| **Title:** Corporate Governance Reform | # Impact Assessment (IA) |
|---|---|
| **IA No:** BEIS019(F)-18-BF | **Date:** 23/05/2018 |
| **RPC Reference No:** RPC-4224(1)-BEIS | **Stage:** Final |
| **Lead department or agency:** Department for Business, Energy and Industrial Strategy | **Source of intervention:** Domestic |
| | **Type of measure:** Secondary Legislation |
| **Other departments or agencies:** | **Contact for enquiries:** Kimon Doulis: kimon.doulis@beis.gov.uk |

## Summary: Intervention and Options

**RPC Opinion: Green**

| **Cost of Preferred (or more likely) Option** | | | | |
|---|---|---|---|---|
| **Total Net Present Value** -£92.35m | **Business Net Present Value** -£92.35m | **Net cost to business per year** (EANDCB in 2014 prices) £9.0m | **One-In, Three-Out** tbc | **Business Impact Target Status** Qualifying provision |

**What is the problem under consideration? Why is government intervention necessary?**

Corporate governance refers to the system of rules and processes that determines how companies are directed and controlled. It defines the rights and responsibilities of the different stakeholders involved with the company, and it should ensure that their interests are appropriately balanced. Good corporate governance addresses 'agency problems' within companies. It can help protect the interests of shareholders and help ensure that companies (and their senior management) take wider impacts, such as impacts on supplier businesses, employees or the environment, into account during their decision-making process.

**What are the policy objectives and the intended effects?**

The Government is proposing changes that will build on the strengths of the existing UK corporate governance framework to ensure that the UK remains an attractive place in which to do business. The reform package is specifically targeted at addressing corporate excesses and short-term thinking that go against the interests of shareholders and stakeholders, such as the employees of companies, and that undermine trust in business in general. The proposals are part of the wider work to enhance public trust in business as a force for good.

**What policy options have been considered, including any alternatives to regulation? Please justify preferred option (further details in Evidence Base)**

**Option 0:** Do nothing.

**Option 1 (preferred):** A reform package that combines legislative action with non-legislative approaches. Please refer to chapter V of the impact assessment for further detail.

The reforms are targeted and are an evolution of the current framework which is seen as very robust in many regards. However, not making any changes would fail to address the weaknesses that have been identified.

**Will the policy be reviewed?** It will be reviewed **If applicable, set review date**:

| Does implementation go beyond minimum EU requirements? | | | No | | |
|---|---|---|---|---|---|
| Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base. | **Micro** No | **< 20** No | **Small** No | **Medium** No | **Large** **Yes** |
| What is the $CO_2$ equivalent change in greenhouse gas emissions? (Million tonnes $CO_2$ equivalent) | | | **Traded:** N/A | **Non-traded:** N/A | |

***I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.***

Signed by the responsible Minister: [signature] Date: 04/06/18

## Summary: Analysis & Evidence Policy Option 1

**Description:**

**FULL ECONOMIC ASSESSMENT**

| Price Base Year: 2017 | PV Base Year: 2019 | Time Period Years: 10 | Net Benefit (Present Value (PV)) (£m) | | |
|---|---|---|---|---|---|
| | | | Low: -111.86 | High: - 72.77 | Best Estimate: -92.35 |

| COSTS (£m) | Total Transition (Constant Price) Years | Average Annual (excl. Transition) (Constant Price) | Total Cost (Present Value) |
|---|---|---|---|
| Low | £5.9m | £7.8m | **£72.8m** |
| High | £10.3m | £11.8m | **£111.9m** |
| Best Estimate | £8.1m | £9.8m | **£92.3m** |

**Description and scale of key monetised costs by 'main affected groups'**

All estimated costs are the result of increased regulatory burden imposed on affected businesses. For the four legislative components we estimate this burden to be as follows:

- Pay ratios: £4.05m in year one; £2.59 annually thereafter.
- Explaining impact of share price changes on remuneration: £1.18m annually.
- Section 172 reporting: £11.41 in year one; £5.46m annually thereafter.
- Governance arrangement disclosure: £1.23m in year one; £0.59m annually thereafter.

**Other key non-monetised costs by 'main affected groups'**

We do not foresee other significant costs that are caused by the proposals, i.e. that can be seen as additional to the counterfactual of option 0 - the 'do nothing' case.

| BENEFITS (£m) | Total Transition (Constant Price) | Average Annual (excl. Transition) (Constant Price) | Total Benefit (Present Value) |
|---|---|---|---|
| Low | | | |
| High | | | |
| Best Estimate | | | |

**Description and scale of key monetised benefits by 'main affected groups'**

**Other key non-monetised benefits by 'main affected groups'**

- Incentivise stronger stakeholder engagement, sustainability and long-termism.
- Help reduce the risk of future governance failures, improve transparency and restore trust in business.
- Greater transparency to shareholders and others on how share price changes affect executive remuneration.
- Incentivising company boards and senior management to think more about pay dispersion within their companies and how pay is shared across the wider workforce.

**Key assumptions/sensitivities/risks** **Discount rate (3.5%)**

Potential policy risks are: 1) increased burden on listed companies leading to 'delisting'; and 2) unintended consequences of pay ratios, such as companies changing their employment structures to influence the pay ratio. See detail provided in section XII on why these risks are not seen as material.

Uncertainties in economic assessment: Regulatory burdens on individual companies, and thus overall, could be larger than expected. The assessment provides a range of estimates and explains in detail how the estimates are derived. The proposals are also a result of intense consultation with affected stakeholders. We thus assess the likelihood of unexpected regulatory burdens as limited.

**BUSINESS ASSESSMENT (Option 1)**

| Direct impact on business (Equivalent Annual) £m: | | | Score for Business Impact Target (qualifying provisions only) £m: 45 |
|---|---|---|---|
| Costs: £9.0 | Benefits: Not monetised | Net: -£9.0 | |

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# I. Problem under consideration

## I.I. Background

### *The role of corporate governance*

1. Corporate governance refers to the system of rules and processes that determines how companies are directed and controlled. It defines the rights and responsibilities of the different stakeholders involved with the company, and it should ensure that their interests are appropriately balanced.

2. Good corporate governance should facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of a company. It involves a framework of legislation, codes and voluntary practices. A key element is protecting the interests of shareholders where they are distant from the directors running a company. To meet wider responsibilities, such as the duty of directors under section 172 of the Companies Act 2006, it also involves having regard to: the interests of employees; the need to foster business relationships with customers, suppliers and others; and the impact of the company's operations on the community and environment. Good corporate governance provides confidence that a company is being well run and supports better access to external finance and investment.

3. One of the most fundamental purposes of corporate governance is to overcome a 'principal-agent' problem. The separation of ownership from control leads to information asymmetries[1] and leaves room for directors to act in their own self-interest to the detriment of the owner. Governance structures, and in this case especially remuneration principles, aim to ensure that the incentives of those running the company (executive directors) are in line with the interests of those who ultimately own the company (shareholders).

4. However, directors' remuneration is only one element of corporate governance, which also determines a company's relations with other stakeholders, such as employees or suppliers. In the long-term it is in a company's own interests to practice good governance in this area, because the failure to take into account, among others, the views of employees, the impact on suppliers and on the environment, can ultimately be damaging to a business and its reputation. Failure to have regard to these issues can also have negative impacts on the wider economy that go beyond the immediate impact on the business itself, e.g. pollution, negative impact on supplier businesses.

5. Private companies are usually characterised by the fact that the owners of the company are also its executive directors. While the aim of corporate governance to overcome the agency problem between those owning and those running the company does not exist to the same degree for private companies, as there is largely no split between ownership and control, the potential wider impacts of a breakdown in good governance are relevant independent of the legal form of a company. For example, poor governance in a large private company with a large pension scheme can have large negative impacts on its employees and ultimately the wider public who may have to step in to protect the pension rights of employees.

[1] Managers are often better informed about their levels of effort and its impact on company performance than shareholders.

*The current corporate governance framework*

6. The current regulatory framework in the UK that sets out the roles and duties of company directors (section 172ff.) and that provides for current shareholder voting rights as well as reporting requirements of companies, such as the requirement to produce a triannual pay policy and an annual remuneration report, is largely embedded in the Companies Act 2006. The legislative requirements set out in the Companies Act can though apply to different subpopulations of companies. For example, while the directors' duty set out in section 172 applies to all company directors, smaller companies are exempt from the requirement to produce an annual Strategic Report,[2] and only 'quoted companies'[3] are required to comply with the existing shareholder voting regime.[4] The number of 'quoted' companies has fallen through the years, and there are currently around 900 such companies, which have to comply with the current reporting requirements around executive pay and apply the shareholder voting arrangements for executive pay matters.

7. In the UK model of corporate governance, this regulatory framework is then complemented by voluntary measures, the Financial Conduct Authority's (FCA) Disclosure and Transparency Rules (DTR) and Listing Rules[5], and the UK Corporate Governance Code.[6] All premium-listed companies on the London Stock Exchange, independent of their country of incorporation, are required to report against their adherence to the Code, on a 'comply or explain' basis, meaning that companies have to comply with the provisions of the Code, or explain why they deviate from a provision of the Code where they do so. As of 22 January 2018 there are just over 500 commercial companies, around 400 closed ended investment funds and approximately 300 open ended investment companies with a premium equity listing.[7]

8. The Code is overseen by the Financial Reporting Council (FRC), which monitors compliance and reports annually on developments. It sets standards of good practice in relation to board leadership, structure and effectiveness, remuneration, accountability and relations with shareholders. The Code provides a mix of broad principles and more specific provisions, such as, for example, that the CEO of a company should not act as Chairman of the Board.

## I.II. The case for reform

9. One of Britain's biggest assets in the global economy is its reputation for being a dependable place in which to do business. The UK's legal system, framework of company law and standards of corporate governance are admired internationally and are important factors in making the UK an attractive place in which to invest.

10. During the last few years there have been a number of proposals, sometimes developed by business itself, to update the corporate governance framework. In some cases, these

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[2] http://www.legislation.gov.uk/uksi/2013/1970/pdfs/uksi_20131970_en.pdf

[3] As defined in section 365 of the Act, these are UK registered companies that are quoted on the main London Stock Exchange or on a stock exchange in the European Economic Area, the New York Stock Exchange or NASDAQ.

[4] http://www.legislation.gov.uk/uksi/2013/1981/pdfs/uksi_20131981_en.pdf

[5] https://www.handbook.fca.org.uk/handbook/LR.pdf

[6] https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx

[7] The number of companies with premium equity listings is larger than the number of UK quoted companies as it includes non-UK companies. Companies with a premium listing have to comply with the Corporate Governance Code independent of their country on incorporation. Information taken from the FCA's Official List, which is available at: http://www.fsa.gov.uk/ukla/officialMainList.do?view=true

have been made in response to concern that actions by a small number of businesses can undermine the reputation of British business generally.

11. The Government thus published its Green Paper on corporate governance reform,[8] inviting the views of all stakeholders and the wider public. It focused on three specific aspects of corporate governance where the Government thought there could be particular scope to build on, and enhance, the current framework:

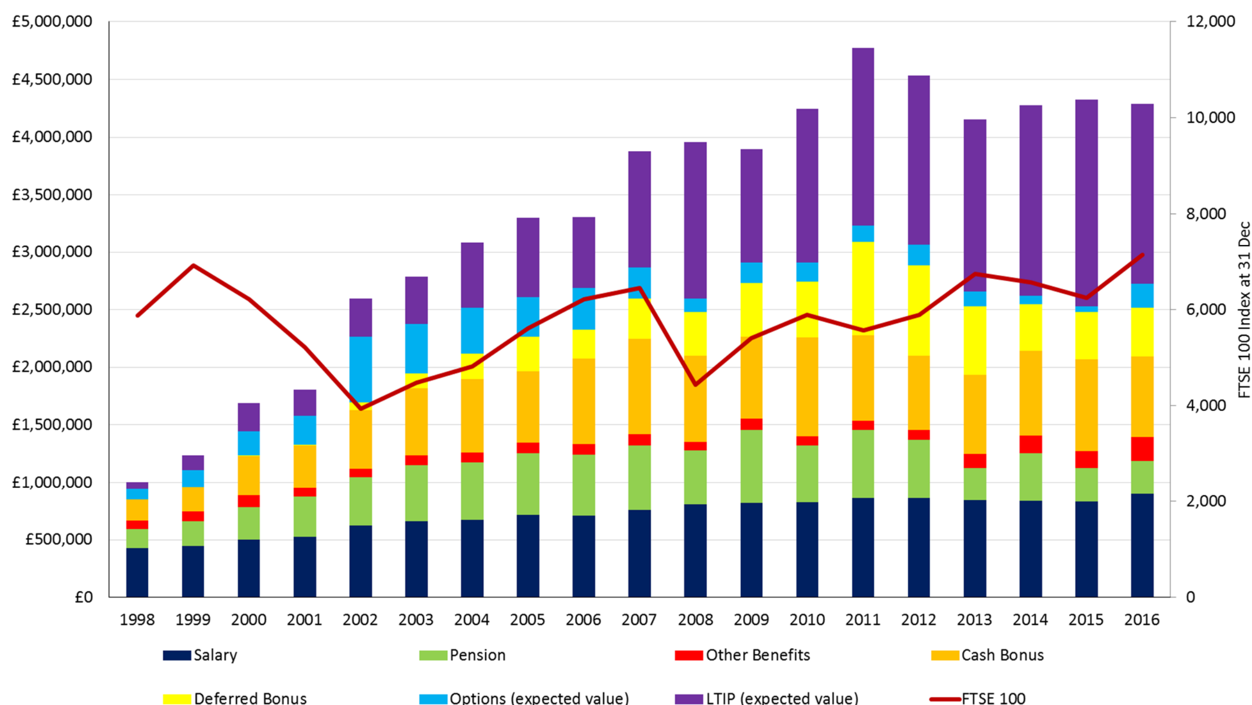
    - Executive pay and shareholder voting.
    - Strengthening the employee, customer and wider stakeholder voice.
    - Corporate governance in large privately-held businesses.

