therefore, we argue that the threshold for AGM votes on pay awards to pass should be raised to a 'super majority' of, for example, 75 per cent. Any company that fails to achieve this should be required to put their pay policy to another binding vote.

We also support the disclosure of pay ratios between the CEO and UK workers at different pay quartiles throughout the organisation and believe that this provides a useful insight into the culture and business model of a company. Fears that such ratios would be used inappropriately have been exaggerated.

The proposed introduction of stakeholder panels or committees, with a mandate to monitor the company's impact on and relationship with its various stakeholder communities could provide the board with a valuable insight into the 'shop floor' of their organisation.

For these panels/committees to work most effectively, a non-executive Director should attend meetings and the committee should provide a fair and balanced update on its work in the annual report.

INTRODUCTION

The UK's flagship companies provide jobs for millions of workers, directly and indirectly, and contribute to incomes in retirement for millions of savers who invest in them through their pension fund. These companies provide many of the products, services and tax revenues that enable our society to flourish.

But while far from typical of corporate Britain as a whole, there have been too many scandals associated with UK companies in recent years, relating to exploitative working conditions; poor supply-chain management; mis-selling and market manipulation; environmental degradation; and mis-leading audit processes.

Wider concerns that our current economic model only serves the interests of those at the top have been exacerbated by executive pay increases that have vastly outpaced those experienced by the wider workforce.

There is some evidence from both the UK and other countries, where similar perceptions of corporate malpractices have taken hold, that this has led to a weakening of both public and political support for businesses. This has serious consequences for investors, including pension funds who depend on their investments in UK companies to deliver secure incomes in retirement for their members.

The fact that the benefits of a successful business are distributed across investors, suppliers, workers, customers and wider society explains why business growth is a key objective of government policy. This is also why business enjoys the more informal social license to operate deriving from public goodwill. If the support of either policymakers or the general public weakens, the outlook for businesses becomes much less optimistic.

Therefore, the PLSA is supportive of the view taken by the Prime Minister that 'big business must earn and keep the trust and confidence of their employees, customers and the wider public.' We also support the objectives of 'ensuring that executive pay is properly aligned to long term performance, giving greater voice to employees and consumers in the boardroom, and raising the bar for governance standards in the largest privately held companies.'

As stakeholders and the source of significant investment in these companies, the holistic interest of pension savers should be a key consideration in how the companies are run.

Pension savers' interests relate most directly to the capacity of companies to deliver sustainable returns on investment, but also include the influence over their lives that major companies can exert through their impact on the environment, wider working practices or social cohesion. As shareholders, pension funds do not exist in isolation from a company's other stakeholders – they are also workers, customers and citizens who have to live in the world in which the company operates.

Box 1: Pension funds and UK companies

Responses to the PLSA's annual member survey suggest that a typical private sector Defined Benefit pension scheme invests around 28 per cent of its assets in equities, with the figure rising to 61 per cent for local government defined benefit pension schemes and 70 per cent for a defined contribution scheme's default fund at the growth stage. 90 per cent of DB respondents to the survey reported that their main DB scheme invested in UK equities.

These figures highlight the important stake that pension funds retain in the governance of UK companies

As such, the PLSA recognises the value of incorporating a stronger stakeholder perspective into corporate governance structures and of an integrated approach to reporting and measurement of a company's success in relation to its impact beyond its financial performance. We believe that in general, working towards the stakeholder interest is consistent with the need to deliver sustainable returns for investors.

The PLSA has always sought to be at the vanguard of the corporate governance debate. Our principles of executive remuneration, published in 2013, now enjoy broad support across the investment community as a basis for appropriate and accountable pay structures, as demonstrated by the reiteration of similar principles in the final report of the Investment Association's executive remuneration working group.[1] Last year our AGM review and member survey went further than other prominent documents published by the investment community to identify the size of executive pay packages, as well as their structure, as a key and systemic problem for investors.[2]

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[1] PLSA/Hermes, Remuneration principles for building and reinforcing long-term business success, 2013 via http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0290-Hermes-EOS-NAPF-Pay-Principles.ashx

[2] PLSA, *AGM Season report 2016*, 2016 via http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0606-AGM-Report-2016.pdf

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Our ongoing work on corporate reporting of organisational culture and employment practices, beginning with our discussion paper on this subject in 2015 and continuing with our stewardship toolkit for pension funds last year, has led the investment industry's engagement on low pay, precarious working and the related issues that have done so much to undermine public confidence in business.[3]

Our objective in undertaking these projects is to bring about a change in the mentality of UK businesses from one that is in many cases still too wedded to short-term profitability and the company share price, to an approach focused on delivering the best possible outcome for all stakeholders over the long-term.

