Corporate governance reform

Submission to the Department for Business, Energy and Industrial Strategy

Submission from the CIPD and High Pay Centre

February 2017

Contents

About the CIPD

The CIPD is the professional body for HR and people development. The not-for-profit organisation champions better work and working lives and has been setting the benchmark for excellence in people and organisation development for more than 100 years. It has 140,000 members across the world, provides thought leadership through independent research on the world of work, and offers professional training and accreditation for those working in HR and learning and development.

Our membership base is wide, with 60% of our members working in private sector services and manufacturing, 33% working in the public sector and 7% in the not-for-profit sector. In addition, 76% of the FTSE 100 companies have CIPD members at director level.

Public policy at the CIPD draws on our extensive research and thought leadership, practical advice and guidance, along with the experience and expertise of our diverse membership, to inform and shape debate, government policy and legislation for the benefit of employees and employers, to improve best practice in the workplace, to promote high standards of work and to represent the interests of our members at the highest level.

About the High Pay Centre

The High Pay Centre is an independent non-party think tank focused on pay at the top of the income scale. We argue that growing differences in pay between high and low earners are neither fair nor proportionate, and campaign to reduce the income gap between the super-rich and the rest of the population.

It aims to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre was formed following the findings of the High Pay Commission. The High Pay Commission was an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK, launched in 2009.

Introduction

Speaking at the CBI annual conference in November 2016, the Prime Minister Theresa May, pledged her Government would take on a new, active role that backs British business and ensures more people in all corners of the country share in the benefits of their success. Her statement recognised that in order for business to regain the trust of the public, organisations have a responsibility to balance their economic needs with social accountability.

There is little doubt that trust in large business and corporate behaviour has significantly eroded. Ongoing corporate scandals, the growing pay gap with growth of top executive pay whilst average pay has stagnated are two obvious concerns, but also job security, and how people feel they are being treated and managed at work, how their skills are being used and what opportunities they have for progression all add to the mix.

Corporate governance is the vital thread from the top of any organisation through the Board and the executive that has the primary responsibility and accountability for the decisions, actions and behaviours of the organisation. Good governance is about **clarity**, **accountability, and transparency**. Clarity of the organisation's purpose, and the values and principles which drive it; accountability for all the organisations stakeholders not just the financial stakeholders; and transparency in understanding and demonstrating how the organisation lives up to the purpose, values and principles that drive it.

Good governance should be applicable to all organisations, large or small, public or private. It creates better outcomes for any organisation and for all their stakeholders, and taken collectively creates a positive environment for business, the economy and society, all of which have never been more important in the changing political, economic, and social context we are in.

Beyond rules to principles and values, and from tangibles to intangibles

Ensuring or encouraging good governance has primarily been viewed in the past as compliance to rules and mechanisms such as through the UK Corporate Governance Code. This may have been easier when the ways in which businesses were organised and run tended to converge on common ideas of hierarchy, command and control, and standardisation – indeed the principles of rules and policies to govern behaviour were inherent in this thinking.

However, in the last 25 years since the current approach was developed, much has changed. Not only has there been much more growth in smaller private enterprise and greater job mobility, but new organisational forms and philosophies have emerged which aim to humanise work more, to create more flexible and diverse corporate cultures, to better engage the employee as a key stakeholder and to give them voice. Ultimately, in a fast-changing world, these approaches lead to greater agility and responsiveness, and enable innovation, as well as being better for people themselves.
Corporate value has also significantly shifted from the tangible to the intangible, yet the agreed systems and metrics we use are still very predominantly focused on the tangible. The

required financial reporting provides little insight on the key 'intangibles' of human and organisational capital, and the measures are almost exclusively backward looking, giving little insight on how an organisation is responding to the changing context and building for a sustainable future. If we are to **encourage longer term thinking and investment,** as we need to, then more measures and insight on how organisations are investing for the future and building sustainable organisations must be part of it.

Currently we mostly have to rely on whatever different organisations want to report through vehicles such as annual reports and narrative, which is invariably inconsistent and hard to compare. It's time to define and find ways of encouraging much more consistent reporting and transparency on how organisations are changing, how they are investing in their people, the make-up of their workforces, and how they are living to principles of what good work should be. There are growing calls for this now from the investor community, but also other stakeholders who are not seeing their interests clearly recognised or accounted for. This has been a critical stream of work for the CIPD over the last few years in combination with others, to help to define more common frameworks and metrics to understand all dimensions of human capital and organisation.

Behaviour is at the heart of the challenges

Behavioural science research over many decades that has shown that in rule-bound environments there is the danger of many unintended consequences, such as following rules without any sense of individual accountability or understanding of outcomes, or perhaps worse, in diverting attention to working around the rules or 'gaming' the system. It's also true that in a much more diverse working world, we could never write enough rules to govern all the circumstances or behaviours anyway.

With all these points in mind, we believe at the heart of the governance debate, to improve trust in business and, ultimately, also the performance of business, some of the ideas outlined in the Green Paper not only need to be progressed, but also extended into a wider debate. Good governance and the regulation of business needs to be grounded more in the idea of principles and not just rules. Rules have their place and there has to be a legal basis underpinning the core obligations of business. But the kind of mind-set and cultural change being talked about if we really are to make a step change in collective organisational behaviour must start from a higher order of principles, from which we should be looking for application and evidence of application through greater transparency. From a philosophy of **comply or explain, to apply and explain**. Consequently, the recent announcement by the Financial Reporting Council that it is review the UK Corporate Governance code is timely and presents an opportunity to embed a more principles oriented approach which is more appropriate for our modern economy.

