GOVERNANCE

August 2018 Issue 288

Too much expected of section 172?

'Although the FRC's Guidance on Board Effectiveness states that in order to protect the company's long-term interests, difficult board decisions may "sometimes" adversely impact stakeholders, section 172 cannot prevent directors taking actions that are contrary to stakeholder interests or even the long-term interests of the company. No doubt such a company would not thrive. Nevertheless the section does not guard against bad business judgements taken in good faith.'

Professors Joan Loughrey and Terry McNulty

More authenticity?

'Society and key stakeholders have more expectations than ever before in companies and they expect companies to be part of the solution within society, rather than the problem. The growing recognition that "good" business behaviour supports strong financial performance is becoming the norm.'

Anne Kirkeby

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The new UK CG Code

Anthony Fitzsimmons looks at the new UK Corporate Governance Code and Guidance on Board Effectiveness which were both published last month.

The FRC has delivered radical revisions of the UK Corporate Governance Code and Guidance on Board Effectiveness (the Code and the Guidance respectively, collectively Rules), which apply for accounting periods beginning on or after 1 January 2019. They tackle a large proportion of the behavioural, organisational and leadership risks that regularly cause organisations, and their boards, to collapse.

The Code has 'long-term sustainable success' (LTSS) at its heart: the Rules refer to *'long-term'* over 40 times.

The Rules have been substantially recast, with a focus on making 'tick-box' approaches and boilerplate reporting more difficult. The Guidance is laced with 80 penetrating open-ended questions designed to make boards think about important questions.

Sir Win Bischoff has written to proxy advisers to encourage them to move away from encouraging tick-boxing as it 'does not serve the needs of your clients or promote high standards of corporate governance in the UK'. Whether they will heed his request is moot.

Five important themes emerge from the changes:

1. Long-term sustainable success;
2. Board skills knowledge and experience;
3. Interacting with the workforce;
4. Whistleblowing and Speaking Up;
5. Remuneration.

Long-term sustainable success

For years there has been trenchant criticism of short-termism and opportunism among UK company leaders and their shareholders at the expense of long-term success and sustainable growth. Some companies have borrowed to pay dividends or replaced equity with debt, increasing dividend yield or earnings per share but making their companies more vulnerable to adverse events. Others have put the future at risk by postponing investment, research or maintenance.

The Code has 'long-term sustainable success' (LTSS) at its heart: the Rules refer to *'long-term'* over 40 times. Boards are expected to promote LTSS, thereby *'generating value for shareholders and contributing to wider society'*. They are expected to align workforce policies and the company's values with it, reporting to shareholders on how they have addressed the sustainability of their business model.

Despite an FRC open letter to institutional shareholders and the forthcoming review of the Stewardship Code, we believe that countervailing pressure from short-termist shareholders cannot be dealt with by the FRC alone. For success, the FCA must tackle the mismatch between the short bonus-driven time horizons of investment professionals and the far longer horizons of retail investors saving for the long-term towards retirement. This was highlighted by the Kay Report. Action is long overdue.

Board skills knowledge, experience and character

The history of corporate disasters is littered with boards that lacked key skills, knowledge or experience, a pattern that persists. In an attempt to dam this river, the FRC has tackled board composition. They have three aims: to encourage non-executive (non-exec) teams that are fully competent; to encourage diversity of perspective; and to bring board member character into sharper focus.

As to skills, one of the questions the FRC poses nomination committees is: 'Do we take account of the technical skills and knowledge required by the committees when recruiting members?' For example, does our audit (or risk) committee need a non-exec who thoroughly understands the risk we face? Do nomination and remuneration committees need a non-exec with systematic knowledge and experience of how humans think and behave?

As to personal strengths, the Guidance has given greater emphasis to courage, openness, ability to listen and tact, adding strength of character to the qualities that nomination committees should seek. The boardroom should be 'a place for robust debate where challenge, support, diversity of thought and teamwork are essential features', with executives 'welcom[ing] constructive challenge' from non-execs. Whilst the FRC has highlighted 'signs of a possible culture problem' including dominance and arrogance, they have missed the opportunity to highlight signs of a possible leadership character problem such as bombast, hubris, egotism and greed.

Beyond acquiring the skills they need to do their own job, nomination committees are encouraged to use skills matrices to identify the skills knowledge and experience their board has before identifying what the board and its committees need to be effective. The Guidance also encourages structuring

Feature

the recruitment process to explore the personal qualities, values and expected behaviours the post requires and what candidates will bring.