We believe one of the most useful contributions that the Government could make would be to explicitly recognise and encourage this more holistic understanding of the purpose of a company. Without doing so, there is a risk that the policies outlined in the green paper will constitute insufficient tweaks to existing corporate governance structures rather than the bolder proposals that are necessary.

However, more incremental, implicit changes can also contribute to the emergence of a more positive culture over the long-term. The following consultation response sets out the PLSA's view on which of the options set out in the Green Paper we favour and how they might be implemented.

[3] PLSA *Where is the workforce in corporate* reporting, 2015 via http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0439-Where-is-the-workforce-in-corporate-reporting-An-NAPF-discussion-paper.pdf and PLSA, *Understanding the worth of the workforce: a stewardship toolkit for pension funds*, 2016 via http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0591-Understanding-the-worth-of-the-workforce-a-stewardship-toolkit-for-pension-funds.pdf

EXECUTIVE PAY

DO SHAREHOLDERS NEED STRONGER POWERS TO IMPROVE THEIR ABILITY TO HOLD COMPANIES TO ACCOUNT ON EXECUTIVE PAY AND PERFORMANCE? IF SO, WHICH OF THE OPTIONS MENTIONED IN THE GREEN PAPER WOULD YOU SUPPORT? ARE THERE OTHER OPTIONS THAT SHOULD BE CONSIDERED?

Shareholders already have some significant powers to hold companies to account over their executive pay practices – most obviously, the votes on the pay policy (tri-annual, binding) and pay award (annual, advisory) at company AGMs and their votes against the re-election of the Directors responsible for setting pay levels.

Existing shareholder voting patterns

However, many shareholders do not use these powers. According to The PLSA's analysis, the average level of dissent against a remuneration-related vote at a FTSE 350 company between September 2015 and August 2016 was around 7 per cent.[4]

This should not be taken as a unanimous shareholder endorsement of existing pay levels. The average across the entire index disguises a number of outlying companies where dissent was much higher, and of course, shareholder views are not homogenous. From the perspective of pension funds, a survey of PLSA members found that 87 per cent respondents felt that executive pay was too high, while 85 per cent said they were concerned about gaps between executives and the wider workforce.[5]

The UK's shareholder base is increasingly fragmented and internationally distributed, while a growing number of shareholdings are held on a short-term basis. Many shareholders find it difficult to engage with the UK companies in which they are invested, or are less concerned with the strategy for the long-term leadership of the company, of which the approach to executive pay is a key component.

Of those that are engaged, co-ordinated action that carries enough weight to force the company to change course is difficult to arrange. Our analysis found that there were 42 companies last year where an executive pay-related vote attracted levels of dissent of over 20 per cent.[6] Despite the fact that many of the dissenting shareholders would have been the most engaged investors, with the keenest interest in the company's long-term success, these dissent levels were not taken especially seriously by the

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[4] PLSA, *AGM Season report 2016*, 2016 via http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0606-AGM-Report-2016.pdf
[5] Ibid
[6] Ibid

companies, with subsequent responses failing to acknowledge any mistakes or committing to anything beyond boilerplate promises to engage with shareholders, which ought to be taking place anyway (see box 2).