Our response to the Green Paper - a people centric view

In the view of CIPD, responsibly and ethically run businesses recognise that their people are fundamental to their long-term success; they are unique and worthy of care, understanding and investment. On the issues of executive pay, we have combined our response together with the High Pay Centre.

From our vantage point, we have a primary interest and perspective on the issues of corporate culture and behaviour, the alignment, engagement, and development of people, both to support the needs and outcomes of the organisation from a risk and value perspective, but also the needs and outcomes for the workforce and individuals themselves. The levers of corporate culture and behaviours are principally through the processes of people management – from recruitment to training and development, performance measurement and management, opportunity and progression, and to reward. The critical outcomes of engagement, wellbeing, diversity and inclusion, and productivity and performance are all connected and enabled through good people practices and line management capabilities, shaped by the function of HR and delivered in large measure through the management and leadership at all levels.

Our submission is based on these perspectives and context. We focus particularly on the questions about executive pay and employee voice, with some specific recommendations we believe could be enacted within the existing corporate governance frameworks, being required where possible, but encouraged and advocated by Government more widely as good practice.

To achieve this we recommend:

- ***All publicly listed companies to be required to establish a standalone human capital development sub-committee, chaired by the HR director, with the same standing as all board sub committees.***
- ***Government should set voluntary human capital (workforce) reporting standards to encourage more publicly listed organisations to provide better information on how they invest in, lead and manage their workforce for the long-term.***
- ***Publicly listed companies should be required to have at least one employee representative on their remuneration committee.***
- ***Publicly listed companies should be required to publish the ratio between the pay of their CEO and median pay in their organisation. Other ratios should be considered in due course– top to bottom, and top to senior management team, as well as the ratio been top pay and those in under-represented or minority groups such as BAME, for example***
- ***The Remuneration Consultants Group's code of conduct be reviewed to encourage remuneration advisers to balance external drivers for pay increases such as benchmark data, with internal contextual measures providing insight on the reward and contribution of the wider workforce.***
- ***The FRC's recently announced review of the UK corporate governance code should consider whether a more principles-based should be adopted, placing greater emphasis on the importance of organisations' human capital investment and development***

Executive Pay

Why change is needed

There is clear evidence that CEO pay in large corporates has been growing much faster over the last two decades than pay generally, and much faster than typical corporate performance would merit. According to the High Pay Centre, the ratio between FTSE 100 CEO pay and the average total pay of their employees in 2015 was 129:1, compared with a ratio of 48:1 in 1995.

CIPD research suggests this growing disconnect between what those at the top earn and the pay of the wider workforce undermines trust in business and employee engagement. Seven-in-ten (71%) employees believe executive pay in the UK is ‘too’ or ‘far too’ high, with six-in-ten (59%) employees saying the high level of executive pay in the UK demotivates them at work. This matters, given the UK’s poor productivity record and a growing body of evidence highlighting the relationship between high-quality leadership and people management, more engaged and resilient staff, and improved business performance (Engage for Success, 2012).

More broadly, the value of intangible assets within organisations, such as human and intellectual capital, has increased significantly in recent years as the global economy has become more knowledge intensive. Research by NESTA (Goodridge et al 2014) estimates that between 1990 and 2011, the value of intangible assets in the UK, including human capital, grew from £50.2 billion to £137.5 billion, while at the same time the value of tangible, physical assets has increased much more slowly from £72.1 billion to £89.8 billion. Unless organisations get better at investing in and utilising their human capital, efforts to undermine UK productivity will be undermined.

However, while the value and importance of human capital to organisations and the economy has increased, boards and executive teams in too many companies remain narrowly focused on return on financial capital management and risk management.
Our recommendations are designed to help address this imbalance and to ensure more organisations have greater insight and evidence on the value of their investment in people when making decisions about executive pay and business investment more widely.
Any reforms to the UK’s corporate governance framework also need to be considered in the context of the forthcoming industrial strategy through, which the Government wants to achieve its ambition of improving living standards and economic growth by increasing productivity and driving growth across the whole country.

The Government’s response to this Green Paper represents an opportunity for it to ensure that any new approach to corporate governance helps rebuild trust in business and enhances the competitiveness of the UK’s corporate sector as the country looks to develop its economy post-Brexit.

Question 1: Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

It can be argued that shareholders already have all the powers they might need to hold companies to account. They could, and should, engage more critically and energetically with company boards and remuneration committees (RemCos). Too many shareholders (although there are, of course, exceptions) have been too relaxed for too long about executive pay. There are occasional flurries of activity – a so-called “shareholder spring” – followed by a return to acquiescence. If asset managers are not sufficiently concerned about levels of executive pay no amount of new powers will change their approach. What is needed above all is a change of attitude.