12. Section VI summarises the evidence and views gathered during the consultation period and presents the most commonly expressed views on the issues raised in the Green Paper.[9]

### *Executive pay*

13. There are different ways of calculating executive remuneration levels. This is due to the complex structure of executive pay that in theory allows for accounting of different elements at different points in time. For example, the value of conditional share awards could be measured using expected or market values at different points in time. Share options can be accounted for and measured when they are awarded, when they vest or at the time they are exercised. Existing regulations require companies to report on executive remuneration using a standardised method, the Single Figure of Total Remuneration (SFTR). This is the official measure used by government and regulations.

Figure 1: FTSE100 CEOs, mean Total Remuneration Awarded 1998-2016 (Manifest data)




[8] https://www.gov.uk/government/consultations/corporate-governance-reform

[9] See also the Government's response for more detail: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf

14. However, the existing reporting requirements, and thus SFTR, were only introduced in 2013, and data on executive pay levels collected before then did not use SFTR. This is why figure 1 above uses Total Remuneration Awarded (TRA). TRA differs from SFTR largely in that it accounts for options and 'Long Term Incentive Plans' (LTIPs) at their expected value at award (rather than their notional value when vesting, or their value when vesting respectively). While this can lead to very large differences for individual companies and to significant differences within years[10] (mainly when a company or the overall market experienced significant share price movements), the overall long-term trends are shared and captured well by figure 1.

15. Overall, the figure shows that executive compensation levels in the largest companies have increased significantly since 1998, particularly in the period to 2011. The large increase in pay levels from c. £1m in 1998 to £4.3m in 2015 is not reflected by increases to pay levels in the wider economy. While CEO pay has more than quadrupled over this time period, wages across the economy have grown at significantly lower rates. For example, mean hourly earnings of full time employees have less than doubled from £9.40 in 1998 to £15.77 in 2016.[11] The result of this is that the gap between executive remuneration and the pay for the wider workforce in a company has widened very significantly in many companies.

16. Figure 1 does though show that the trend in CEO remuneration appears more aligned with wider pay developments over the last few years, with it having largely stagnated on average. The fact that average CEO pay figures can fluctuate substantially from year to year (due to share-based remuneration) and that the rise in CEO remuneration levels in many cases appears to have slowed and potentially even reversed is also highlighted by joint research carried out by the High Pay Centre and CIPD.[12]

17. Figure 1 shows very clearly how CEO pay structures have changed over time. While base salary on average made up over 40% of CEO compensation in 1998, there has been a move towards performance and incentive-based pay, with LTIPs and bonuses making up the large majority of average CEO compensation today. The maximum value of bonus awards and share awards via an LTIP are typically tied to base salary via a multiplier. For bonus awards, the actual amount received depends on performance over the financial year, while a multi-year performance period applies to LTIPs.

18. The aim of performance-based pay is to incentivise behaviour that is in the long-term interest of the company, and to dis-incentivise behaviours by executive directors that are in their personal interest, but not in the best interest of the company overall.

19. Disquiet about directors' ability to reward themselves with excessive pay packages has surfaced periodically, leading to a number of legislative and non-legislative changes in the

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[10] For example, the mean SFTR figure for 2015 in the data was £5.75m rather than the £4.33m measured by TRA. This was due to a small number of companies in which the SFTR figure was very significantly higher than the TRA figure. This was due to large share price increases resulting in LTIP values being significantly higher at vesting than expected at award. In general, SFTR can be higher or lower than TRA.

[11] Annual Survey of Hours and Earnings 1997 to 2017 selected estimates, table 1. Available here: https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/ashe1997to2015selectedestimates

[12] The analysis covered CEO pay for FTSE100 companies as reported in annual reports for 2016 financial year ends. The analysis showed a drop in mean CEO compensation (SFTR) from £5.44m in the previous year to £4.53 in 2016. When compared to 2010, mean pay was up by £0.4m (from £4.13m), corresponding to annualised growth of less than 2%. The analysis excluded Scottish Mortgage and did not adjust for the year-to-year changes in the components of the FTSE100. Small differences to average figures presented in other reports arise from these methodological differences. The report is available at: http://highpaycentre.org/files/2016_CEO_pay_in_the_FTSE100_report_%28WEB%29_%281%29.pdf.

corporate governance framework, and on executive pay and shareholder voting specifically.

20. Disquiet about executive pay has become more acute in recent years in the context of the economic downturn and relatively weak overall pay growth during the recovery. Issues around general income and wealth inequality have come to the forefront of public discussion, and executive pay is seen as emblematic of an unfair division of reward in society. There is strong concern that executive pay is often excessive, and that success is not shared fairly.[13] There is also evidence that current pay structures can provide problematic incentives,[14] and that pay can be asymmetric (i.e. strong performance is rewarded, but poor performance is not punished).[15]

21. Annex A reviews the current literature and provides an assessment of the likely drivers behind the observed trends in level and structure of executive remuneration. However, independent of the ultimate drivers behind the increase in pay levels, and whether current pay structures set the right incentives or not, the perceived excessiveness of executive pay is a significant explanatory factor for the observed strong downward trend in trust in business.[16] This trend is worrying as it undermines the possibility for business to act as an agent for positive change, and it can damage cohesion in society.

22. Finally, even if the incentives provided by current remuneration packages work to some extent, and there is some evidence that they do,[17] it is not clear that these incentives are truly needed or induce good performance at the lowest cost to shareholders and stakeholders. Many would argue that pay incentives are not the primary drivers for executives.[18] There is also a concern that the existing system attracts precisely those who react strongly to pay incentives, rather than those with more prudent management styles and intrinsic motivation, independent of the pay reward.

23. The 2013 Directors' Remuneration Reforms, which were implemented through a combination of primary and secondary legislation,[19] changed the existing shareholder voting and reporting system around executive pay. Prior to these reforms, quoted

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[13] Kiatpongsan and Norton (2014) show, using international survey responses, including for the UK, that people underestimate the pay ratios between CEOs and average workers, and that their ideal ratios are much lower than actual observed ratios.

[14] Edmans et al (2016) show that vesting equity induces CEOs to reduce investment in long-term projects and increase short-term earnings. Continuous and frequent vesting of share plans can thus result in CEOs aiming to deliver to short-term targets.

Edmans et al (2014) provides evidence highlighting that CEOs strategically time corporate news around months in which their equity vests.

[15] Bell and Van Reenen (2016) find supporting evidence for this in UK companies with weak corporate governance.

[16] Edelman Trust Barometer 2017: trust in UK business is declining and at a record low level of 33%, with high net worth households (53%) being twice as likely to trust business as low-income households (27%). The credibility of CEOs has also fallen strongly in the UK, and across the globe, with only 28% of UK respondents seeing CEOs as extremely or very credible (40% in 2016). It should be mentioned that these negative trends also hold for other institutions such as government, the media and NGOs.

High Pay Centre/IoD survey: 'Anger over senior levels of executive pay' was the most commonly named threat to public trust in business by IoD members; 52% identified it as a threat.

[17] Flammer and Bansal (2016) establish a likely causal link by examining shareholder proposals on long-term executive compensation that pass or fail by a small margin of votes. They find that those companies in which these votes 'just' passed outperform those where they did not; furthermore, these companies tend to invest more into long-term strategies.

[18] High Pay Centre/IoD survey: Only 13% of surveyed IoD members saw 'financial reward' as the most important driving force for executives, with 54% identifying 'building a successful company' as the most important factor.

[19] Namely the Enterprise and Regulatory Reform Act 2013 which amended the Companies Act, and the Large and Medium-sized Companies and Groups (Account and Reports) (Amendment) Regulations 2013.

companies were required, to publish a Directors' Remuneration Report (DRR) as part of the annual reporting cycle. The DRR had to contain details of:

- the company's policy on remuneration;
- salary, bonus and share-based compensation of each individual director;
- pension arrangements;
- performance conditions for any share-based schemes; and
- the policy on notice periods and termination payments.

24. Addressing a perceived lack in transparency in pay reporting, the government at the time decided to improve leverage for shareholders on pay matters. The main elements of the 2013 reforms were:

    a) Splitting the pre-existing DRR into two components. A forward looking pay policy that summarises the company's future approach to remuneration (covering up to the next three years), and a backward-looking implementation report that explains how the pay policy has been implemented in a given year and summarises the remuneration awarded based on the pay policy.

    b) Increasing reporting and transparency requirements for the individual components of the pay policy and implementation report, mainly to show more clearly the link between performance and pay. This, for example, included the requirement to explain in the pay policy how much directors will receive for on-target performance, and what maximum and minimum remuneration levels will be (assuming a constant share price). It also introduced the need to report pay based on a standardised methodology, using the Single Figure of Total Remuneration.

    c) Introducing a binding shareholder vote on the forward-looking pay policy. The legislation required companies to secure shareholder approval for a pay policy via a simple majority vote at least every three years. The legislative changes kept the annual advisory vote for the backward-looking implementation report.

25. There are some signs that these reforms have resulted in behavioural change of some companies, and that the growth of executive pay has been more modest in recent years (see figure 1). However, there is still significant concern about the level of pay and about its structure. There has also been concern from shareholders that, while most companies demonstrate good practice, there remain too many examples of companies that do not act in accordance with the intended spirit of the rules, for example by not reacting to significant dissent, or even the loss of advisory shareholder votes on remuneration, or by providing little evidence that they have taken employee and wider stakeholder considerations into account.

26. While it remains vital to allow companies the flexibility on pay they need to recruit and retain talent, there is thus still scope for possible improvement.

### *Strengthening the stakeholder voice*

27. Shareholders are the owners of the company, and a shareholder focus thus appears natural. The UK equity market is one of the largest in the world, attracts a lot of investment and has a very international shareholder base. According to ONS analysis, shares in UK quoted companies were worth a total of £2.04 trillion at the end of 2016, with 53.9% of this value of shares being held by the rest of the world rather than UK shareholders.[20] Good

[20] ONS: Ownership of quoted shares 2016. Available at: https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2016

investor protection is a vital driving force in attracting investment, and being able to have a strong say about how your money is utilised is a dominant component of this.

28. Section 172 in the Companies Act is a careful balance, maintaining shareholder primacy whilst also putting a duty on directors to "in doing so" (i.e. while acting in the interests of the owners of the company) have regard to a variety of other stakeholder and wider considerations. These wider considerations range from impacts on the local community, to environmental impacts, to listening to employee voices and considering relationships with suppliers and customers.

29. Investors and asset managers are increasingly emphasising the importance of wider societal factors for long term sustainable growth and calling for more transparency around how companies manage the considerations above in order to demonstrate that they are creating long term value.[21]

30. Furthermore, given that many companies will benefit from public investment and use public services, that they rely on their employees and that they have the capacity to cause large externalities on the environment and on supplier businesses, it appears right that section 172 places this duty on directors.

31. There are recent developments such as B Corps, which meet high social sustainability and environmental standards, and the Big Innovation Centre with its Purposeful Company agenda.[22] They make the point that long-term value creation depends on companies having a clear strategic vision around their purpose – *"their role in the world from which profits result"*. Having a clear understanding of all the relevant stakeholder voices appears of vital importance for this.

32. While we acknowledge such developments coming out of the business community, it is clear from recent corporate failings, and from the responses we received during the consultation period, that more could be done in this area to drive further change. The consultation responses raised concerns that many businesses and directors treat the wider considerations in section 172 as too much of a tick-box exercise, without really giving sufficient thought to them.

***Corporate governance in large privately-held and public unlisted companies***

33. While the agency problem and the issues arising from it are less acute in the case of private companies because ownership and control of the business are usually closely intertwined, all the wider problems identified above arise independent of the legal form of the business. This is especially true where companies should have due regard for wider stakeholder views.

34. Employees are as important a stakeholder in private companies as they are in public companies. The impact bad employment practices can have on the business itself in the long-term, but also on wider society, applies irrespective of the legal form of a company. The same holds for the effects caused by companies not taking into account their environmental impacts, effect on the community, or poor treatment of suppliers; they exist whether a company is public or private. Bad practices among private companies contribute to the erosion of trust in business, and where bad business practice leads to the collapse

[21] https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter
http://cecp.co/wp-content/uploads/2018/02/SII-Investor-Letter_final.pdf?redirect=no

[22] http://www.biginnovationcentre.com/purposeful-company

of companies and potentially large pension schemes, this can have devastating effects on local areas and create wider economic costs.

35. We acknowledge that private companies are different, and that many successful private companies are driven by the entrepreneurial spirit of their owners. Our approach is thus not to treat public and private companies identically. There are, however, areas in which the legal form of a company is largely irrelevant. In areas where this is the case, we think it is fair and beneficial to ask private companies to think about their governance standards with the aim to spread good practice and increase standards among those companies that are currently not thinking about good governance enough.