Box 2: Selected quotes from response by FTSE 100 companies to significant levels of shareholder dissent (companies with five highest levels of dissent in 2016)

'*We have already spoken to a number of shareholders and have a continuing dialogue. They are seeking changes to our remuneration policy for the future. We will continue that engagement and will bring a revised policy to our next AGM in 2017.*' **(BP)**

'*In spite of the voting outcome, the Remuneration Committee and indeed the Board unanimously believe that in these particular circumstances the Remuneration Committee made the right decision in aligning executive reward to the shareholder experience.*' **(Smith and Nephew)**

'*We have engaged extensively with our major shareholders on the remuneration report and acknowledge the vote today. We remain firmly committed to a constructive and appropriate dialogue to fully understand shareholder views as we compete in a global market place.*' **(Shire)**

'In light of these important factors, the Remuneration Committee believes it was justified in its decision not to reduce the level of shares under award upon retirement for these two executives.' **(Babcock)** [1]

'Setting executive remuneration in a volatile industry such as mining can be challenging and the Remuneration Committee intends to again engage with shareholders in order to refine the policy to ensure that it is both appropriate and motivational' **(Anglo-American)**

This is concerning, as such high levels of dissent should not be treated lightly. We are worried that companies regard any vote that passes as a success, even if it fails to win the support of the most engaged proportion of their shareholder base. There is also a real possibility that at least some of the 42 pay packages that attracted significant levels of dissent but were still passed by the AGM were only successful because of the support of dis-engaged investors, meaning that many companies are adopting sub-optimal pay practices that do not reflect their long-term interest or that of the wider economy.

'Supermajorities' needed for remuneration report votes

As such, we would recommend requiring advisory votes on remuneration reports to achieve a 'supermajority' of, for example, 75 per cent– making it harder to go through as a result of passive, dis-engaged shareholders. Any companies whose award fails to achieve this threshold would have to put their policy to a binding vote, even if they had held one in the past three years.

Such an approach would ensure that companies take significant levels of shareholder dissent over executive pay much more seriously than is currently the case. Those long-term shareholders that do study companies approach to executive pay and its link to strategy, performance and culture would be empowered.

Other Green Paper options

The PLSA would favour this reform over certain options outlined in the Green Paper – for example, option i (making certain parts of the vote on the remuneration report binding) and option ii (introducing stronger consequences for companies that lose the remuneration report) would not address the problem of dis-engaged shareholders – analysis in the Green Paper shows that option ii would only have affected four votes across the FTSE 350 out of over 900 since 2014.

Similarly, option iv (requiring the binding vote on remuneration policy to be held every year, in all circumstances) seems overly burdensome. The remuneration policy should relate to the company's strategy and the culture it is trying to build over the long-term. Holding a vote every year would be counter-productive to these efforts. With the model we are proposing, more frequent votes would only occur when there are grounds to think that the current pay strategy is failing.

Option iii (requiring companies to set an upper limit on pay awards) and option v (requiring clearer guidance in the corporate governance code on engaging with stakeholders over pay) could both complement the model that we propose.

DOES MORE NEED TO BE DONE TO ENCOURAGE INSTITUTIONAL AND RETAIL INVESTORS TO MAKE FULL USE OF THEIR EXISTING AND ANY NEW VOTING POWERS ON PAY? DO YOU SUPPORT ANY OF THE OPTIONS MENTIONED? ARE THERE OTHER IDEAS THAT SHOULD BE CONSIDERED?

The PLSA strongly believe that investors should be active stewards of their investments and engage closely with the companies they invest in. However, it is important to be realistic about the prospects of improvement in this area and the impact of any new regulations.

Empowering those shareholders that are most engaged with their investee companies (as outlined in our response to question 1) should be a first priority.

The Stewardship Code

The UK Stewardship Code also already provides an instrument for the promotion of investor engagement. The Financial Reporting Council issued the current iteration of

the code in 2012 and this year categorised signatories into three tiers, based on the quality of their disclosures.

The Stewardship Code has been a useful innovation, as demonstrated by its replication in other countries, such as Denmark and Japan. The Code already contains recommendations in relation to actively voting shares, while the introduction of a tiered structure shows how it could be strengthened to further encourage better engagement practices. This would be our preference as a medium through which to encourage shareholders to actively engage with investee companies and vote at AGMs.

Other Green Paper options

Of the proposals made in the Green Paper, option i (mandating disclosure of voting records and accompanying rationale) would also be helpful (and could be introduced via strengthened guidance in the Stewardship Code). The principle of option iii – requiring nominee account holders to facilitate voting by the underlying beneficiary – is also sound, but we would expect very few retail investors to take up this option.