That said, some of the options mentioned in the Green Paper have merit. An annual binding vote on the entire pay package would force shareholders to engage more fully. Failing that, the stronger consequences hinted at for losing an advisory vote might help a little. Shareholders are already supposed to be agreeing a maximum figure – although it proves impossible in practice to anticipate what that figure might actually turn out to be. It is not clear what adding more complexity in this area would do to help moderate executive pay growth.

We believe there is scope to reform the UK Corporate Governance Code to place more emphasis on requiring companies to report on how they invest in and manage their people. The code states: “The board should present a fair, balanced and understandable assessment of the company’s position and prospects.” In our view it is impossible for organisations to do this without having much greater information and understanding about their workforce and Human Capital Management practices, regardless of their size or sector. This information is particularly important when it comes to discussions about executive reward because it is hard to justify very high pay for senior executives if it is unconnected to the rewards, contribution and performance of the wider workforce. In very large multinational organisations with tens of thousands employees it is hard to justify disproportionate rewards to a single individual or select group of individuals, as their ability to singlehandedly drive performance and innovation is extremely limited.

Consequently, we welcome the announcement by the Financial Reporting Council of a comprehensive review of the UK Corporate Governance Code. We believe there should be a stronger focus on core principles beyond the current comply or explain approach. The approach taken by the Netherlands and South Africa on corporate governance is based on an ‘apply or explain’ approach linked to an underlying set of principles, and is one that we feel should be considered for the UK. The excesses in executive pay, in fact, reflect systemic failure. It is not the fault of any one ‘player’ or element in the system. So, whilst shareholders could be made to do more, that would only ever be part of the solution. There needs to be a change of attitude, and an increase in urgency, among all the current participants responsible for setting and agreeing executive pay levels – something that could be aided by a change to the corporate governance regime.

Recommendation: The FRC's recently announced review of the UK corporate governance code should consider whether a more principles-based should be adopted, placing greater emphasis on the importance of organisations' human capital investment and development.

Question 2: Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

Mandatory disclosure of fund managers' voting records would formalise what is already happening to some extent, and would be helpful in increasing transparency of the process. The shareholder committee idea – discussed by Chris Philp MP in this High Pay Centre paper http://highpaycentre.org/blog/restoring-responsible-ownership-new-paper-by-chris-philp-mp – is also worth pursuing. Retail (individual) shareholders can still struggle to make their voices heard – except perhaps on occasion at AGMs – and we would be guided here by the views of ShareSoc and the UK Shareholders Association.

We also believe that greater transparency on executive pay, for example through the publication of pay ratios, and on how organisations' invest in and manage their workforce, would encourage investors to think beyond purely financial measures of performance and make better use of their voting rights. If investors were armed with better human capital management information they would be able to pick up on material risks to the business created by poor management, as demonstrated by the recent, high-profile case of Sports Direct, and be more likely to make use of their voting rights.

CIPD believes that the Government should, therefore, set voluntary human capital reporting standards encouraging organisations to, for example, report on their overall level of investment in their workforce, including contingent labour, level of investment in training and development, recruitment and turnover costs and employee engagement survey scores.

Recommendation: All publicly listed companies should be required to publish the ratio between the pay of their CEO and median pay in their organisation.

Recommendation: Government sets voluntary human capital (workforce) reporting standards to encourage publicly listed organisations to provide better information on how they invest in, lead and manage their workforce for the long-term.

Question 3: Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

Remuneration committees should be braver and tougher, although it should be appreciated that it is a difficult task which confronts them. The job of RemCo chair, it has been said, is something that everyone wants done but that nobody wants to do. The RemCo should be prepared to challenge the claims of executives (and the suggestions of pay consultants) that a certain package represents a “going rate”, or that there is a risk of “talent flight” if supposedly inadequate pay packages are offered. And executives should be hired (and paid) for the contribution they will make: what they put in matters much more than what they will take out.

This, again, points to the need for RemCos to have much better information about the state of the business measured in both financial and non-financial terms. CIPD and High Pay Centre believe that any assessment of the business and the contribution and performance of the chief executive cannot be made in isolation of an assessment of how their leadership has impacted on the investment in and management of the workforce for the long-term. Consequently, it is crucial that RemCos have much better data about how employees are treated and rewarded, reinforcing the need to improve the quality of human capital information available to RemCos. As stated above, the Government could encourage this by setting voluntary human capital reporting standards to ensure that, over time, more organisations improve the quality of the workforce data that they generate and report on, both internally and externally.

There are PR and investor relations challenges involved in not attracting or keeping highly regarded individuals. But succumbing to pressure to pick or retain supposed “stars” means the pay ratchet effect will continue.

The quality of engagement between RemCos and shareholders clearly varies; both sides could raise their game. Some shareholders (although there are exceptions) have been relaxed about the measures used to assess executive performance and the size of executive pay. More mandatory voting may help, but ultimately there has to be a change in attitude and overall approach. Shareholders should be more questioning how much alignment there is between executive pay and corporate purpose and performance, and between the pay of senior executives and that of the wider workforce relative to their individual contribution(s). The best way of engaging more effectively with employee views would be to include representation from the workforce in the process – for example, through introducing staff representatives into the RemCo. For them to play an effective role, they would need to be properly supported and resourced and to have access to the appropriate information on how the organisations invests in its workforce.