A well-deserved criticism of many boards is that they are drawn from a narrow stratum of society and dominated by particular backgrounds. Our research into FTSE 100 boards revealed them as heavily skewed towards current and retired CEOs, CFOs, financiers and, less-markedly, accountants. Evidence of diversity of perspective and background is rare. Skills matrices should help boards to recognise skewedness, but head-hunter methods and an aversion to people who might not 'fit' have also played a role. The FRC encourages selection and interview processes that do not put candidates with unusual backgrounds at a disadvantage. They should have given greater encouragement to using advertisements to bypass head-hunters whose methods appear to block diversity of perspective and unusual backgrounds.

Interacting with the workforce

There has been a long-running debate around how boards should take account of relationships with stakeholders other than shareholders, and the workforce in particular.

The Code states that the board should have 'workforce policies and practices that are consistent with the company's values and support its [LTSS]' and that the workforce 'should be able to raise any matters of concern'.

To reinforce this boards are now expected to welcome a director appointed from the workforce; to establish a formal workforce advisory panel and/or to designate a non-exec to act as a structural bridge between board and workforce.

Whistleblowing and Speaking Up

It is all too common to discover, after a crisis, that the workforce knew important things which they would not, or dared not, tell their leaders. This is the 'unknown known' problem.

Whistleblowing of bad behaviour has long been encouraged but whistleblowers are regularly persecuted. The FRC explicitly recommends that companies have a system that allows informants anonymity and protection against retaliation. 'Companies need to create an environment in which the workforce feels it is safe to raise concerns', adding that there is widespread fear of 'being negatively labelled, side-lined for promotion or bonuses, and even [loss] of employment'.

But FRC Guidance now goes further, encouraging a culture that makes routine 'speaking up' on less high profile concerns. 'Speaking up' only works if employees believe it is risk-free and that leaders will both listen and act on what they are told.

Remuneration

A crucial issue is the potential for executive reward systems to create incentives that encourage behaviour against an organisation's long-term interests. A long-running sore with the public and with politicians is the divergence between C-suite pay and workforce pay. The FRC has tackled both.

The remuneration committee's remit includes all aspects of reward in the company, including the relationship between workforce pay and executive pay.

The Code provides that the board's policies on remuneration 'should be designed to support strategy and promote [LTSS]', with executive pay packages 'aligned to company purpose and values' and 'clearly linked to the successful delivery of the company's long-term strategy'.

Remuneration committees are expected to 'focus on the strategic rationale for executive pay and the links between remuneration, strategy and [LTSS]', and to avoid 'pay structures based solely on benchmarking to the market, or the advice of remuneration consultants' in order to reduce the risk ratcheting executive pay upwards.

Remuneration committees are also expected to supervise workforce remuneration and the alignment of incentives and rewards with culture across the whole company and to '[take] these into account when setting the policy for executive director remuneration'. They are expected to explain to the workforce, every year, how executive pay relates to workforce pay.

When it comes to executive shareholdings, the *long-term* is again emphasised. Executive pay schemes should require 'long-term shareholdings by executive directors that support alignment with long-term shareholder interests': and the remuneration committee is expected to 'counteract the risk of incentives that are detrimental to the long-term success of the company'. Share awards should be '… subject to a total vesting and holding period of five years or more'.

Remuneration committees are now encouraged to develop formal policies for 'post-employment shareholding requirements encompassing both unvested and vested shares', forcing executives to hold shares until long after they have left. This is the simplest and probably the most effective way to discourage boosting short-term profit at the expense of long-term success. New CEOs will have a strong incentive to examine their predecessor's record.

The FRC has made valuable progress but many will remain unconvinced.

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If you see the changes to the Rules as unnecessary bureaucracy, our book *Rethinking Reputational Risk: How to Manage the Risks that can Ruin Your Business, Your Reputation and You*, will provide you with the perspective to understand most of the changes. Others will talk of the parable of motes and beams. Their criticisms will not be assuaged until the FRC has robustly applied its guidance to itself and fixed the weaknesses that outsiders perceive.

Anthony Fitzsimmons is an authority on reputational risk and the behavioural, organisational and board risks that underlie it. He is chairman of Reputability LLP and lead author, with the late Derek Atkins, of 'Rethinking Reputational Risk: How to Manage the Risks that can Ruin Your Business, Your Reputation and You'.

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