Regarding option ii (the creation of shareholder committees) this would increase accountability to shareholders, but overall we do not favour its introduction. It would effectively create two classes of shareholder, and criteria for representation would be difficult to establish – a threshold based on size or length of shareholding would inevitably require a cut-off point, potentially giving shareholders who had a slightly larger shareholding or had held their shares for slightly longer than others a much greater influence over the company.

DO STEPS NEED TO BE TAKEN TO IMPROVE THE EFFECTIVENESS OF REMUNERATION COMMITTEES AND THEIR ADVISERS, IN PARTICULAR TO ENCOURAGE THEM TO ENGAGE MORE EFFECTIVELY WITH SHAREHOLDER AND EMPLOYEE VIEWS BEFORE DEVELOPING PAY POLICIES? DO YOU SUPPORT ANY OTHER OPTIONS YOU WANT TO SUGGEST?

Research has previously revealed that companies' disclosures on how they have complied with the requirement in the corporate governance code to have regard to pay and conditions across the wider workforce when setting executive pay are often vague and unspecific.[7] It may now be appropriate to consider introducing more detailed guidance on consulting with the workforce over pay practices as suggested in option i.

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[7] See for example High Pay Centre, *One law for them: how big companies flout the rules on executive pay*, 2013 via http://highpaycentre.org/files/one_law_for_them_report.pdf concluding that 'the vast majority of FTSE 100 companies say they have shown sensitivity to pay and conditions of the wider workforce but do not provide evidence of how they have done so.'

This could be a very effective way of taking much of the emotion out of the issue over executive pay. Investors rightly focus on pay, sometimes at the expense of other important strategic issues, because of the understandable societal concern at pay levels so far removed from those of ordinary workers. If companies were able to demonstrate that they had discussed their approach with the workforce, there would be less grounds for criticism on grounds of insensitivity. The input of employee perspective could also help avoid particularly egregious pay practices, such as those resulting in huge pay-outs for executives at companies issuing significant job losses.

We do not support option ii, requiring remuneration committee chairs to have served for at least 12 months on the remuneration committee before assuming the position of chair. While experience and knowledge of the executive pay-setting process is useful in ensuring that the committee is not overly beholden to its advisers, there is also an argument that more directors who are not bound by conventional thinking on executive pay would be beneficial. New rules requiring any external candidates for chair to sit on the committee for 12 months might hinder companies' efforts to incorporate fresh perspectives.

SHOULD A NEW PAY RATIO REPORTING REQUIREMENT BE INTRODUCED? IF SO, WHAT FORM OF REPORTING WOULD BE MOST USEFUL? HOW CAN MISLEADING INTERPRETATIONS AND INAPPROPRIATE COMPARISONS (FOR EXAMPLE, BETWEEN COMPANIES IN DIFFERENT SECTORS) BE AVOIDED? WOULD OTHER MEASURES BE MORE EFFECTIVE? PLEASE GIVE REASONS FOR YOUR ANSWER.

The PLSA outlined our support for the publication of pay ratios in our 2016 stewardship toolkit for pension funds on engaging with companies over their corporate culture and employment practices.[8] The toolkit was developed in partnership with PLSA members, as well as asset managers, companies, social partners and other stakeholders, and recommends standards for corporate reporting of employment practices and workforce-related issues.

The toolkit advises that the ratios between the Chief Executive; the next best-paid employee; and the median or lowest-paid worker are all useful insights into the corporate culture of the organisation.

Narrative reporting

[8] PLSA, *Understanding the worth of the workforce: a stewardship toolkit for pension funds*, 2016 via http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0591-Understanding-the-worth-of-the-workforce-a-stewardship-toolkit-for-pension-funds.pdf

Obviously, the pay ratio is a blunt tool. Our toolkit set out how companies should outline the vitally important strategic characteristics of their workforce (the composition; stability; skills and capabilities; and engagement levels of their workers) in their annual reports, as this is a critical component of any business model and future strategy. We were keen to emphasise that this should be communicated in narrative form because the character and culture of each workforce is unique (and rarely homogenous) and cannot be explained by a series of data points. However, the toolkit also acknowledged that without underpinning data, narrative reporting can take the form of a corporate PR exercise.