The presence of ordinary members of the workforce would ground the conversation in reality and enhance perceptions of transparency and fairness in the system. It would also require executives and pay consultants to come up with persuasive arguments as to why a level of pay is being proposed and the performance that is expected for that pay to be awarded. In addition, the availability of better HCM information would help employee representatives to have much better knowledge and insight on how executive leadership has supported the engagement, resilience and performance of the workforce as a whole.

We also believe remuneration advisers should be required to sign up to code of ethics requiring them to balance external drivers for pay increases such as benchmark data, with internal contextual measures providing insight on the reward and contribution of the wider workforce. Businesses could avoid a good deal of PR and reputational damage by settling these matters in private ahead of these public disputes.

With regard to the Green Paper's proposals in this area, it would be wise for a RemCo chair to have already served on a committee for a year or more before being appointed. However, a Non-Executive Director cannot represent employees' views properly for the reasons set out above.

Recommendation: All publicly listed organisations should be required to have at least one employee representative on their remuneration committee.

Recommendation: The Remuneration Consultants Group's code of conduct be reviewed to encourage remuneration advisers to balance external drivers for pay increases such as benchmark data, with internal contextual measures providing insight on the reward and contribution of the wider workforce.

Question 4: Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

A requirement to publish pay ratios would help shine useful light on pay gaps in business, which would be a first step towards restoring the public's trust. As the adage has it: "if you don't measure it you can't manage it". A feeling that pay at the top is out of control lies behind much of the public's loss of confidence in business. Employees are demotivated by excessive pay gaps too, as CIPD research has revealed (2016). http://www2.cipd.co.uk/pm/peoplemanagement/b/weblog/archive/2015/12/18/dramatic-rethink-needed-on-demotivating-ceo-pay-levels-warns-cipd.aspx

The discipline of having to publish pay ratios would concentrate minds on remuneration committees, and give investors another area in which to engage intelligently about what is being rewarded, how and why. Executives might also adjust their pay expectations in the light of what the ratios reveal.

A top to median ratio would be a reasonable first step, although other ratios – top to bottom, and top to senior management team – might also be considered in due course. It might make sense for businesses themselves to have a clearer understanding of what the ratios are between managers and their teams, and how and why they are changing over time. Pay ratios are relatively easy to calculate, and any properly run enterprise will have all the pay data to hand – indeed, with the new requirement to report on gender pay gaps no extensive new research should be needed.

Clearly, comparisons within business sectors will be useful, other types of comparison less so given the variability across sectors of market pay norms, and the types and nature of how value is created. However, there is an argument that top executives can and do move between sectors so that there may be some validity in comparing executive reward, for example, based on size and complexity of organisation. However, the danger to be avoided, which has clearly contributed to the rise of executive pay for larger organisations, is the upward ratcheting of pay simply because RemCos get persuaded that they must pay in the 'top quartile' to attract and retain top talent. Executive search consultants also can be inclined to encourage this thinking since, traditionally, they have been rewarded on a percentage of the CEO pay package.

A fuller case for publishing pay ratios is made here: http://highpaycentre.org/pubs/pay-ratios-just-do-it

Recommendation: All publicly listed companies should be required to publish the ratio between the pay of their chief executive and median pay in their organisation.

Question 5: Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

If bonuses were smaller, they would be less controversial (see answer 6 following). If pay packages were simpler, there may well be less controversy also – they would at least be easier to explain and understand. The complexity of many pay packages can confuse even the recipients of the package, which obviously then hugely diminishes the incentive value. It's clear from behavioural science research (CIPD, 2016) that bonus systems can provide perverse incentive, and can often be discounted by the recipient (e.g. if the bonus does not acrue for a long time). There needs to be far greater challenge on the evidence base for most bonus systems devised as to whether they really do encourage the positive behaviours or make a real difference to results.

RemCos should be able to explain straightforwardly why a bonus is being proposed, and that should be part of the normal ongoing engagement with shareholders. The retrospective disclosure of previously commercially sensitive targets might be helpful also.

In our view, exceptional performance that might merit additional reward or bonus should be fairly easy to identify and should be reflected by both financial and non-financial measures. There should be a tangible link between decisions taken by senior executives and value creation in the form of profits, revenue or market share, for example, as well as evidence of sound stewardship of the business and its workforce. If the performance criteria selected against which an executive is assessed is so complicated that even analysts struggle to understand them, then this undermines transparency and trust in the system. Greater simplicity on performance measures will enhance trust in the link between pay and performance.

Recommendation: The Remuneration Consultants Group's code of conduct be reviewed to encourage remuneration advisers to challenge the validity of bonus

systems and encourage greater simplicity over both financial and non-financial measures of performance

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

We believe that so-called “Long Term Incentive Plans” (LTIPs) are a flawed instrument. It is hard to see why a contract designed to run for three or even five years can be described to as a “long term” arrangement.

Tying executive pay to the share price has also turned out to be a perhaps well-intentioned but ultimately misguided exercise. Share prices move for all sorts of reasons, many of which have little to do with the actions (or contribution) of a single human being.

For example, British equities have been boosted since the June vote last year to leave the EU because firms such as Rio Tinto, Smiths Group and WPP, for example, generate most sales abroad and benefit when they convert these revenues back into the weakened pound. The fall in the value of the pound has also made UK stocks more affordable for overseas investors.