# II. Rationale for intervention

36. The proposed reforms are unlikely to affect substantially the large majority of UK companies that already follow good governance practice. Instead, the proposals build on the existing strengths of the system, with targeted further interventions. They aim to incentivise more companies to think long-term and take stakeholder voices into consideration, and to ensure that systems are in place to address instances of bad governance and corporate excesses. Such bad practices in a small number of companies can and have had, large negative impacts on perceptions of business overall. They reduce trust in business as a force for good. Ensuring that good practices are more wide-spread and that bad practices are addressed should thus, by improving the public perception of business, be beneficial especially to those companies that already do the right thing.[23]

37. The previous section set out the problems under consideration, explaining what problems can currently be observed. Clearly a rationale for intervention is to address those observed problems. But this section, following Green Book guidelines, explains the precise rationales in more detail, making the analytical and economic cases for intervention, based on some of the evidence provided in the previous section. It sets out why we would expect policy intervention to actually improve upon the currently observed market outcomes.

38. The rationales for intervention can broadly be classified in three areas. Firstly, the proposed policy package aims to address **equality and fairness** concerns; it aims to address the notion that current systems do only benefit a small minority and to halt the observed erosion in trust in business. This rationale is primarily not about economic efficiency but aims to address distributive concerns. It is overarching and is thus a rationale for intervention across all three main areas for reform.

39. This rationale is not only about distributive concerns though, but also evolves around **externalities of good and bad governance**. Corporate excesses, the perception of unjustified inequality and bad business behaviour can lead to the erosion of trust in business, which can ultimately harm business itself.[24] However, there can be limited incentives for individual companies to improve their behaviour if they are still going to be lumped together with those businesses which behave poorly. In this case businesses cannot internalise the full benefits of their good behaviour. This lack of incentive can be even worse when executives with relatively short tenure have no financial incentive to

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[23] Acharya and Volpin (2010) explain how weak corporate governance can lead to excessive compensation even in firms with good governance because of competition on pay. Due to such externalities, the overall level of governance in the economy can be inefficiently low.

[24] In a recent survey carried out on behalf of the High Pay Centre, about half (48%) of respondent IoD members saw a lack in public trust in business as a threat to the success of their business. Available at: http://highpaycentre.org/files/FINAL_IOD_report.pdf

invest in corporate governance when potential benefits would only accrue over the long-term. In summary, good corporate governance practices, including appropriate pay that takes into account concerns around fairness, can enhance the UK's business climate, while poor practices can cause significant monetary damages to investors and undermine the confidence of the wider investment community. In the absence of government intervention, the market is thus likely to result in companies not taking enough action to address low levels of trust in business, even if this is likely to be damaging to businesses overall.

40. The second rationale evolves around **asymmetric information and a principal-agent problem**. As explained above, corporate governance systems and especially executive pay has evolved in order to address the principal-agent problem in public companies. However, it seems clear that some problems still remain, and that implemented solutions might at times cause unintended consequences. Short-termism might be a particular problem as, according to a recent study by PwC, median CEO tenure has fallen significantly to 4.8 years.[25] Therefore, CEOs often do not face potentially negative consequences associated with short-termist behaviour. The interests of stakeholders, whose relationship with the company is often much more long-term than that of short-term shareholders or CEOs, can often be better aligned with those of long-term shareholders. Giving more emphasis to the stakeholder voice could thus provide valuable insights to companies themselves.

41. The agency problem fundamentally derives from the fact that information is asymmetric, i.e. that those running the company have information that is not available to the owners of the company. Other elements included in the proposed reform package that focus on more transparent and meaningful reporting, for example on pay structures or on how directors fulfil their section 172 duties, thus also help in overcoming the identified agency problem.

42. Finally, not only are there externalities of good and bad governance as described above (i.e. bad governance causing an erosion in trust in business which ultimately can affect all businesses), but companies, independent of legal form, can cause **more direct externalities.** Bad employment practices can be to the detriment of employees, not having due regard to environmental impacts can cause unnecessary environmental damage, and companies not maintaining good relations with suppliers and not factoring in impacts on the local community can have devastating localised effects. Incentivising all companies to have proper regard to such issues should thus mean that companies might internalise more of these externalities into their decision-making, leading to better outcomes for society as a whole.

## III. Policy objective

43. The Government is proposing changes that will build on the strengths of the existing UK corporate governance framework to ensure that the UK remains a great place in which to do business. The reform package is specifically targeted at addressing corporate excesses and short-term thinking that go against the interests of shareholders and stakeholders, such as the employees of companies, and that undermine trust in business in general.

44. These proposals are part of the wider work to enhance public trust in business as a force for good. This includes Matthew Taylor's review of employment practices in the modern economy. It also includes the Government's support for the Hampton-Alexander Review

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[25] PwC: CEO Success Study. For summary findings, see: https://www.strategyand.pwc.com/uk/home/press_contacts/displays/ceo-success-study-2016-uk

on gender diversity in the boardroom and in senior management, and Sir John Parker's work on ethnic diversity, all of which has relevance to the challenge of connecting boards effectively with their workforce and customer base.

45. Specifically, the proposed reforms are designed to contribute towards:

- better engagement between companies, shareholders and stakeholders which should ultimately lead to companies taking a wider selection of views into account in their decision-making processes;
- companies taking more tailored approaches towards corporate governance and executive pay, taking into account the specific needs of their shareholders and stakeholders;
- halting the erosion of trust in business which is damaging to the UK economy;
- companies and executives focusing more on long-term performance rather than on short-term performance; and
- improved governance standards among private companies, especially the very largest ones, reducing the risk of corporate scandals and excesses.

46. The reforms are targeted and specific. They are designed with the aim of introducing negligible or limited burden on the majority of businesses that are already following good practice. Instead, the proposals are largely targeting those businesses that currently fail to follow good standards and are causing negative impacts on business as a whole. Where the Government introduces new requirements to all businesses, it aims to be proportionate by exempting smaller businesses, and cause minimal administrative burden by building on existing requirements and processes.

## IV. Coverage of this impact assessment

47. As explained in detail in the following section, the reform package includes four areas of legislative change, which are going to be introduced via a single statutory instrument. The legislative changes are combined with a number of non-legislative initiatives, for example industry-led and shareholder initiatives and inviting the FRC to consider changes to the Corporate Governance Code. These elements are mutually reinforcing and will help deliver the desired outcomes. They are thus explained in this impact assessment to provide a more holistic picture of the changes to the corporate governance framework. Code-based changes are though ultimately the responsibility of the FRC and industry-led action is voluntary and non-regulatory by nature. This impact assessment will thus only 'cost' the legislative elements introduced by BEIS in sections VII ("Assessment of options") and VIII ("Monetised Business Impacts") and provide a more high-level assessment of effects and impacts of non-regulatory elements in VII.

48. Each legislative element of the reform package has a targeted purpose and is aimed at different segments of the business population. We do not expect any significant interdependencies between them. The introduction of each legislative element does not significantly change the impacts of another element. We thus estimate that the overall impact of the combined policy package will be the sum of the impacts of its individual components.

# V. Description of options considered

49. This document presents the preferred policy package as the only option, apart from maintaining the status quo. The impacts of the combined policy package are assessed against the do nothing of maintaining the status quo. The final policy package presented in this impact assessment is the result of a very extensive consultation with 375 substantial responses to the green paper on corporate governance reform. Since then, during the policy development process, the Government has been in ongoing and extensive contact with stakeholders, and the mix of legislative changes and non-legislative approaches highlights that the Government is proposing a reform package that carefully balances off any potential impacts. Section VI. provides further explanation and evidence of the consultative approach that was taken which has led to the development of this package of reform measures.

50. With the above in mind, the two options considered are as set out below. Based on the evidence provided, the Government sees the policy package set out under option 1, which uses a mix of legislation and non-legislative initiatives, as proportionate and targeted to deliver on the desired outcomes.

***Option 0:* Do nothing, maintaining all existing regulations and requirements as well as non-legislative approaches with no changes.**

***Option 1 (preferred):* A reform package including the following elements on the three themes set out in the Green Paper, and on enforcement:**

**Executive pay**

1) *(Secondary Legislation).* Require quoted companies[26] with over 250 UK employees subject to current *executive* pay reporting requirements to:

   - report annually, in their remuneration reports, the ratio of the CEO's total annual remuneration to the average of the company's UK employees. The ratio will be based on the CEO's Single Figure of Total Remuneration and compare that to the figure for the UK employee median full-time equivalent remuneration, and also to each quartile of UK employee remuneration (the 25th and 75th percentile points, with the median already covering the 50th percentile point). Employee remuneration must include wages and salary, employer pension contributions and variable pay, and it can include other pay and benefits the company may wish to include provided that this is stated clearly. Companies will to have to provide explanatory detail, which sets out assumptions made in the calculation of the median and other quartile employee figures. Companies should as a default base the ratio on the 'true' employee remuneration level taking into account data on all employees. However, where a company considers that this is not possible, the legislation allows for flexibilities. Such companies can use existing data collected for Gender Pay Gap (GPG) reporting purposes to identify the median and quartile employees and calculate the full pay for these employees, explaining why they remain a reasonable estimate for overall total remuneration within the company at those percentile points. A company can also use other methods to estimate the employee remuneration provided it explains why such a method will be more accurate than using existing GPG data for the company in question;

[26] That is, UK-registered companies with a listing on the UK Official List, NASDAQ, the New York Stock Exchange or a regulated exchange in the EEA.

- show in each subsequent year how this ratio changes over time. Overall, companies will be required to report the ratio in table format over the last 10 years. However, no retrospective reporting will be required, meaning that companies will start building up the table once the new pay ratio requirement comes into force; and
- provide a short narrative explanation each year showing how the ratio relates to the company's wider strategy and workforce pay and policies, including a comment on the change to the ratio compared to the previous year and on long-term trends.

2) *(Secondary legislation).* Require companies to provide more clarity and explanation on the impact share price changes have (had) on executive compensation. Quoted companies will have to:
   - set out, in the annual remuneration report, the amount of the executive compensation package (SFTR figures) for executive directors that is a result of share price changes, and whether the remuneration committee has used discretion when awarding the pay package, especially as a result of share price changes.
   - show, in the forward-looking pay policy, the impact share price changes could have on compensation of executive directors, specifically on variable remuneration under Long-Term Incentive Plans (LTIPs). The illustrative share price increase will be 50%.
3) *(Non-legislative).* Invite the FRC to revise the UK Corporate Governance Code to:
   - be more specific about the steps that premium listed companies should take when they encounter significant shareholder opposition to executive pay policies and awards (and other matters);
   - give remuneration committees a broader responsibility for overseeing pay and incentives across their company and require them to engage with the wider workforce to explain how executive remuneration aligns with wider company pay policy (using pay ratios to help explain the approach where appropriate); and
   - extend the recommended minimum vesting and post-vesting holding period for executive share awards from 3 to 5 years to encourage companies to focus on longer-term outcomes in setting pay.
4) *(Non-legislative).* Invite the Investment Association to implement a proposal it made in its response to the green paper to maintain a public register of listed companies encountering shareholder opposition to pay awards of 20% or more, along with a record of what these companies say they are doing to address shareholder concerns. The Investment Association launched this register in December 2017.

### Stakeholder voice in the boardroom

5) *(Secondary legislation).* Introduce new reporting requirements on all large companies to explain how their directors comply with the requirements of section 172 of the Companies Act to have regard to employee interests and other factors.
   - 'Large' companies that are already required to produce a strategic report will be required to add a statement in the Strategic Report describing how directors have had regard to the wider stakeholder matters and interests set out in section 172(1)(a)-(f) of the Companies Act.[27] In order to achieve more visibility for reporting on this aspect

[27] Section 414A of the Companies Act 2006 requires all companies that are not small to prepare a strategic report. This new requirement will though only apply to large companies as defined in the Companies Act – i.e. companies meeting at least two out of the following three criteria: i) turnover of more than £36m; ii) balance sheet total of more than £18m; and iii) more than 250 employees.

of the duty of directors, companies not already required to make their annual accounts and reports available on a website will be required to make this new statement available on a suitable company website.

- Build on the existing content of the Directors' Report to require companies to provide a summary of how the directors have engaged with employees, how the directors have had regard to employee interests, and the principal effects of that regard during the financial year. This requirement thus extends the existing 'Employee Involvement statement' and will apply to all companies covered by the current reporting requirement, in other words all companies with more than 250 UK employees.
- Require 'large' companies[28] to report, as part of the Directors' Report, on their engagement with suppliers, customers and others in a business relationship with the company. This will comprise a statement summarising how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the principal effects of that regard during the financial year.

Companies can set out all the new information required in their Strategic Report with a cross-reference in the directors' report.

6) *(Non-legislative).* Invite the FRC to augment this by consulting on the development of a new Code principle establishing the importance of strengthening the voice of employees and other non-shareholder interests at board level as an important component of running a successful, sustainable business. As a part of developing this new principle, the Government has invited the FRC to consider and consult on a specific Code provision requiring premium listed companies to adopt, on a "comply or explain" basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce.