We would like to see – and are encouraging our members to request – a detailed narrative explaining the company's employment model in terms of the above characteristics, and how this relates to its long-term purpose and strategy, supported by concrete, comparable metrics that can act as proxies for the relevant characteristics, such as staff turnover; number of workers by employment type; employee survey results; and pay ratios. We have already engaged with a number of companies promoting this approach to reporting and have found them receptive to our interest in this area. We would encourage policymakers' guidance for companies to take a similar approach.

Pay ratio methodologies

On pay ratios specifically, the forthcoming gender pay regulations will require companies to calculate the threshold for each pay quartile in their organisation, for UK workers. Combined with the 'single figure' for CEO pay, this can be used to calculate a pay ratio, so mandating this methodology would be the least burdensome pay ratio disclosure requirement to impose on companies. This would also enable them to publish a ratio between the CEO and each quartile, as well as with other executives whose pay is also documented in the single figure disclosures. If accompanied by an explanation of why particular ratios are appropriate between different levels of workers, these figures would be of great value to investors.

Given the extent to which many companies rely heavily on agency and temporary workers, there is also a risk that ratios relating to direct employees only may prove slightly mis-leading. As such, we would recommend that any worker spending the majority of their working time on behalf of a particular company should be included in the calculation of that company's pay ratio.

Mis-leading comparisons?

In terms of the risk of mis-leading or inappropriate comparisons, we believe this is exaggerated and the Government should ignore objections to the publication of pay ratios made on these grounds.

There is nothing preventing from companies including an explanation for pay differentials within their company alongside the pay ratio– indeed, as our toolkit states, it is to be hoped that they will do so. Companies that produce good annual reports, clearly communicating their strategy and business model, will be able to explain their organisational pay structure and how this positions them to thrive over the long-term. Those that fear publication of this information probably do so on account of their sub-optimal pay practices.

Stakeholder discussion of pay ratios plays a powerful and important role in shaping companies' approach to pay, and helping to ensure they get it right. While there will inevitably be some cross-sector media comparisons of the highest pay ratios, these will nearly always affect those with the highest ratio in the sector. No relevant stakeholder (for example shareholders, workers or regulators) is likely to make a comparison across two companies with significantly different types of worker, such as a supermarket and a financial services company. Indeed most pay ratio comparisons will not look at different companies at all, but at year-on-year changes within the same company. So we hope the Government will not be deterred from introducing requirements on these grounds.

SHOULD THE EXISTING, QUALIFIED REQUIREMENTS TO DISCLOSE THE PERFORMANCE TARGETS THAT TRIGGER ANNUAL BONUS PAYMENTS BE STRENGTHENED? HOW COULD THIS BE DONE WITHOUT COMPROMISING COMMERCIAL CONFIDENTIALITY? DO YOU SUPPORT ANY OF THE OPTIONS OUTLINED IN THE GREEN PAPER? DO YOU HAVE ANY OTHER SUGGESTIONS?

As investors, our members are naturally interested in the bonus targets that are used to incentivise the executives of the companies they are invested in. At the same time, there is a growing body of evidence questioning the value of performance-related pay for employees in strategic positions, particularly when linked to specific benchmarks that are inadequately reflective of the holistic nature of the role.[9]

Therefore, we are increasingly sceptical about the justification for bonus payments. Where they are used, we are open-minded about awards made on a more qualitative basis, linked to progress against strategic objectives. Inevitably, this makes it harder to disclose clear targets or conditions for pay-out, but provided that long-term strategy is clearly communicated in annual reports and elsewhere, it ought to be possible to ensure that bonus payments are justifiable.

[9] See for example, *CFA Institute, An analysis of CEO Pay arrangements and value creation for FTSE 350 companies*, 2016 via https://www.cfauk.org/media-centre/cfa-uk-executive-remuneration-report-2016, concluding that the association between CEO pay and fundamental value creation in the UK remains weak.

Again, this suggests that a key focus for policy-makers/regulators should be on encouraging better disclosure of broad company strategy.