Variable, or so-called individual “performance related pay”, has often been a blind alley for many businesses for years. Far too much faith has been placed in using pay as a proxy to manage employee performance, and there is little evidence that it works in knowledge-, innovation-, and service-based economy that we are moving towards. The most recent, substantial piece of research into pay and performance at the top of business found only a negligible link between the two (Lancaster Management School, 2016) and this in spite of the years spent trying to get this right.

It follows that tweaking LTIPs is another example of what the late Prof Russ Ackoff of the Wharton Business School used to call “doing the wrong thing righter”. For instance, linking LTIPs to a variety of financial performance measures, paying the award in a mixture of cash, options and restricted shares, some of which are deferred and all subject to ‘clawback’, is very unlikely to influence behaviours in any meaningful way. Evidence from behavioural science (CIPD, 2016) suggests that giving smaller, simpler and more immediate bonuses may be more effective than huge LTIPs, which may crowd out intrinsic motivation and could even result in adverse behaviours.

Remuneration committees should use their discretion and judgment to assess the performance of top executives, and find ways to provide reward or smaller bonus payments if they feel the quality of work carried out by those executive(s) merits it. Shareholders can then vote on that judgment. The “bonus”, or variable element, of top pay should be much smaller, a percentage of base pay rather than a multiple. That may, of course, mean a rise in base pay, but overall payment packages would become much more proportionate. We think that the Institute for Business Ethics’ idea – that any executive bonus should be matched by one of the same percentage for the workforce – also has merit. Executives are, of course, free to buy shares on their own account but it is doubtful that they should be given shares for free or at a discount simply for doing the job which they are already being well paid to do.

However, we also recognise that there will be resistance from organisations to being told how to reward their executives. What we believe is needed is not something that mandates pay and reward strategies, but provides a lot more onus and expectation on organisations to understand the real basis for reward, to ensure packages are rational and defensible, and link to an overall understanding of reward strategy. Transparency will provide a strong incentive to rethink appropriateness.

Recommendation: The Remuneration Consultants Group's code of conduct be reviewed to encourage remuneration advisers to challenge the validity of long-term incentive plans and encourage greater simplicity over both financial and non-financial measures of performance

Strengthening the employee, customer and wider stakeholder voice

Why change is needed

Employees are arguably the most critical stakeholder in any organisation. It is through them that value is created, and through which most risk occurs as well. For too long organisations have been asserting that their people are their most important asset and then fail to demonstrate this through how they invest in, lead and manage their workforce for the long-term. In our view, attempts to improve the UK's poor productivity performance have been undermined by a lack of understanding and insight amongst business leaders about the value and risks associated with how they invest in their workforce. As the Green Paper points out, giving employees more opportunity to contribute and have their say can lead to better employee engagement and wellbeing, as well as productivity improvements. Building responsive and agile businesses in today's more complex environment greatly depends on innovation, sense checking, and insight, and the people who are closest to the customers and markets, and the effectiveness of products and services, are the people on the 'front line'.

In order to address these points, it is crucial that employee voice and understanding of people and workforce issues is strengthened at boardroom level to ensure that the interests and insights of the wider workforce are taken into account. Improving employee voice at board level is also central to ensuring there is a better and earlier understanding of emerging risks and of the value that people bring to business.

Question 7: How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

The Green Paper sets out a number of options for reform for consideration under the heading **Strengthening the employee, customer and wider stakeholder voice**. Below we take each in turn.

Option (i): Create stakeholder advisory panels

Developing stakeholder advisory panels does offer some opportunity to amplify the voices of representatives who may have historically had little representation at that level. A panel may be able to highlight more clearly the areas in which stakeholders are in conflict; an example being that of low pay. Employee representation may, at times, be in conflict with those views of the supply chain, and as such issues that require deeper understanding can be highlighted. This may be of particular use for exploring issues through an ethical lens: ensuring that all parties benefit from the success of the organisation. CIPD research has shown that workplace dilemmas of this type can be approached a number of ways – and considers a set of principles as an effective mechanism by which senior leaders can appreciate risks and opportunities (CIPD, 2015a). This mechanism is also appropriate for an advisory panel scenario.

CIPD has concerns that a mixed stakeholder advisory panel would not have enough time to consider the different views of stakeholders, meaning that any advice to the board may lack substance or focus. There is a particular need for organisations to improve the way in which they appreciate and understand human capital risks and opportunities, with particular cultural and behavioural risks.

A CIPD literature review of research exploring behavioural risk and the value of the measurement of culture (CIPD, 2016) explored how boards currently account for human capital risks, and took into account the needs of all stakeholders in debate. The research found that there are various ways in which leadership, in particular boards, may be at risk of discounting or underexploring alternative perspectives, particularly when working across a diverse set of stakeholders – and in the case of employees there may not be enough expertise within current boards to champion employee human capital risks and opportunities, and ensure that these issues are thoroughly considered.

We, therefore, recommend the development of a **human capital committee at board level** which considers human capital opportunities and risks as an ongoing concern. The committee should consist of those in the business who make decisions which may have both direct and indirect impacts on human capital, and it must be the role of the committee to challenge the board with regards to decisions which have implications on human capital outcomes for the firm.