7) *(Non-legislative).* Encourage industry-led solutions by asking ICSA (the Institute of Chartered Secretaries and Administrators: The Governance Institute) and the Investment Association to complete and publish joint guidance on practical ways in which companies can engage with their employees and other stakeholders. The Government has also invited the GC100 group of the largest listed companies (FTSE100 General Counsels) to complete and publish new advice and guidance on the practical interpretation of the directors' duties in section 172 of the Companies Act 2006.

**Corporate governance in large private companies**

8) *(Secondary legislation).* Require companies of a significant size to disclose their corporate governance arrangements in their Directors' Report and on their website, including whether they follow any formal code, or recognised set of corporate governance principles. Following discussions with stakeholders, the Government has decided that the threshold for "significant size" will be set such that companies will be covered by this requirement if they: a) have more than 2,000 employees globally; or b) have a global turnover figures over £200m and a balance sheet over £2 billion. This is unless they are subject to an existing corporate governance reporting requirement (such as listed companies, charitable companies and others).

9) *(Non legislative).* Inviting the Financial Reporting Council to work with the Institute of Directors, the CBI, the TUC, the Institute for Family Business, the British Venture Capital Association and others to develop corporate governance principles for large private companies. These will be voluntary principles, and companies will be under no

[28] Applying the Companies Act definition of 'large' explained in footnote 33.

compulsion to adopt them. The objective is to develop principles that command widespread support and endorsement from business and that, in due course, they become the framework which most large privately-owned companies will choose to reference.

**Enforcement**

10) *(Non-legislative).* Government has asked the FRC, the FCA and the Insolvency Service to conclude new or, in some cases, revised letters of understanding with each other to ensure the most effective use of their existing powers to sanction directors and ensure the integrity of corporate governance reporting. The Government will consider, in light of this work, whether further action is required.

# VI. Assessment of options

### VI.I. Option 0: Do nothing.

51. This option would leave the existing corporate governance framework untouched. It would thus not create any additional regulatory burden on UK businesses. However, it would also not address the problems explained in section I, and achieve the policy objectives set out in section III.

52. Section II of this impact assessment sets out the overarching rationale for reform. The 'do nothing' option acts as the counterfactual against which the impacts of option 1 are assessed.

### VI.II. Option 1: The combined policy package.

53. This option is to implement the broad policy package outlined in V, consisting of four legislative changes requiring secondary legislation and a variety of non-legislative initiatives that the Government has initiated or supported.

54. Table 1 below provides a summary of the likely impacts (monetised and non-monetised) associated with the individual measures. The description of impacts for non-legislative elements is more high level, while legislative elements are assessed in more detail.

**Table 1: Summary of reform elements and their estimated impacts**

| Proposed measure | Type | Impacts |
|---|---|---|
| **Executive Pay** | | |
| Pay ratio reporting | Secondary legislation | Benefits (non-monetised)<br>• Incentivises company boards and senior management to think more about pay dispersion within their companies and how pay is shared across the wider workforce.<br>• Provides a tool that enables shareholders and stakeholders to observe basic trends on pay distributions within companies over time, and to |

| | | |
|---|---|---|
| | | question boards more effectively about levels of pay and reward within the company.<br><br><u>Costs (monetised), best estimates</u><br>Additional regulatory burden of (in total):<br>• £4.05m in year one; and<br>• £2.56m annually thereafter. |
| Illustrate impact of share price changes on executive remuneration | Secondary legislation | <u>Benefits (non-monetised)</u><br>• Greater transparency to shareholders and others on how future share price changes may affect executive remuneration.<br>• Encourage a more informed approach to the scrutiny and approval of share-based remuneration that discourages mechanistic outcomes.<br><br><u>Costs (monetised), best estimates</u><br>• Annualised additional regulatory burden to business, estimated to be £1.18m in total. |
| Invite FRC to revise the UK Corporate Governance Code with respect to the three elements set out under 3) on page 15. | Non-legislative / code-based | Changes to the Code apply on a 'comply or explain' basis. While Code provisions are thus not legislative requirements, they are likely to have some cost impact on businesses. The Code is owned by the FRC. Should the FRC decide to adopt the Government's proposal, it will assess the regulatory impacts of changes.<br><br>However, we expect any possible Code-changes to have a minimal impact on business overall. This is because:<br>a) the impact on individual business would be limited - many companies already follow good practice in this area and could implement changes to their practice at minimal cost;<br>b) the Code applies 'only' to premium-listed companies. As of January 2018, the FCA Official List identifies c. 1,200 premium equity-listings, with 750 being by UK companies.[29] A large proportion (over half) of these 1,200 listings are also by closed-ended investment funds and open-ended investment companies. |
| Invite the Investment Association to implement a register of listed companies encountering shareholder opposition of 20% or more, along | Non-legislative / industry-led | The register will help to hold those companies that encountered significant shareholder opposition to account, but also gives such companies a visible platform to explain their decisions, and to demonstrate what they are doing to address concerns raised by shareholders. |

[29] Applying the Corporate Governance Code is a pre-requisite for a premium listing independent of the country of incorporation.

| | | |
|---|---|---|
| with a record of what these companies say they are doing to address shareholder concerns. | | The register does not introduce any direct regulatory burden on business. It is now live and is available under: https://www.theinvestmentassociation.org/publicregister.html |
| **Strengthening the stakeholder voice** | | |
| Section 172 reporting | Secondary legislation | Benefits (non-monetised)<br>Driving up overall standards to levels already attained by many companies.<br>⇨ Incentivise stronger stakeholder engagement, sustainability and long-termism.<br>⇨ Help reduce the risk of future governance failures, improve transparency and restore trust in business.<br>Costs (monetised), best estimates<br>Additional regulatory burden, estimated to be (in total):<br>• £11.41m in year one; and<br>• £5.46m per annum thereafter. |
| Invite FRC to develop new Code principles on importance of stakeholder voices at board level. | Non-legislative / code-based | See explanation provided for *"Invite FRC to revise the UK Corporate Governance Code with respect to the three elements set out under 3) on page 15* above. |
| Asking ICSA and the Investment Association to complete guidance on engagement with stakeholders. Invite the GC100 group to complete and publish new advice and guidance on the practical interpretation of the directors' duties in section 172. | Non-legislative / industry-led | This work will complement legislative changes by providing helpful guidance to companies.<br>By providing guidance on the interpretation of s172 duties it should make it easier for companies to comply with the newly introduced reporting requirement in a meaningful way. |

| Corporate governance in large privately-held and public unlisted companies | | |
|---|---|---|
| Require companies of a significant size to disclose their corporate governance arrangements in their Directors' Report and on their website | Secondary legislation | Benefits (non-monetised)<br>Driving up overall governance standards to levels already attained by many companies.<br>⇨ Help reduce the risk of future governance failures, improve transparency and restore trust in business.<br>⇨ Build lender and supplier confidence that a company is well run.<br>Costs (monetised), best estimates<br>Additional regulatory burden, estimated to be (in total):<br>• £1.23m in year one; and<br>• £0.59m per annum thereafter. |
| Invite the FRC to work with a Coalition Group consisting of the Institute of Directors, the CBI, the TUC, the Institute for Family Business, the British Venture Capital Association and others to develop voluntary corporate governance principles for large private companies. | Non-legislative / industry-led | This work will complement legislative changes by providing a helpful framework for companies.<br>The development of governance principles for private companies that has wide support from stakeholders should:<br>a) help raise standards by identifying what is best-practice and what is expected; and<br>b) provide a widely used – but voluntary - reference point which large private companies can use in reporting on their corporate governance arrangements.<br>The work of the Coalition Group, for which the FRC provides the secretariat, is now underway under the leadership of James Wates (of Wates Construction). |
| **Other** | | |
| Invite the FRC, FCA and Insolvency Service to update existing MoUs and letters of understanding between them (or conclude new ones). | Non-legislative | This work will ensure that existing enforcement powers are used effectively and reduce duplication, overlap and regulatory inefficiency.<br>It will help build confidence in the robustness of the existing enforcement regime. |

55. The following sections provide more detailed analysis on the overall figures presented in table 1, focusing for the most part on the legislative elements of the reform package. In addition to providing step-by-step derivation of the impacts for the regulatory provisions, the following will also further explain how the consultation process has fed into the final policy design.

**a) Require quoted companies to report on their pay ratio.**

56. Changes to legislation will require annual disclosure in the directors' remuneration report of the ratio of the CEO's Single Total Figure of Remuneration to the remuneration of the

company's UK median employee (calculated on a full-time equivalent basis), and employees at the 25th and 75th percentile, accompanied by a narrative explanation of the ratio.

57. The Government, in its response to the green paper, committed to introducing a requirement for UK quoted companies to report the ratio of pay between the CEO and the average UK employee. In the final policy design, the Government has had to consider various trade-offs and methodologies and has based its assessment to a large extent on stakeholder responses received.

58. **On the definition of "average" the government has opted to require the report of the ratio of CEO pay to the '*median'* of the company's UK employees, rather than mean pay.** The Government has also confirmed an additional requirement, suggested in the response to the green paper, that companies should also report the ratio of CEO pay to the 'quartiles' of the company's UK employees. In practice, this means the addition of two other ratios; the ratios of CEO pay to the 25th and 75th percentile points of UK employee remuneration (the 50th percentile point being the median). The use of median is in line with the new pay ratio reporting requirement introduced in the US, which also requires calculations based on median pay.[30] The use of quartile reporting also has some read-across to the Gender Pay Gap Information regulations, which require the reporting of some information across pay quartiles, as well as with reference to average employee pay. A pay ratio reporting requirement based on mean UK employee pay would have been more straightforward for companies to implement, because the total spent on the necessary pay elements (salary, pension, bonus, employee share schemes) is largely already collected and reported on in the annual accounts. Mean calculations would only require companies to divide such aggregates by the employee count to derive a mean UK employee pay figure, and ultimately to derive a pay ratio. A mean-based ratio would thus not require any significant additional data collection, and the regulatory burden on business would have been limited to the presentation of the results within the annual remuneration report and providing the required narrative.

59. However, while we acknowledge that the regulatory burden on businesses would have been smaller for most companies, a mean-based ratio would likely have added little extra value, because it would not have revealed any significant new information. Secondly, mean pay figures can be skewed significantly upwards by very high pay at the top of the organisation, particularly in companies with smaller numbers of employees. Many of the quoted companies within scope do not have large numbers of employees so mean pay figures in such companies would likely not provide a very accurate figure for pay of the average employee. The collection of data necessary to calculate a median-based pay ratio on the other hand will enable companies and their shareholders to get a wider and more accurate picture about the distribution of pay within the company.

60. In order to reduce the regulatory burden introduced by the median and quartile-based pay ratios, companies will be allowed to apply reasonable methods to identify their median employee, and his or her overall pay. For example, companies can rely on existing data collected for Gender Pay Gap (GPG) reporting purposes to identify the median and quartile employees based on a subset of pay categories (salary and bonuses). The ability to identify the median employee using this or more accurate approaches will reduce the need for potentially large-scale data collection.

61. Having identified the median employee (and employees at the 25th and 75th quartiles) based, for example, on GPG data companies will thus only have to collect data on other

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[30] Final rule: https://www.sec.gov/rules/final/2015/33-9877.pdf
Guidance: https://www.sec.gov/rules/interp/2017/33-10415.pdf

pay elements for this median employee, using reasonable estimates for some pay benefits such as implied pension benefits derived from defined benefits pension schemes. In essence, companies can use GPG data, which covers slightly different pay elements than the CEO SFTR (not covering for example deferred income, but only income taxable in that year) to identify the median employee and then calculate that employee's overall pay package in a similar way as the CEO's SFTR figure. In doing so, companies will have to set out why the pay received by the identified employee remains a reasonable estimate for overall median pay across the company. Where, for example, the identified median received a large bonus share-reward, which would make it unlikely that the identified employee remains the median when talking about total pay, the company will have to provide a separate reasonable estimate for median employee pay and explain its approach, or consider other employees close to the identified median in the GPG data.

62. Not all individual companies within groups that will be covered by the new pay ratio reporting requirement are necessarily currently covered by GPG requirements. This is largely driven by the fact that the new pay ratio reporting requirement will apply at the group level (the requirement will sit with the quoted parent company), while the GPG requirement applies to individual employers/companies with more than 250 employees. This means, for example, that a hypothetical quoted holding company "Group A PLC" that operates with two UK subsidiaries, "Sub B LTD" and "Sub C LTD" with 200 UK employees each, will now be covered by the pay ratio reporting requirement, while the individual subsidiaries do currently not have to comply with GPG reporting requirements.

63. Whether the company uses the full data on all employees or has to rely on making use of reasonable methods for estimation, the company has to set out its basic approach and make clear if it changed its approach compared to the previous year to ensure that share- and stakeholders are provided a full picture of trends within companies over time.

64. While giving companies some flexibility for the applied methodology will probably result in different companies identifying their median employee pay in slightly different ways, this does not undermine the primary policy aim of the policy, which is not to compare the ratios of different companies, but to ensure that companies explain to their shareholders and wider stakeholders why the ratio in the company is seen as appropriate. As part of this conversation, companies will have to explain why the methodology they applied is a reasonable approach given its specific circumstances.