HOW COULD LONG-TERM INCENTIVE PLANS BE BETTER ALIGNED WITH THE LONG-TERM INTERESTS OF QUOTED COMPANIES AND SHAREHOLDERS? SHOULD HOLDING PERIODS BE INCREASED FROM A MINIMUM OF THREE TO A MINIMUM OF FIVE YEARS FOR SHARE OPTIONS AWARDED TO EXECUTIVES? PLEASE GIVE REASONS FOR YOUR ANSWERS.

The PLSA is supportive of longer-term vesting periods for executives share awards, and a move towards restricted share awards, rather than more complex long-term incentives plans. Government could encourage this approach, but we would not support compulsory pay structures of one form or another.

It is often wrongly suggested that it is the structure of executive pay awards that is responsible for the high levels of anger and confusion that the issue provokes. We believe that this is mistaken – it is the size of pay packages, both in absolute terms and relative to the wider workforce – that people object to. Obviously incentives are important in terms of how they shape behaviour, both intentionally and unintentionally, while structures drive some of the problems with perceived excessive value (for example, the conditional nature of long-term incentive plans forces companies to increase their size in order to make them seem more meaningful). However, most people – including pension funds – consider the size of executive pay packages to be generally excessive and just want to see it reduced.

The PLSA recently surveyed our members' views on executive pay. 87 per cent of respondents felt that it was too high.

Table 1: PLSA members views on executive pay

In general, which of the following best reflects your view of current executive pay levels for UK listed companies?	
	%
Too high	87%
About right	7%
Too low	2%

Don't know	5%

When we asked whether they thought pay was too high in the case of failing executives or too high across the board, they responded by around two to one in favour of the latter option.[10]

Table 2: What PLSA members think is problematic about executive pay

If you had to choose, which of the following statements best reflects your opinion on executive pay levels	
	%
Large pay packages for under-performing executives are particularly inappropriate, but executive pay is disproportionately high across the board	63%
There is nothing wrong with large pay packages for successful executives, but they are too often awarded regardless of performance	37%

This reinforces our view that it is size or 'quantum' that is the problem here, as much as poorly-structured packages leading to a few high-profile unmerited pay-outs. The Government should concentrate its corporate governance reform efforts accordingly.

STAKEHOLDER REPRESENTATION

HOW CAN THE WAY IN WHICH THE INTERESTS OF EMPLOYEES, CUSTOMERS AND WIDER STAKEHOLDERS ARE TAKEN INTO ACCOUNT AT BOARD LEVEL IN LARGE UK COMPANIES BE STRENGTHENED? ARE THERE ANY EXISTING EXAMPLES OF GOOD PRACTICE THAT YOU WOULD LIKE TO DRAW TO OUR ATTENTION? WHICH, IF ANY, OF THE OPTIONS (OR COMBINATION OF OPTIONS) DESCRIBED IN THE GREEN PAPER WOULD YOU SUPPORT? PLEASE EXPLAIN YOUR REASONS

As noted in our introduction, the PLSA believes that a company's stakeholder relations are critical to its long-term performance and therefore of vital importance to pension funds as investors.

We also believe that it is fair and appropriate that a company's stakeholders have a say in its corporate governance, and that it is in the company's interest to ensure that stakeholder perspectives are heard at board level.

In order to achieve this, we favour variations on the options outlined in the Green Paper.

Stakeholder panels/committees

[10] PLSA, *AGM Season report 2016*, 2016 via http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0606-AGM-Report-2016.pdf

Option i (creating a stakeholder advisory panel) has much to commend it.
Many companies will operate similar bodies, as they are already required to create 'joint consultative committees' for their employees, if requested - so in some cases this would not involve a radical extension of existing requirements or practice. Mandatory stakeholder panels or committees would enable better representation for those workforces that are insufficiently aware or organised to request a consultative committee, while also involving a wider range of stakeholder perspectives.

If such panels/committees are to work effectively, however, they will need real influence. The inevitable concern for investors is that any feedback on stakeholder relations intermediated via the company board may not be entirely reliable. There is a risk stakeholder panels/committees become a PR exercise to whitewash controversial practices.

Detailed guidance on appointments to the panel/committee and how its work is reported could alleviate this risk.