Recommendation: All listed companies to be required to establish a standalone human capital development sub-committee chaired by the HR director with the same standing as all sub board committees.

Option (ii) Designate existing non-executive directors to ensure that the voices of key interested groups, especially that of employees, is being heard at board level

The voice of employees being represented at board level is a particularly important requirement that corporate governance reform must address. One of the reasons why employee voice and workforce matters are too often not given the attention they merit is that there is a lack of HR expertise within too many boards. Research by the Korn Ferry Institute found there were no HR directors on the main board of FTSE100 companies in 2011 and, in some cases, the senior HR leader did not even have a seat on the executive board. While this may have changed to some degree, the likelihood is that the vast majority of the main boards of FTSE companies will not have an executive director with an HR background.

This lack of insight on the people side of business amongst main board executive directors is compounded by the fact that too few NEDs have an HR background. A survey by Harvey Nash (Harvey Nash, 2014) of more than 220 NEDs found that just 4% had an HR background compared to 26% with a finance background.

Consequently, we believe there should be more attention paid by boards to increasing the background and experience of NEDs with strong backgrounds in HR (and other disciplines which are notably underrepresented, particularly IT). This should be good governance practice and boards should be challenged by shareholders and other stakeholders to demonstrate they have the breadth of experience at board level.

However, this is not a panacea in itself and we would argue that greater overall board appreciation of specific human capital issues of material concern should be the goal of reform. Utilising NED expertise may be a good way to explore issues that boards may otherwise miss, and acts to ensure there is ownership of issues – particularly useful for those concerning human capital in organisations with little or no analytical maturity, of which we know there are a number (CIPD, 2016). However, in isolation, as the paper suggests, this may also remove the opportunity for other board members to take an active interest in issues of material concern, and as such the individual stakeholder representative approach may not lead to more effective understanding of risk issues.

The Green Paper suggests that each designated NED could chair a board-level committee with the status to ensure that executive decision-making takes account of employee, supplier or consumer issues. As stated above, the CIPD and High Pay Centre believe that a bespoke board-level committee focusing on workforce issues would help ensure that material human capital issues and employee voice receive more attention from the main board on an on-going basis.

Recommendation: Publicly listed companies should appoint a Non-Executive Director with an HR background to ensure that people and workforce issues are given more weight in board level discussion and decisions.

Recommendation: Boards should be held accountable for ensuring a broader base of experience amongst Board members.

<u>Option (iii): Appoint individual stakeholder representatives to company boards</u>

An alternative to developing representative committee is to invest in appointing individual stakeholder representatives to the company board, as highlighted in option 3. This idea does have some credence; organisations would undoubtedly benefit from improving employee voice at this level and there are examples where this works. However, there is also a risk this approach may appear to be tokenistic and may, in fact, mean that significant issues are not tackled by the entirety of the board, instead sitting only in the domain of the employee representative.

The value of this particular option may also be difficult to realise, given the constraints of directorship that the representative would have to adhere to (duty to champion the success of the company; confidentiality in particular for the organisation may hamper the ability of the representative to operate with their stakeholder group). For an employee representative this would be particularly hard to make effective without very significant training and support. On balance, we agree that the Government is right not to mandate the direct appointment of employees or other interested parties to company boards. However, if employee voice is not to be strengthened through this approach, it is even more important that other steps are taken to ensure employee views and insights on the business are given much greater attention and priority at board level.

The Prime Minister has made a high profile pledge to ensure “employees’ voices are properly represented in board deliberations, and that business maintains and – where necessary – regains the trust of the public”. To achieve this, there has to be a very significant change to the status quo, including for example, as suggested above, a human capital board sub-committee to report directly to the board in detail on workforce matters.

Just as important is improving the quality of human capital information on the workforce available to the board, which needs to give a full understanding of the opportunity, value and risks that arise from an organisations’ investment in people – and a clear picture of whether people are being treated as human beings, or merely as widgets which can be easily replaced.

<u>Option (iv): Strengthening report requirements related to stakeholder engagement</u>

The Green Paper emphasises the potential of further developing reporting requirements and suggests “companies could be encouraged to provide detailed information and measures possible so that they can be held to account”. CIPD and High Pay Centre believe this option presents a very significant opportunity to improve corporate governance and ensure employee matters and concerns are given much greater priority.

One of the biggest obstacles to effective corporate governance is a lack of transparency, particularly in the area of corporate culture. This is because organisation culture is one of the hardest attributes of an organisation to articulate and measure. However, it is also one of the most important, as recent corporate scandals have illustrated. All definitions of organisational culture agree that it is about people and behaviours.

Positive corporate cultures are underpinned by common, purpose, values and behaviours which motivate employees to perform and build trust so people feel confident to share their ideas and knowledge, as well as any concerns if and when they arise.

However, when a toxic culture can cause significant issues for the business and its employees, leading to low performance and morale, as well as an environment where people feel they don’t have any voice and are scared to speak up if they witness malpractice, or inappropriate behaviour.