65. **The pay ratio reporting requirement will apply to UK employees only**, mainly because: a) the absolute pay of employees in different countries can often not be compared; and b) including all employees would increase the compliance costs for companies. While respondents raised concerns that outsourcing of low-paid staff could be used to reduce the pay ratio, we consider it unlikely that such fundamental decisions will be driven by a basic pay ratio reporting requirement. The required narrative nonetheless asks companies to set out whether and how changes to the employment model have affected the pay ratio, which would also reveal if such practices were used.

66. In the final design of the statutory instrument, the Government has also decided that the **pay of the UK employee median is to be identified on a full-time equivalent (FTE) basis**. This is in line, for example, with existing GPG reporting requirements, which compare pay on an hourly basis. The aim in both cases is to compare the going rate of pay rather than the absolute value. Not allowing for FTE-based pay would, for example, disincentivise the creation of part-time roles at more senior levels.

67. While we point towards examples of large listed companies that are already reporting a pay ratio based on median employee pay,[31] we acknowledge that the data gathering necessary will be a challenge for some companies, particularly companies with a large number of subsidiaries and with different payroll systems. Estimated impacts for companies in the UK (more detail in the relevant section below), while still significant in individual cases, are estimated to be significantly lower than the figures provided in the US context for a variety of factors - the two main ones being the restriction to UK employees only and the existence of regulatory reporting requirements, such as GPG reporting, that mean that necessary data collection systems should already be in place to some extent.

**Benefits/purpose**

68. The Government's objective is to ensure that the new pay ratio reporting requirement is based on a methodology that is as transparent and robust as possible, and that can be implemented consistently by the wide range of quoted companies to which it will apply, while allowing companies some flexibility to take into account their specific circumstances and challenges.

69. Pay ratio measures, no matter how detailed the methodology, will probably remain a somewhat rough measure for pay comparisons. It is thus not an aim of the pay ratio reporting requirement to encourage comparisons across companies that are fundamentally different and should thus likely not be compared. The main aim of the pay ratio reporting requirement is to act as a tool that **incentivises company boards and senior management to think more about pay dispersion within their companies and how pay is shared across the wider workforce**. The necessary narrative and explanation for the trend of the ratio over time within companies - why the level and trend is seen as appropriate for the company - will force boards to justify their decisions. This explanation and justification will arguably be of more value to share- and stakeholders than the basic number provided.

70. The Government is not specifying what the 'correct' ratio is for a specific company, rather it is giving shareholders and stakeholders new **information to observe basic trends over time in a simple but robust fashion**.

**Costs/regulatory burden**

71. The only clear cost associated with this proposal is the regulatory burden imposed on affected businesses. The likely level of this additional regulatory burden imposed on business is estimated and discussed in the following paragraphs.

Number of affected companies

72. All UK-registered quoted companies listed on the Official List, or on NASDAQ, the New York Stock Exchange or a recognised stock exchange in the European Economic Area will be covered by the new requirement, unless they have fewer than 250 UK employees. The burden associated with this requirement appears disproportionate for these companies as the pay ratio would be less meaningful and robust. Small staffing changes would result in large changes to the pay ratio.

73. Analysis using the FAME database, which uses company filings, identified just over 900 quoted UK companies. Of these, about 420 have more than 250 employees and there are an additional 110 companies without a clear employee count. This can be due to data

[31] Such examples, such as Standard Life, Legal & General and Schroders, highlight that some of the covered companies already have the systems in place to comply with the proposed pay ratio requirement at little additional cost.

missing for the last financial year or because these companies are newly formed and have not reported such data yet. This impact assessment makes the conservative assumption that all companies without an employee count in the data will be above the threshold and will thus be covered by the legislation.

74. The relatively large number of quoted companies with no more than 250 employees is largely due to closed-ended investment funds (investment trusts) and open-ended investment companies (OEICs). The Official List, which covers only listings on the London Stock Exchange, shows that approximately 300 of the around 870 equity listings by UK companies are by investment trusts or OEICs. These typically have very few employees, and in most cases do not have a formal CEO (or other executive director), and therefore would have no annual Single Total Figure of Remuneration with which to produce and report a pay ratio. Executive pay reporting requirements placed on these types of companies would therefore have little practical purpose and impact.

75. Focusing only on the 620 UK quoted companies that are not identified as investment trusts in the FAME database, the analysis identified approximately 470 companies with more than 250 employees. The remaining 150 companies that would be exempt due to the employee threshold are typically either: a) indeed very small listed companies; or b) while not classified as an investment trusts or OEIC in the data still, in practice, operate in this sector (investment vehicles), for example Real Estate Investment Trusts. The analysis needs to be caveated as it considers worldwide employee counts, while the thresholds applied refer to UK employee headcounts. There will thus be a small number of larger organisations with a significant number of employees worldwide that will not be covered based on the UK employee threshold only.

76. Based on this analysis, we thus estimate that **the pay ratio reporting requirement will apply to around 450 UK quoted companies**.

<u>Impact per business</u>

77. Consultation responses and discussions with stakeholders have indicated that the proposed pay ratio reporting requirement will be relatively straightforward for some companies, as evidenced by the fact that some already provide a similar ratio, but that collecting and collating the necessary data may be a significant challenge for others.

78. The large variation in the likely impact on individual companies is also highlighted in responses the U.S. Securities and Exchange Commission (SEC) received in response to its proposed rule for the forthcoming pay ratio reporting in the US, which is also median-based. In the economic assessment[32] of its final rule the SEC, based on responses received from registrant companies and informed by surveys carried out by the Centre on Executive Compensation and the Chamber of Commerce, provided estimates of potential regulatory burdens placed on businesses.

79. The small number of registrants (ten) that provided full estimated costings for initial compliance costs to the SEC provided a very large range of estimates, mainly highlighting that the level of compliance costs is strongly linked to the software systems and data collection already available within individual companies. Overall, the SEC used the estimates provided by individual registrants and matched it against the employee count of these companies to calculate an average per-employee compliance cost for registrants. The cost for initial data collection and compliance costs was thus estimated as $38.04 per employee. However, responses from individual registrants and survey responses highlighted that stakeholders estimated that the need to cover non-US employees would be a large driver of these costs. In line with estimates provided by registrants and surveys,

[32] https://www.sec.gov/rules/final/2015/33-9877.pdf. Section III.

the SEC thus assumes that the per-employee for companies with just US-based operations only would be half ($19.02 per employee).

80. Applying this to the average number of employees per registrant, the SEC thus provided indicative estimates of approximately $156,000 (£112,000) for registrants with US-operations only and $714,000 (£512,000) for registrants with foreign operations in the first year. Using the median of estimates provided by commenters, the SEC assumed that compliance costs in following years could be 40% of the initial costs; approximately $63,000 (£45,000) and $286,000 (£205,000).

81. BEIS analysis of Capital IQ data on US-listed companies and FAME on UK-listed companies shows that the average size of the roughly 450 UK-quoted companies that will be covered by the pay ratio requirement is roughly comparable to the average size of US listed companies (looking at companies on the Russell 3000 which covers 98% of the US public equity market). FAME shows that the covered UK companies have on average roughly 15,000 global employees, with the average company included in the Russell 3000 having approximately 13,000 employees. The average market cap of the covered UK quoted companies was £4.5bn, compared to £7.4bn for Russell 3000 companies. While the covered UK companies are thus slightly larger in terms of number of employees on average, the average US listed company appears slightly larger in terms of market capitalisation. Overall though, the two company populations appear roughly comparable in terms of average company size.[33]

82. However, though the company population covered by the respective regulations appear roughly comparable, the estimates provided above cannot be seen as reasonable estimates for the likely burden placed on UK businesses for a variety of reasons.

83. Firstly, the pay ratio reporting requirement in the UK applies to UK employees only. The inclusion of worldwide employees was highlighted by SEC registrants as a significant factor in the overall costs. Even if one was to apply the indicative estimates provided by the SEC, this means that the more relevant comparator group would be the group of registrants in the US with US operations only.

84. Secondly, the indicative estimates provided by the SEC are based on requiring companies to carry out full data collection on all employees. The analysis does not allow for any of the flexibilities that will be incorporated in the UK regulations.[34] For example, as explained, while companies in the UK will be asked to derive the 'true' median pay where the systems to do so are in place, companies will be allowed to identify the median based on existing data collected for GPG reporting purposes. This will mean that companies will in practice not have to collect pay data on all pay components on all employees.

85. Thirdly, the ability to identify the median and quartile employees based on data collected for GPG reporting purposes means that less new data collection is necessary. The raw data on which to base most of the calculations is largely already available. The new components will be that the affected companies will have to collate and combine the data across their subsidiaries. Companies will also have to perform some additional data manipulation on the existing data, for example annualising the pay data on an FTE basis

[33] This holds on average because the largest US listed companies are significantly larger than the largest UK quoted companies, but the population of US-listed companies also has a much longer lower tail of small companies compared to the 450 UK companies that will be required to report pay ratios.

[34] The final rule developed by the SEC also allows for significant flexibilities, and the indicative estimates provided by the SEC are thus likely also not best estimates for the US scenario.

(rather than calculating hourly pay as done for GPG purposes) and combining the resulting annual salary with the data collected on annual bonus payments received.

*Familiarisation and transition costs (identifying the right approach for the company)*

86. Key personnel will have to identify what the requirements mean for the company and will have to identify a way to implement pay ratios that is deemed to be reasonable and proportionate. We assume that familiarisation and identifying a suitable approach will involve senior management and some board level discussion.[35] For senior management, we assume that this will take up one day (eight hours) of two HR directors. As the calculation will require using financial information, we assume that the input of a finance director could be necessary as well. We thus allow for eight hours of a finance director's time. Allowing for the fact that the affected companies tend to be large corporations and that staff at that level of seniority in these companies will likely be paid at the upper end of the distribution for their occupations, we apply the 75$^{th}$ percentile from 2017 ASHE data and thus apply an hourly wage rate of £31.90 for 'human resource managers and directors' and £46.66 for 'financial managers and directors'.[36] Following Eurostat estimates for non-wage labour costs, we then uprate these wage rates by 20.2%. Finally, we specifically assume that NEDs on Remuneration Committees will have to familiarise themselves with the new requirement and be involved in identifying a suitable approach; for this we allow for fifteen hours of total NED time which we cost at £150 per hour. While the size of the Remuneration Committee, and the frequency of committee meetings, differ depending on type and size of company, Remuneration Committees typically consist of about five members, and they tend to meet about five times a year. Fifteen hours of NED time would thus translate to pay ratio design being a substantive item at one of the meetings, requiring three hours of each NED. In total we thus derive total **familiarisation and transition costs of £3,312 per affected company**.[37]

87. While non-executive directors are paid a flat fee and usually do not have a set number of contracted hours, it is common practice to assume that a non-executive director will spend about one day (eight hours) per week, or ca. 400 hours a year, on their role as a NED for a company.[38] Recent surveys on the fees received by non-executive directors[39] show the difference in fee levels for non-executive directors and additional fees for committee roles depending on company size, with fee levels being larger in FTSE100 companies than in smaller companies. The proposed regulations will apply to approximately 450 quoted companies, which will span from the FTSE100 all the way to small quoted companies. We thus consider the average covered company to be roughly represented by the median of the FTSE250. The provided surveys estimate median FTSE250 NED fees to be just over £50,000 per annum, with an additional fee of £5,000 per annum for members of the Remuneration Committee (£10,000 for a chairmanship).

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[35] Some companies might also (or instead) bring in external advice, for example from remuneration consultants.

[36] The familiarisation time and costs assumed are roughly in line with / slightly higher than those made in the analysis of the impact of the gender pay gap reporting requirement. Impact assessment available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/580037/GPG_regs_IA3_signed_and_scanned_dated_27.04.16.pdf

[37] $1.202 * (2 * 8 * £31.90 + 8 * £46.66) + 15 * £150 = \mathbf{£3,312.}$

[38] Many chairs of board committees of the largest companies likely spend more time than this on their role, at least during specific periods. However, using a potentially low estimate is conservative in this instance as it will result in a higher hourly rate applied to NED time.

[39] https://www.pwc.co.uk/human-resource-services/assets/ftse-100-review-of-ned-fees-january-2016.pdf
https://www.pwc.co.uk/human-resource-services/assets/ftse-250-review-of-ned-fees-february-2016.pdf
https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2018/01/2017-kpmg-guide-to-directors-remuneration.pdf

88. Based on this data we thus assume that a representative member of a Remuneration Committee in the affected companies will be paid roughly £60,000 per annum, which we translate into an hourly rate of £150 (£60,000/400) for the calculations above.

89. Some companies might choose to make changes to their HR and payroll system, for example integrating them to a higher degree. While integrated HR systems allow companies to calculate true median pay figures, and some companies already provide ratios based on such analysis, the flexibilities allowed for in the regulations should not necessitate any significant changes to data collection systems. We account for costs associated with collating the data across subsidiaries in the annual data collection costs below. Individual companies might though decide that incurring an upfront cost associated with upgrading HR and payroll systems, rather than incurring higher annual data collection costs, is a more cost-effective way to implement pay ratio reporting for them.

*Annual data collection (identifying the median/quartile and calculating total median/quartile pay)*

90. The complexity of collating and combining the data collected across the group will largely depend on the complexity of the group structure. Groups that operate in a single market segment and with a small number of subsidiary companies and/or have an integrated payroll system will experience very limited costs in collecting the necessary data as evidenced by some companies already reporting a median-based pay ratio on a voluntary basis within their annual reports.