We would favour membership of the panel/committee comprised, as suggested in the Green Paper, on the basis of the individual company's particular stakeholders but with strong guidance that some constituencies – suppliers, customers, workers and pension fund trustees – are common across most companies and merit inclusion on the panel/committee. The panel/committee would be required to produce a report on its work, detailing how it has overseen stakeholder relations at the company and the impact that the company has had on different stakeholder communities in the annual report, in similar fashion to the reports produced by the Audit, Nominations and Remuneration committees on their respective remits.

NEDs with stakeholder responsibilities

We would also expect a board member to attend the stakeholder panel/committee and have responsibility for updating the rest of the board on its work, similar to the model proposed in option ii (creating a non-executive Director with responsibility for stakeholder affairs).

We do not favour turning boards into a 'parliament of competing interests' but should instead work collectively towards a strategic goal. So the board member serving on the stakeholder panel/committee should see their role in similar terms to that of members of other board committees – approaching a particular issue for the long-term benefit of the company as a whole - rather than as a representative of particular interest.

It ought to be possible, however, for board members serving on stakeholder committees/panels to be mindful of their responsibilities to the company as a whole while also acting as advocates for improved stakeholder relations, given that, as we have noted, positive stakeholder relations are in the long-term interest of the company. As the Green Paper envisages, the nature of this role ought to lead to companies seeking out candidates with different professional backgrounds to typical candidates for boardroom roles and more experience of the particular company's stakeholder community. Relevant regulatory bodies could issue guidance to this effect.

Workers on boards

On the proposal outlined in option iii (the appointment of worker directors to company boards) the Association's position is that some fears of this have been overblown. A board operates collectively, with each member bringing particular strengths and insights – indeed it is a principle of good governance that boards should be challenging and self-critical. A wide-range of different perspectives and life experiences is a necessary pre-condition for this. So worker directors bringing knowledge of the 'shopfloor' that has been lacking in some prominent corporate scandals, with disastrous consequences for investors, could be of considerable benefit to a company. The fact that a worker director may lack expertise in some particular areas of a board's work need not hinder the board's collective capacity.

Any boards prepared to subvert a hypothetical requirement to include worker directors by meeting informally without them would be violating important principles of transparency and accountability, raising serious questions about their own judgement and fitness for their roles. So objections to worker directors (rather than existing boardroom culture) on the grounds that they would encourage more informal and secretive board meetings seem at least partly mis-targeted.

Any worker directors would need to be subject to the same requirements as other board members in terms of acting in the company's long-term interest and both they and the wider workforce would need to understand that some matters discussed in the boardroom remain confidential. Investors should also be consulted on any potential changes to corporate governance arrangements. Provided these conditions were met, we would not object to their introduction at those companies that wish to appoint them.

Reporting against requirements in the Companies Act

On option iv (stronger reporting requirements of how Directors have fulfilled their responsibilities to stakeholders as outlined in the 2006 Companies Act) the extent to

which these responsibilities are ignored is concerning but whether stiffer reporting requirements will address this is questionable.

The consultation itself identifies existing domestic and European rules mandating disclosure of various environmental and social outputs, but the quality of these disclosures is mixed. That said, new requirements could be beneficial if implemented alongside the proposed stakeholder committee, with the powers to produce an unvarnished report to shareholders in the annual report.

If reporting and compliance with the Companies Act's requirements were monitored by the relevant bodies and proper enforcement of the duty to have regard for a wider range of stakeholders introduced, then this would also have a tangible and positive impact on stakeholder relations.

Implementation of reforms

Given the stakeholder committee model we favour draws on many of the existing committees reporting to shareholders and plc boards, it makes sense to prioritise listed companies for reform, with new requirements communicated via the corporate governance code. The 'comply or explain' principles of the code might allow for some flexibility over immediate implementation, though it would be extremely disappointing if larger number of companies declined to comply.

Equivalent measures should also cover very large private companies with significant stakeholder networks and a significant economic impact. Given that the relationship between management and employees is one of the key stakeholder dynamics that the Green Paper is intended to improve, it makes sense for the determining threshold in terms of size to be set in terms of the number of people working for the company. As with the calculation of executive pay ratios, this should include temporary and agency staff in order to accurately reflect the true scale of a company's operations and impact.

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