The UK’s Corporate Governance Code highlights the importance of organisational culture to effective governance. It states that: “One of the key roles for the board includes establishing the culture, values and ethics of the company. It is important that the board sets the ‘correct tone from the top’. The directors should lead by example and **ensure that good standards of behaviour permeate throughout all levels of the organisation**. **This will help prevent misconduct, unethical practices and support the delivery of long-term success**.”

To help boards understand how they can set, assess and evaluate organisational culture, the FRC published revised Guidance on Risk Management, Internal Control and Related Financial and Business Reporting in September 2014.

The guidance states boards need to *consider "whether the company's leadership style and management structures, human resource policies and reward systems support or undermine the risk management and internal control systems."*

However, recent research by both the CIPD and the Pensions and Lifetime Savings Association into human capital reporting suggests many organisations still need to significantly improve practice in this area. CIPD research (Valuing your talent, 2014) highlighted the lack of consistency with which human capital data is collected, analysed or reported both internally and externally. Despite a significant body of research and government initiatives such as the Accounting for People review in 2002, which all point to the need for better insight and reporting, there remains a real gap which means too many business have very little transparency over their culture and how they recruit, manage and develop their people.

The PLSA's 2015 report *Where is the workforce in corporate reporting* found that there is very limited quantitative or qualitative reporting by companies on their approach to managing their workforce.

Of the companies in the FTSE 100 during 2014:

- less than half disclosed the levels of staff turnover;
- less than a quarter reported on their investment in training and development; and
- approximately only one in ten provided information about the composition of the workforce.

Further CIPD research (*Valuing your Talent, 2016)* found that while overall, the quality of human capital reporting by FTSE 100 organisations in annual reports had improved between 2013 and 2015, there remains a lack of consistency and little evidence of companies providing a common narrative. Some companies provided sparse levels of human capital reporting; for example, NEXT gave little attention to human capital measures in their reporting. The research also showed that many companies tend to rely on subjective qualitative measures and weighted their reporting towards positive features and initiatives. There were clear instances where firms were acting in an opportunistic manner and not reporting the full extent of incidents or excluding details of incidents that had been reported in the media. Sports Direct's 2015 annual report does cover areas such as some aspects of staff development and staff share schemes, and health and safety compliance, but the report fails to address issues such as employee engagement, job satisfaction and employee wellbeing and consequently fails to provide any meaningful insight to address concerns over its organisational culture.

One of the reasons for the shortcomings in human capital reporting is that currently there is significant flexibility over what publicly listed companies have to report under the *Companies Act*. For example, there is only an obligation to report on employees in order to provide an understanding of 'the development, performance or position or future prospects of a company's business.' If information is regarded by the board as immaterial to this objective, there is no obligation to report it. This has contributed to a lack of clarity and therefore different levels of reporting with regard to human and organisational capital.

Both the CIPD and the PLSA's research concluded that there was a need to improve the quality of human capital reporting by publicly listed companies to improve transparency and governance. The CIPD has called for a common approach to human capital reporting which is underpinned by a consistent narrative on: workforce composition, for example, diversity and proportion of contingent labour; recruitment and turnover; investment in training and development; measures of employee engagement and wellbeing. This would not require a 'boiler plate' approach, but would mean companies should be encouraged to report on broadly the same key aspects of human capital management.

Valuing your Talent
The CIPD is committed to continuing to raise the standards of how organisations collect, analyse and measure human capital data to improve transparency over whether businesses are being led and run for the long-term for the benefit of all stakeholders including employees. CIPD has been working in partnership with the Chartered Management Institute and the Chartered Institute of Management Consultants on a major research and change programme called *Valuing your talent* in order to highlight best practice and improve capability around human capital reporting across the HR, management and finance professions. CIPD's most recent research in this space (CIPD, 2016) has informed the recent report by the Financial Reporting Council on Corporate Culture and the Role of Boards (2016). The report explores the importance of culture to long-term value and how corporate cultures are being defined, embedded and monitored.

In our view, there is a significant opportunity for the Government to play a more active role by promoting better standards of workforce/human capital reporting as a means of increasing transparency and ensuring that over time there is more consistency in the quality and quantity of human capital information that companies report externally. The use of voluntary targets to improve the representation of women on boards has proved successful and the CIPD believes the Government could similarly support greater transparency and improved corporate governance by setting voluntary standards in human capital reporting.

The Government can also use its convening and communication power to build a partnership on this agenda with business, professional bodies and the investment community to catalyse action. Furthermore, there is an opportunity for the Government itself to lead by example and take action to improve the quality of human capital reporting and transparency over organisational culture in the public sector.

Recommendation: Government should set voluntary human capital (workforce) reporting standards to encourage publicly listed organisations to provide better information on how they invest in, lead and manage their workforce for the long-term.

Question 8: Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

We believe that stakeholder voice should factor in all leadership discussions across all publicly listed organisation types, **irrespective of sector and size**, and within this employees must have greater representation in ongoing debate which has implications both in the short and long-term. This is particularly important given research points to the positive relationship between employee voice and aspects of organisation and individual performance, including productivity. There is a particular need for organisations to improve the way in which they appreciate and understand human capital risks and opportunities, with particular cultural and behavioural risks.

Question 9: How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

For change to happen for the positive, we believe that there must be mixed approach to reforming corporate governance practice that takes the form of nudge policies to promote good practice, as well as a legislative evolution that mandates the ways in which changes in human capital risks and opportunities are made at board level.