91. In general though, group structures are very diverse and often complex. FAME analysis of the affected quoted companies/groups identifies that these companies have on average 39 UK subsidiaries (minimum of zero, maximum of 390) for which the quoted company is the ultimate owner. However, two in five of the affected companies operate with fewer than ten UK subsidiaries. These subsidiaries are also often subsidiaries with very limited economic activity, and they are often not owned directly by the group. When restricting the analysis to the number of companies that are directly owned by the affected companies, the average number of subsidiaries falls to eight (with a maximum of 98).

92. Overall, the analysis shows that there will in practice be significant variation in compliance costs across companies and that affected companies will in theory have to collate and combine pay data from up to 39 subsidiaries on average, though the number of significant subsidiaries (in terms of having a significant number of employees for the data collection to be a challenge) is probably closer to ten on average. Payroll data will be also integrated at least for some subsidiaries, with employees sitting on the same payroll system, though stakeholder responses showed that this is often not the case; especially following mergers and acquisitions. Finally, where the company uses GPG data to identify the relevant employees it is true that this data is currently only required to be held at the individual employer level; but, in reality, this data is already calculated on a wider group level in many instances as well.

93. We thus estimate that requiring the publication of pay ratios following the methodology outlined above, and allowing for flexibilities set out in this assessment, will lead to very little/negligible costs in terms of the need for data collection and system upgrades for many companies. This is either because some companies do already report ratios following a similar methodology or because they do not operate across many different sites and with many UK subsidiaries. Those companies with multiple payroll systems could either choose to upgrade their existing systems, or, more likely, will use the available flexibilities, such as using existing data collected for GPG reporting purposes to identify median/quartile employees. For these companies the additional burden is mainly caused by a need to:

a) collate existing data on employee remuneration from on average around 39 subsidiary companies, where the majority of subsidiaries are relatively minor with few employees and thus limited data to collate;

b) carry out some data manipulation (such as annualising hourly rates to FTE annual pay and combining data on salary and wages with annual data on bonuses, which is collected separately in GPG data) where no superior other data is already available to identify the median/quartile employees;

c) calculate total remuneration for the median/quartile employees; and

d) provide a sense-check that the total remuneration for the employees is likely to remain an accurate estimate for median/quartile remuneration within the group after having added all pay components.

94. Element a) is mainly an exercise of commissioning the data from subsidiaries where it is not already aggregated at group level. We assume this to take on average around two hours per subsidiary, and thus 78 hours per company affected by the policy. Two hours per individual subsidiary company is in line with the estimated time applied on a per company/employer basis for similar reporting requirements, such as used in the assessment of GPG reporting. Combining and merging the individual datasets and identifying the median employee based on the overall data is assumed to take up an additional three days of work (24 hours) of a relevant staff member's time. Finally, identifying the actual level of pay for the identified employees, checking whether they remain reasonable estimates for the levels of remuneration across the company and making adjustments, if deemed to be necessary, is assumed to take another day (eight hours). In total, we thus assume that carrying out the annual data collection exercise necessary will require around 110 hours of staff time. We assume that an HR director (hourly wage from 2017 ASHE: £31.90) is a reasonable estimate for the level of staff that will carry out this work. After allowing for non-wage labour costs (20.2% uprate), we thus **estimate that the annual data collection will place an additional burden of** $1.202 * £31.90 * 110 = £\mathbf{4218}$ **per affected quoted company.**

*Presentation and board discussion (narrative creation)*

95. In the first instance we assume that senior staff within the company will create the overarching narrative and presentation of the data for the purposes of the annual report.[40] We assume that it will require six hours of an HR director's time and an additional six hours of a finance director's time to do so; i.e. 1.5 days of total staff time. As done throughout this assessment we apply the 75th percentile of the relevant wages from 2017 ASHE data (£31.90 and £46.66) and allow for non-wage labour costs of 20.2%. We also assume that the overall presentation of the pay ratios, including the surrounding narrative, requires two hours of senior sign-off, for which we apply the most senior category in ASHE data, 'chief executives and senior officials'. Once again we apply the 75th percentile (£63.70 per hour), which has also been uprated to account for non-wage labour costs. We thus estimate that creating the overall presentation (including surrounding narrative) of the pay ratios and senor sign-off below board level will on average create an additional regulatory burden per affected quoted company of $1.202 * (6 * £31.90 + 6 * £46.66 + 2 * £63.70) =$ £720 per year.[41]

[40] As with other components involving executive pay, some companies might choose to bring in external advice/help, for example from remuneration consultants rather than carrying out the analysis in house.

[41] This cost is likely to fluctuate somewhat year on year depending on whether the circumstances of the company have changed, which would need to be reflected in the narrative. While creating the narrative from scratch in the first year might result in higher costs in year one, the description of trends in the data will only materialise in later years. We thus deem the estimated cost to be a reasonable estimate for costs per year.

96. Finally, while discussion and sign-off at the board level might not be necessary in the narrowest and strictest compliance sense, it is a specific purpose of this policy that such discussions happen. We thus assume that the analysis and narrative will be discussed and factored in by the Remuneration Committee of affected companies. The size of the Remuneration Committee will vary from company to company. For the purpose of this IA we assume that a total of five hours of NED time will be used for the discussion of pay ratios. Following the argument provided in paragraph 86, five hours of NED time is akin to assuming that pay ratios will form a substantive (one-hour) item on one Remuneration Committee meeting per year. We thus cost discussions at Remuneration Committee level, which are a direct intention of the policy, as $5 * £150 = £750$ per year per company.

97. **Overall, we thus estimate an additional regulatory burden imposed on the roughly 450 affected companies of (in total):**

| | |
|---|---|
| **Year one only** | **Familiarisation and transition:** $450 * £3{,}312 = £\mathbf{1.49m}$ |
| **Annual** | **Data collection (identifying the median employee and median total pay):** $450 * £4{,}218 = £\mathbf{1.90m}$ |
| | **Presentation and discussion (creating the narrative):** $450 * (£720 + £750) = £\mathbf{0.66m}$ |

Overall impact

98. Applying the per business impacts to the identified ca.450 companies, **we estimate a total additional cost to business of: £4.05m in year one and £2.56m annually thereafter.**[42]

**b) Require quoted companies to explain the impact of share price changes on executive remuneration.**

99. First, any new directors' remuneration policy will in future have to provide an illustration of the impact of share price growth on maximum executive remuneration outcomes received via LTIPs – the illustration is a 50% increase in the share price over the life of the relevant performance period.

100. Second, the annual directors' remuneration report will in future have to provide an actual figure for, or estimate of, the value of executive remuneration for each director that year which is be attributable to share price growth, and to state whether and how any discretion

[42] The analysis of the GPG reporting requirement referenced throughout this impact assessment estimated total transition costs (familiarisation, software and training costs) of ca. £2.3m and annual recurring costs of ca. £3.8m. As the necessary data collection for the pay ratio reporting will in many instances be more limited than necessary for GPG reporting (especially because it can build partially on GPG data), and the number of covered companies (roughly 500) is much smaller compared to ca. 8,000 companies covered by GPG reporting, it might seem surprising that the overall estimated costs in this assessment are similar in total (and thus much larger per company). This is largely for two reasons.

Firstly, the scope of covered companies is very different with pay ratios applying to quoted companies, which are often groups consisting of many individual companies that are counted as individual companies for the purpose of GPG reporting. The pay ratio reporting will thus in practice require the collection of data in many more than 500 companies; it is just reported on a more aggregated level.

Secondly, the pay ratio reporting requirement sits within annual reports and is aimed at encouraging discussions at board level. This is reflected in the provided estimations, which specifically allow for conversations at board level.

has been exercised in respect of the impact of share price growth on remuneration outcomes.

**Benefits/purpose**

101. Current regulations require companies to provide a “minimum” pay scenario, an “on-target” pay scenario, and a “maximum” pay scenario. Under the maximum scenario the executives receive the maximum bonus and LTIPs vest fully. However, current regulations require companies to develop these scenarios under the assumption of no share price changes. In reality, it is likely that, in the maximum scenario, there will have been significant share price changes. Actual remuneration outcomes can thus lie significantly above what some might have interpreted as a strict maximum. The proposal would provide shareholders and others a clearer forward-looking illustration of potential remuneration outcomes that could result from the presented remuneration policy. The additional reporting requirement in the backward-looking remuneration report will then provide additional information on the effect of share price changes in actual remuneration.

102. Targets linked to share price growth often play a key role in directors’ performance plans. While this can partially help overcome the agency problem by linking the executive’s remuneration level with the fortunes of the owners of the company (shareholders), the precise impact that share price growth can have on remuneration levels is often difficult to understand. This can result in scenarios in which shareholders approve a remuneration policy, only to be surprised by remuneration levels in the following years resulting from the implementation of the pay policy. The objective is to **provide greater clarity for shareholders and others** on how share price changes may affect executive remuneration, and to **encourage a more informed approach to the scrutiny and approval of share-based remuneration that discourages mechanistic outcomes.**

**Costs/regulatory burden**

103. The only clear cost associated with this proposal is the regulatory burden imposed on affected businesses. The likely level of this additional regulatory burden imposed on business is estimated and discussed in the following paragraphs.

<u>Number of affected companies</u>

104. The proposal will apply to all companies that are currently in scope of the existing regulations, namely all UK-registered quoted companies listed on the Official List, or on NASDAQ, the New York Stock Exchange or a recognised stock exchange in the European Economic Area. FAME data currently identifies just over 900 such companies. The FCA’s Official List currently identifies approximately 870 UK companies with an equity listing on the London Stock Exchange specifically, providing further evidence that around 900 companies will be covered in theory.[43]

105. However, a significant proportion of quoted companies are not commercial companies but open ended investment companies or closed ended investment funds. Executive pay regulation do in practice often have little impact on these types of companies, for example when they do not operate with executive directors, but solely uses non-executive directors. FAME data currently identifies about 620 as commercial quoted companies, while the FCA’s official identifies approximately 560. As explained, the Official List provides only a subset of covered companies (may it be the vast majority of covered companies as there do not exist many UK-registered companies that are quoted overseas but not on the LSE). FAME and the Official List also use slightly different company-type classification. Overall,

[43] The small difference between the two figures can likely be explained by UK companies that are quoted on a foreign exchange.

the data suggests that **around 600 companies** will be affected by this new requirement in practice.

Impact per business

106. Companies receive regular advice from remuneration consultants on specific remuneration matters. While the ultimate oversight lies with Remuneration Committees and the extent to which Committees rely on external advice will differ from companies, remuneration consultants will typically advise on the appropriate use of bench-marking and on the design of executive remuneration principles tailored to the company's need.

107. While the remuneration report is thus produced by the Remuneration Committee of a company and some companies may comply with the new requirements internally, we think that most companies will rely on advice by their remuneration consultants to present both the forward looking-scenario analysis and the backward-looking breakdown of pay that was a result of share-price increases.

108. We have, for the purpose of this impact assessment, assumed that most of the costs will be as a result of an increased need for such external advice, with some additional costs arising from integrating the advice into the remuneration policy/report and for additional sign-off be senior managers and members of the Committee.

109. Companies, in their annual reports, publish the fees paid to remuneration consultants over the year. For large and complex FTSE100 companies the total sum of such fees is often in the area of £200,000 per year; total fees are typically much lower for smaller companies. We thus think an overall estimate of £100,000 per annum for companies covered by executive pay regulations is reasonable. As mentioned, remuneration consultants provide advice for a variety of remuneration matters, often developing pay structures, engaging with shareholders on behalf of the company etc. In comparison to services already provided by remuneration consultants, we think the two additional requirements as set out in paragraphs 99 and 100 are minor in nature. They do not require complex calculations, and especially the need to in future report a figure for the amount of pay that was realised as a result of share price growth is a mechanical calculation that can use already existing data and information. As a matter of fact, some companies already report on this. We thus also think that familiarisation costs overall will be negligible. Any familiarisation costs will likely be largely reflected by additional external advice needed and received and is thus implicitly included in the overall annualised estimates provided below.

110. We thus estimate that the need to provide an illustration of the impact of share price growth on maximum executive remuneration outcomes within the remuneration policy will result in a modest 2% uplift in the cost of advice received by companies. Under the assumption of average costs of £100,000 annually currently, this would represent a cost of £2,000. We then assume that it will take two hours of administrative time to translate that advice into text for the remuneration policy. For this we apply the wage of a full-time 'HR director and manager' from the 2017 ASHE (£31.90) and uprate it by 20.2% to adjust for non-wage labour costs. We allow for a total of two hours for additional sign-off which we price at the uprated wage rate of 'Senior executives and officials' from ASHE (£63.70). To adjust for the fact that the companies covered are often very large and that the individuals at question will thus often lie at the upper end of the wage distribution within a job category, we do not use the median or mean figures from AHSE, but apply the 75th percentile in each case. Finally, companies only have to introduce a new pay policy every three years, and the costs described above will thus only occur once every three years in most cases. The **estimated annualised costs per company** for this policy element are thus:

$$\frac{0.02 * £100{,}000 + 2 * 1.202 * (£31.90 + £63.70)}{3} = £\mathbf{743}.$$

111. As the need to report on the value of executive remuneration for each director that may be attributable to share price growth is mainly technical, we estimate a more modest 1% uplift in the cost of external advice received by companies. Under the assumption of average costs of £100,000 annually currently, this would represent a cost of £1,000. We assume that all other costs (administrative and sign-off) are identical to those described in paragraph 124 above. In contrast to the remuneration policy, the remuneration report is an annual exercise. We thus estimate **annual costs per company** for this policy element of:

$$0.01 * £100{,}000 + 2 * 1.202 * (£31.90 + £63.70) = £\mathbf{1,230}$$

Overall impact

Applying the estimated annual costs per company to the population of affected companies, we thus estimate that the proposed changes to require quoted companies to explain the impact of share price changes on executive remuneration will thus result in **a total annual additional regulatory burden on business** of:

$$600 * (£743 + £1{,}230) = £\mathbf{1.18}\boldsymbol{m}.$$

**c) Require large privately-held and public unlisted companies to report on their corporate governance arrangements.**

112. Changes to legislation will require that companies in scope include in their Directors' Report a statement of their corporate governance arrangements. Directors will be required to set out in narrative form in their annual Director's report which if any Corporate Governance Code the company follows and if they depart from that Code, in what way they do so with their reasons.