We believe that there should be a mandatory requirement for publicly listed companies to report the pay ratio between their chief executive and median pay in the organisation, as well as a statutory requirement for publicly quoted firms to establish a standalone human capital development board sub-committee to ensure that employee and workforce issues are given more attention. Additionally, publicly listed companies should be required to have at least one employee representative on their remuneration committee.

However, as set out above, we think a voluntary approach could be adopted to encourage organisations to improve the quantity and quality of their human capital reporting.
We welcome plans by the Financial Reporting Council to review the UK Corporate Governance code, which provides an opportunity to encourage organisations to adopt a more people-centric approach to governance, leadership and risk management. Currently, too many organisations are run with a singular focus on their financial stakeholders which undervalues the human capital – the people – that deliver business success.

Corporate governance in large, privately-held businesses

Question 10: What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

CIPD believes there is a strong case for extending the UK's corporate governance framework to cover large privately held businesses. The Green Paper highlights the example of BHS as a privately owned firm which caused very significant damage to its stakeholders, including its employees, supply chain and pension fund beneficiaries when it failed. Extending the corporate governance framework to the private sector would encourage the owners of privately held businesses to consider the interests and perspectives of these broader stakeholders when they are making decisions about reward, business investment and risk management.

The Green Paper suggests that extending the application of the existing UK Corporate Governance Code to apply to large privately owned companies may not be appropriate because the code had been designed with Premium Listed Companies in mind and some of its provisions will not be appropriate for privately held businesses. However, the Financial Reporting Council has just announced a comprehensive review of the UK Corporate Governance code, which means there is an opportunity to consider whether it would be possible to develop a revised code which applies to both publicly listed companies and privately owned businesses. If this is does not prove possible, we believe the FRC should lead on the development of a separate code for privately owned companies, aligned to the Corporate Governance Code in terms of core principles.

Question 11: If you think that the corporate governance framework should be strengthened for the largest private sector businesses, which businesses should be in scope? Where should any size threshold be set?

The principles of good governance should be applicable to all organisations, large or small, public or private. It creates better outcomes for any organisation and for all its stakeholders and, taken collectively, creates a positive environment for business, the economy and society, none of which have ever been more important in the changing political, economic, and social context we are in.

Good governance is about **clarity**, **accountability, and transparency**. Clarity of the organisations purpose, and the values and principles which drive it; accountability for all the organisations stakeholders not just the financial stakeholders; and transparency in understanding and demonstrating how the organisation lives up to the purpose, values and principles that drive it.

CIPD believes that the size threshold for a voluntary code could be set relatively low, for example, applying to organisations with 250 or more employees, similar to the threshold for organisations required to report on their gender pay gap from April this year.
The voluntary nature of such a code means that its provisions would not necessarily be onerous, yet it could set out the core principles that underpin responsible and ethical business practice and leadership and management of people that helps drive good practice.

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

As stated above, we believe that a voluntary approach should be adopted. The purpose of the code would be to raise awareness over time of the principles of good corporate governance amongst larger privately owned business. Rigorous monitoring of compliance would not be necessary with such a voluntary code.

However where there are obvious breaches of the code, organisations could be named and shamed, which would help encourage employers to be mindful of their obligations under the code.

CIPD is currently revising its Professional Standards Framework for HR practitioners, putting principles of responsible and ethical people management and development and employment practice at the heart of the new standards. We believe there is an opportunity for a new or revised corporate governance code to align with our, and other, professional standards frameworks which are seeking to encourage improvements in organisational practice through a greater focus on ethics and sustainability.

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

In our view, non-financial reporting requirements should be applied on the basis of a size threshold to align with the approach adopted through the gender pay gap reporting regulations. Where possible, policy makers should seek to build on existing approaches to provide more clarity amongst businesses.

CIPD & High Pay Centre

February 2017

Bibliography

CIPD (2016). *A duty to care? Evidence of the importance of organisational culture to governance and leadership*

CIPD (2016). *The view from below: What employees really think of their CEO's pay packet*

CIPD (2016). *The power and pitfalls of executive reward: A behavioural perspective*

CIPD (2015). *From best to good practice HR: Developing principles for the profession*

Engage for Success (2012). *Employee Engagement Task Force "Nailing the Evidence" Taskforce*

Harvey Nash (2014). *The Changing Shape of Non-Executive Directors*

High Pay Centre (2015). *Pay ratios: Just do it*

High Pay Centre (2016). *Restoring responsible ownership: Ending the ownerless corporation and controlling executive pay*

Korn/Ferry Institute (2011). *Growing HR influence in the boardroom*

Lancaster Management School (2016). *An Analysis of CEO Pay Arrangements and Value Creation for FTSE-350 Companies*

NAPF (2015). *Where is the workforce in corporate reporting?*

NESTA (2014). *UK investment in intangible assets*

Valuing your Talent (2014). *Managing the value of your talent: A new framework for human capital measurement*

Valuing your Talent (2015). *Investing for sustainable growth*

Valuing your Talent (2016). *Reporting Human Capital: Illustrating your company's true value*

Valuing your Talent (2016). *People measurement and reporting: From theory to practice*