**Benefits/purpose**

113. Some components of corporate governance are specifically concerned with overcoming an agency and asymmetric information problem between those owning the companies (shareholders) and those running the company (executives). These components do not usually apply to private companies to the same degree. However, other principles of good governance apply to all companies, independent of legal structure as the decisions made by all companies have wider impacts on a variety of stakeholders or creditors. Recent examples of corporate scandals and excess were not limited to listed companies but were arguably often the result of a lack of good governance in private companies.

114. Requiring large private and public unlisted companies to report on their corporate governance arrangements in the way proposed is seen as a proportionate way to incentivise all companies to think about governance and review their standards on a regular basis. This should help driving up overall governance standards to levels already attained by many companies, for example by exposing bad practice, and by highlighting and disseminating good practice. An increase in overall governance standards, as well as increased visibility of arrangements applied by companies, should help reduce the risk of future governance failures, improve transparency and restore trust in business.

**Costs/regulatory burden**

115. The only clear cost associated with this proposal is the regulatory burden imposed on affected businesses. The likely level of this additional regulatory burden imposed on business is estimated and discussed in the following paragraphs.

Number of affected companies

116. The Government Response to the green paper consultation announced that all companies of a "significant size" would be required to disclose their corporate governance arrangements, and that its "initial view" was that the requirement should apply to companies with more than 2,000 employees globally, unless covered by an existing corporate governance reporting requirement.

117. Since then, and following further discussions with stakeholders, the Government has decided that companies with a significant turnover and balance sheet size, but who do not meet the employee threshold, should also report on their corporate governance arrangements. The number of employees on a company's payroll is not the only indicator of a company with a significant economic and societal impact. Some large companies, for example, use a business model which relies on extensive use of agency and contract workers rather than employees.

118. The reporting obligation will therefore apply to companies required to publish a Directors' report in the UK with 2,000 or more employees globally. This will operate as a stand-alone threshold. Companies will also be within the scope of the new reporting requirement where both the turnover and balance sheet exceed the following thresholds:

(i) a turnover over £200 million globally; and
(ii) a balance sheet over £2 billion globally.

119. These turnover and balance sheet thresholds are based on those used for HMRC's Tax Strategy reporting requirement and will therefore be familiar to companies. However - unlike the HMRC reporting requirement - both thresholds (i) and (ii) must be met to bring companies within the scope of the corporate governance reporting requirement. We believe that this is a proportionate measure which ensures only companies of a very significant size are covered.

120. In setting the threshold we considered using a two out of three methodology but were concerned by the approximately 390 companies (based on FAME data) with more than 2,000 employees – some of them having significantly more than 2,000 employees - who would not have been covered by this measure.

121. Using FAME data **we estimate that approximately 1,720 large companies** satisfy the conditions set out and explained above, and **will thus be covered by the requirement**. This number is the assessment against the counterfactual and as such refers only to the additional companies covered by the new requirement and excludes those, such as premium-listed companies, that already face similar requirements.

Impact per business

122. The proposed measure does not enforce any specific governance arrangements on the affected companies. Instead, the measure aims to incentivise companies to think about their governance arrangements by asking them to report on them. Many of the largest companies already think thoroughly about governance and may already report on it within their annual reports or on their websites; others may decide that very few governance principles apply to their specific company and will thus choose to provide little detail. As this new requirement leaves significant scope to companies with regards to the level of detail they choose to report, the impact on businesses will vary.

123. On average, we estimate that the regulatory impact per business will be in line with existing non-financial reporting requirements that are similar in scope. In 2016 government commissioned external research to carry out surveys of affected businesses to estimate the likely regulatory burden imposed by the implementation of the EU non-financial

reporting directive (NFRD) for Public Interest Entities (PIEs) in scope of that Directive (i.e. these with more than 500 employees). As part of this, the research assessed the likely regulatory burden of requiring such companies to report in their annual reports on their approach to anti-bribery and corruption matters.[44]

124. The research concluded that the average costs in the first year (including familiarisation and implementation costs: creating the corporate governance statement, sign-off and publication) for unquoted PIEs would be £951 per company. This was based on survey responses indicating that the reporting requirement would take up five hours of 'director time', twenty hours of 'professional time' and one hour of 'administrative' time, and applying appropriate wages taken from official statistics. The annual costs after the first year per company is estimated to be £455, based on two hours of 'director time', 6.5 hours of 'professional time' and eight hours of 'administrative cost'. The difference between the two figures (£951 and £455) can thus reasonably be interpreted as the familiarisation costs per business.

125. We consider the reporting requirements introduced here to be of comparable scope in terms of what is required of companies. In particular, we do not expect significant ongoing costs as the corporate governance arrangements are unlikely to change significantly year-on-year. Furthermore, the business population of PIEs is similar (though smaller on average) as the one covered by the threshold explained in paragraph 118. We thus think that the figures derived for reporting on anti-bribery and corruption matters provide a helpful baseline.

<u>Overall impact</u>

*Low estimate*

126. FAME data shows that only about 1,100 of the estimated 1,720 companies that are covered do not have a domestic (UK) ultimate owner that is reported to have more than 250 employees itself, i.e. are not owned by another UK company of significant size that would be covered by the requirement separately. Another c. 300 have a global (non-UK) ultimate owner with more than 250 employees, meaning that 'only' around 800 of these companies are not clearly identified as having a corporate majority owner of significant size itself. This means that a large fraction of covered companies are part of wider corporate groups, often with a large public listed company being the ultimate owner (around 350 of the 1,720 companies have a listed company as their domestic UK owner). At a minimum we would expect groups to set an overarching governance strategy. Where these groups apply these principles across the entire group, the implementation and compliance costs for subsidiaries will be lower. Based on the figures provided on covered companies being subsidiaries, we thus provide a **low-cost estimate** of:[45]

$50\% * 1{,}720 * £951 \approx \mathbf{£0.82}\boldsymbol{m}$ **in year one**; and

$50\% * 1{,}720 * £455 \approx \mathbf{£0.39}\boldsymbol{m}$ **per annum thereafter**.

[44] Impact assessment and research findings can be accessed here: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/575540/NFRD_impact-assessment-_final_August_2016.pdf
See Annex A on pages 26 ff. for research findings and detailed costings.

[45] As the overall cost is multiplicative (number of affected companies x cost per company) it does not matter whether this is modelled as a reduction in the number of affected companies or as a reduction in the cost per company. Theoretical arguments could be made for either.

*High estimate*

127. In this case we assume that there are no mitigating factors. We assume that the full per-company cost applies to all companies, whether they are part of a wider group or not. In that case we derive overall **high-cost estimates** of:

$$1{,}720 * £951 \approx £\mathbf{1.64}\boldsymbol{m}$$ **in year one**; and

$$1{,}720 * £455 \approx £\mathbf{0.78}\boldsymbol{m}$$ **per annum thereafter**.

*Medium / best estimate*

128. In some instances, different companies that sit within the same family of companies are not only legally, but also in practice, completely separate; they carry out different business activities and thus likely require a different approach to corporate governance. However, it is clear that there will be many instances in which the numbers provided by the high estimate are unrealistic in reality.

129. For example, in the case where a single private company is by far the most dominant company of a quoted group, it is unlikely that a significant burden would fall onto that private company, as it can realistically refer to and apply the standards applied and reported on by the group. Another example is the scenario where groups are structured geographically. Where a company is divided into separate companies by UK region, each of these companies is part of the 1,720 companies identified by FAME data. Once again, in practice it is likely that these companies would take a joined-up approach significantly reducing the estimated impact, although each individual company that meets the qualifying criteria will be required to provide a report. Being part of a wider group does not provide an exemption but what will need to be reported is likely to be less.

130. We think that the high-cost and low-cost estimates provide reasonable bounds, and that the true impact will probably lie in between. In the absence of strong evidence where exactly it will sit, we apply a mid-point estimate, resulting in **overall best estimates** of:

$$0.75 * 1{,}720 * £951 \approx £\mathbf{1.23}\boldsymbol{m}$$ **in year one**; and

$$0.75 * 1{,}720 * £455 \approx £\mathbf{0.59}\boldsymbol{m}$$ **per annum thereafter**.

**d) Require all large companies to publish information on how their directors have regard to the matters set out in Section 172(1)(a) to (f) in the Companies Act 2006.**

131. Directors of UK companies have an ultimate duty to promote the success of their company for the benefit of its members as a whole. In pursuing that aim, directors must have regard to a number of specified stakeholder and wider issues, including the interests of the company's employees and the need to foster relationships with suppliers, customers and others. This approach, known as "enlightened shareholder value", is set out in section 172 of the Companies Act 2006.

132. The Government has no plans to amend section 172, but intends to enhance its visibility and profile within company boardrooms by requiring directors to be more transparent about how they have complied with the duty to have regard to the matters in section 172(1) (a) to (f). Specifically, government will introduce changes to:

    (i) require a statement in the Strategic Report of how directors have complied with their duty to have regard to the matters in 172 (1) (a)-(f) and publish this on a suitable company website (this could be part of the annual report if the annual report is published on a suitable website);

    (ii) require a statement in the Directors' Report on how they have had regard to employee interests, and the effect on the principal decisions taken; and

(iii) require a statement in the Directors' Report on engagement with suppliers, customers and others in a business relationship with the company.

133. The Government anticipates that many companies will wish to provide a full account of their engagement as part of their strategic report statement (i.e. as part of (i) above), where it is material to the interests of members. However, where this information is not provided in the strategic report, the government wants to ensure that it is reported elsewhere. Therefore, in addition to the general requirement to report on compliance with section 172 (1) (a) to (f), the Government proposes to introduce the additional reporting requirements set out in (ii) and (iii) above. Where companies choose to set out the new information required in their Strategic Report, they will need to state that they have done so in the Directors' Report.

**Benefits/purpose**

134. Investors will be better able to hold directors to account and fulfil their stewardship duties with information on how directors are fulfilling their section 172 duties.

135. Increasing the visibility of wider section 172 requirements at the board level should incentivise directors to take these duties seriously; something that in isolated cases has not been the case in the past. As wider stakeholders, such as employees, often have a particularly long-term interest and view of the company, failures in this area can potentially have large negative long-term impacts. As the wider factors in section 172(1) (a)-(f) have a strong bearing on company performance in the long-term, this should help ensure that directors take long-term implications of their decisions into appropriate account. Increased visibility of the s172 requirements should thus incentivise the consideration of long-term impacts, help reduce the likelihood of governance failures among large companies, improve transparency and ultimately help restore trust in business.

**Costs/regulatory burden**

136. The only clear cost associated with this proposal is the regulatory burden imposed on affected businesses. The likely level of this additional regulatory burden imposed on business is estimated and discussed in the following paragraphs.

Number of affected companies

137. The Government's policy announcement in August suggested that the threshold for reporting on section 172 stakeholder issues could be set at 1,000 employees but said that this would be "subject to further consideration".

138. All company directors are subject to the duty in section 172. In principle, a wide range of companies should thus be within scope. On the other hand, a proportionate approach is needed. Small companies will tend to have less formal means for engaging with stakeholders and less need to explain their approach to shareholders and others who are not directly involved in the management of the business.

139. Government has also considered the existing company reporting thresholds and does not wish to add complexity to the reporting framework unless there is a strong justification for a bespoke approach. It has concluded that such a justification does not exist in this case and that current large company thresholds and criteria should thus be used.

140. The new reporting requirement within the Strategic Report (132(i) above) will thus apply to all companies that are already required to produce a Strategic Report,[46] but will also

[46] Section 414A of the Companies Act 2006 requires all companies that are not small to prepare a strategic report.

exempt medium-sized companies. In practice the requirement will thus apply to 'large' companies, i.e. companies meeting two out of the following three criteria:

- Turnover of more than £36m
- Balance sheet total of more than £18m
- Number of employees more than 250.

FAME data currently identifies **approximately 16,000 companies** that would thus be covered by this new requirement.

141. The new reporting requirement within the Directors' Report set out in 132(ii) above will be implemented by amending Part 4 of Schedule 7 (Matters to be dealt with in Directors' Report) in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, It will build on the existing reporting provisions in Part 4, section 11 (Employee Involvement) and require companies that are currently within the scope of this section to provide a summary of how the directors have engaged with employees. As such this requirement applies to a slightly different set of UK companies, namely those with more than 250 UK employees. As this reporting requirement is specifically about employee interests a pure employee threshold does also appear appropriate. FAME data currently identifies 12,400 UK companies with more than 250 employees.[47]

142. The new reporting requirement to be included in the Directors' Report set out in 132(iii) above does not build on existing provisions and covers interests that go beyond employees. As such, this requirement will apply to all large companies and thus affect the ca.16,000 companies.

Impact per business

143. More detail on the matters that companies will be expected to report on under this new provision is expected to be provided in the Financial Reporting Council's Strategic Report Guidance. The circumstances of individual companies differ, and with it the range of stakeholders that directors will need to consider. However, the government anticipates that statements will include information for members on some, at least, of the following matters:

- Who the company considers to be its principal stakeholders and how it has formed that opinion.
- The main methods the directors have used to understand the interests and views of these stakeholders.
- Information on the effect, if any, that the interests and views of the company's principal stakeholders had on decisions taken by the company.

144. In order to achieve more visibility for reporting on this aspect of the duty of directors, all companies that are not already required by section 430 to make their annual accounts and reports available on a website will be required to make this new statement available on a suitable company website.

145. The proposed measures give significant freedom to affected companies in terms of how to comply with the requirements. They do not require businesses to engage with stakeholders in specific ways; they only require companies to report on the practices they have in place. As set out above, companies will be able to cover everything in the

[47] The figure provided is based on looking at 'active companies' with more than 250 employees overall and eliminating manually a small number of companies that have not provided accounts for many years and are as such likely to be inactive in practice. The provided estimate of 12,400 is a conservative (high) estimate as some companies are likely to have more than 250 employees, but fewer than 250 employees in the UK specifically.

Strategic Report and then 'just' reference this fact in the Directors' Report, rather than actually having to split the reporting into three distinct elements.

146. We thus estimate the regulatory impact on each individual company to be limited. In practice, the impact will vary strongly from business to business. Many businesses already report on employee and stakeholder engagement within their annual reports. The impact for those businesses, and for those who chose to provide the absolute minimum required, will be negligible. However, the Government hopes that these measures will incentivise companies to think about stakeholder engagement and provide useful information. We thus assume that, on average, the regulatory impact per business will be in line with existing non-financial reporting requirements that are similar in scope.

147. We estimate that the regulatory impact in terms of compliance costs is similar to that introduced by the new requirement on large privately-held and public unlisted companies to report on their corporate governance arrangements. We therefore apply the same average per-company costs explained in paragraphs 123-125.[48] Once again, the difference in year one costs and costs in following years is due to initial familiarisation costs.

<u>Overall impact</u>

148. The widest proposed requirement, a statement in the Strategic Report of how directors have complied with their duty to have regard to the matters in 172 (1) (a)-(f), covers c.16,000 companies. It is this requirement that we envisage in practice to be used by most companies to comply with new stakeholder reporting requirements placed on them. As was the case for the new requirement on large privately-held and public unlisted companies to report on their corporate governance arrangements, this requirement will also apply to each individual company. However, the c.16,000 companies identified as in scope include a large number of subsidiaries and holding companies.[49] The compliance burden will be lower for example for holding companies, which carry out no economic activity themselves, and for companies that are part of a wider group with shared stakeholders where large components of the stakeholder statements will be developed jointly or at group level and then applied equally (or with little variation) across individual companies within the group. Following the arguments provided in paragraphs 126-130, we thus provide the following estimates for additional regulatory burden placed on businesses:

| | |
|---|---|
| **Low estimate** | $50\% * 16{,}000 * £951 \approx \pmb{£7.61m}$ in year one.<br>$50\% * 16{,}000 * £455 \approx \pmb{£3.64m}$ per annum thereafter. |
| **Medium / best estimate** | $75\% * 16{,}000 * £951 \approx \pmb{£11.41m}$ in year one.<br>$75\% * 16{,}000 * £455 \approx \pmb{£5.46m}$ per annum thereafter. |
| **High estimate** | $16{,}000 * £951 \approx \pmb{£15.22m}$ in year one.<br>$16{,}000 * £455 \approx \pmb{£7.28m}$ per annum thereafter. |

[48] In this case the company population considered is similar to those of PIEs, with it being on average slightly smaller (>250 employees versus >500 employees).

[49] FAME data identified just over half (9,500 out of 16,000) the companies to not have a global corporate owner with more than 250 employees, with 4,000 companies being identified to have a UK corporate owner that has reported to have more than 250 employees. Due to limitations in the data, this estimate is likely to be conservatively low.

**e) Additional comments on code-based elements and support of industry-led action**

149. The analysis provided in table 2 explains that the Corporate Governance Code is owned by the FRC and that it will have to assess the impact of changes to the Code on business. It also explains why we would expect any changes in line with those currently suggested to only result in very minor regulatory burdens on business. Consulting on, and developing, new code principles, is likely to have some resource impact on the FRC. However, the Corporate Governance Code undergoes regular revisions anyway, and a lot of this work will be carried out as part of this. We thus expect source impacts on the FRC to be limited.

150. Government supports the various voluntary industry-led approaches outlined above. Industry-led action is voluntary in nature and does thus not impose any direct regulatory burden on business. It is nevertheless a key component in the overall strategy to drive the desired changes. By clarifying expectations and defining current best practice, industry-led initiatives can also act as a complement to legislation and can reduce compliance costs in practice while simultaneously improving the information companies provide.

# VII. Monetised business impacts

151. The scope of this impact assessment, as set out in section V, is to:

    a) set out the proposed package for reform as a whole, explaining how the reform package we propose is based on the available evidence and to what extent it is supported by the consultation process; and

    b) explain and estimate (monetising, where possible) in a proportionate way the likely impacts of the proposals.

    For the purpose of estimating economic impacts and, more specifically, direct impacts on business, this impact assessment focuses on the four regulatory elements. The analysis of the impacts of these measures is largely informed by stakeholder responses and experiences with previous similar legislative initiatives.

152. Table 1 in the previous section summarised the likely impacts for the individual measures, including their impact on business. Table 2 below provides a further summary, focusing solely on presenting the estimated monetised impacts associated with each measure, all of which are impacts that fall on business. The presented costs to business are costs associated directly with the compliance with the new reporting requirements. We thus judge all monetised impacts presented in the analysis as direct impacts on business. The desired benefits of an enhanced governance framework, such as improved relationships between share-, stakeholders and companies, a reversal of the decline in trust in business, an increased focus on long-term performance and a reduced risk of corporate excesses and scandals, have, due to their complexities and the uncertainties surrounding them not been monetised in this impact assessment. In any case such benefits would not be seen as positive direct impacts on businesses.

**Table 2: Summary of estimates for monetised (business) impacts**

| | | Low estimate | **Best estimate** | High estimate |
|---|---|---|---|---|
| **Pay ratio reporting** | Year one | | **£4.05m** | |
| | Annual after year one | | **£2.56m** | |
| **Explaining the impact of share price changes on executive remuneration** | Annual | | **£1.18m** | |
| **Section 172 reporting for large companies** | Year one | £7.61m | **£11.41m** | £15.22m |
| | Annual after year one | £3.64m | **£5.46m** | £7.28m |
| **Companies of significant size to disclose their corporate governance arrangements** | Year one | £0.82m | **£1.23m** | £1.64m |
| | Annual after year one | £0.39m | **0.59m** | £0.78m |

153. We estimate the overall net impact on business to simply be the sum of the individual four regulatory components, because we see no clear interdependencies in the impacts of individual elements. **Overall, the proposed measures are thus estimated to introduce an additional regulatory burden on business of:**

- **£13.7m-£22.1m, with a best estimate of £17.9m, in year one.**
- **£7.8m-£11.8m, with a best estimate of £9.8, annually thereafter.**

**The best estimate translates into an equivalent annual net direct cost to business (EANDCB) of £9.0m.**

154. We estimate that the requirement for all large companies to provide more information on how their directors have regard to the matters set out in section 172(1)(a) to (f) will be the largest contributor to the overall estimated additional regulatory burden placed on business. This is purely due to the fact that this requirement will apply to a much larger number of companies than the other measures introduced.

## VIII. Small and Micro-Business Assessment (SaMBA)

155. New requirements related to reporting on executive pay apply only to 'quoted' companies. There are a significant number of investment vehicles (closed ended investment funds and open ended investment companies) with equity listings on the main market of the London Stock Exchange.[50] Currently (as of 4 January 2018) they account for roughly a third of all equity listings (306 out of 867) on the main market. Such investment funds and companies usually have a very small number of employees and often operate without executive

[50] The Official List is openly available at: http://www.fsa.gov.uk/ukla/officialMainList.do?view=true.

directors. In addition, FAME analysis indicates that there is a smaller number of additional companies that also have fewer than 50 employees. However, these companies are usually not 'small' as defined in the Companies Act, as they tend to have relatively large balance sheets and turnover. Those investment companies that function without the use of executive directors are implicitly not covered by the need to report on executive remuneration, and, due to robustness concerns, all companies with fewer than 250 employees are exempt from the requirement to report the pay ratio.

156. Small and micro-Businesses, as well as medium-sized businesses, are exempt from new s172 reporting requirements, which are only going to apply to the ca. 16,000 companies that are 'large' as defined by the Companies Act.

157. Finally, the new requirement for some private and public unlisted companies to report on their corporate governance arrangements applies only to companies of a significant size. The applied threshold (see paragraph 133) ensures that only very large companies are captured, avoiding disproportionate and unnecessary burdens on smaller companies.

# IX. Equalities Assessment

158. The Equality Act 2010 protects against unlawful discrimination on the basis of the following protected characteristics:

- age
- disability
- gender reassignment
- marriage and civil partnership
- pregnancy and maternity
- race
- religion or belief
- sex and sexual orientation

159. The Department for Business, Enterprise and Industrial Strategy is subject to the public sector equality duties set out in the Equality Act 2010. It requires public bodies to have due regard to the need to:

- eliminate unlawful discrimination, harassment, victimisation and any other conduct prohibited by the Act;
- advance equality of opportunity between people who share a protected characteristic and those who do not; and
- foster good relations between people who share a protected characteristic and those who do not.

160. An equality analysis is an important mechanism for ensuring that we gather data to enable us to identify the likely positive and negative impacts that policy proposals may have on certain groups and to estimate whether such impacts disproportionately affect such groups.

161. The policy package in question applies directly to legal entities, mainly introducing additional requirements on how companies interact with share- and stakeholders and how they report on this engagement. No burdens are thus placed on individuals directly. Individuals can be affected indirectly in a professional capacity and in their role as shareholders or stakeholders in a company. Such impacts are likely to be minimal at the individual level, and the policy package is designed to increase the voice of stakeholders and shareholders (which can be individuals), while imposing proportionate requirements

on companies. We thus do not foresee any clear negative impacts on the individual level, and especially no reason to expect any disproportionate negative impact on those protected by the Equality Act 2010.

162. Individuals may also experience indirect effects in their professional capacity if they sit on the board of an affected company, either as an executive or non-executive director. This population of people is very small and we would expect any impacts on the individual to be minor. Increased engagement between company boards, shareholders and stakeholders could also have the positive side-effect of companies further developing their thinking in terms of addressing the gap between the typical composition of company boards and that of employees and stakeholders. It might thus help addressing the wider work on boardroom diversity, in particular the underrepresentation of women and ethnic minorities at the highest management levels.[51]

163. Finally, the proposed pay ratio reporting requires companies to calculate pay and identify employees at the quartiles of the pay distribution based on full-time equivalent pay. This ensures that the assessment is made based on the 'going rate' of pay. Without an adjustment for FTE in the methodology for calculating the pay ratio there could have been a disincentive to part-time working which is used to a far greater extent by women than men. Ensuring that part-time roles are FTE adjusted can provide a further incentive for companies to offer senior, high-paying roles on a part-time basis.

## X. Families Assessment

164. The proposed reform package makes changes to the way companies govern themselves, interact with shareholders and take account of the wider stakeholder voice. The policies have effect at the company level and do not affect individuals directly. If individuals are affected, then this is only indirectly, for example where they are directors, shareholders or stakeholders.

165. There is thus no evidence for any direct impacts on family formation, on families going through key transitions such as becoming parents, or on the ability of family members to play a full role in family life. There is also no evidence that it will specifically affect those families most at risk of deterioration of relationship quality and breakdown.

## XI. Competition Assessment

166. The proposed reform of the UK corporate governance framework does not affect specific markets, sectors or suppliers of goods and services disproportionately. It applies equally to all companies that fall into scope due to their size and nature (for example by being 'quoted').

167. The reform elements are an evolution of the existing framework. The expected regulatory burden on affected companies is thus limited and is not expected to have any measurable impact on the number of suppliers within a specific market, or on a company's ability to compete. The measures will also not lead to a reduction in information available to

[51] Only 23.6% of FTSE350 board members are women (as at 1 May 2017) and the Parker Review (2016) pointed out that directors of colour only represent about 8% of the total FTSE100 director population, with 53 out of the FTSE100 companies not having any directors of colour.

consumers and will not affect the incentives for businesses to compete within specific markets.

168. Overall, the proposed measures are thus not seen to have any significant impact on competition.

# XII. Risks, uncertainties and assumptions

Policy risks

*Delisting*

169. The UK has experienced a ‘delisting’ trend over the last years, with fewer new listings and companies removing their listings, operating as private companies instead. This trend is shared among many advanced economies and is likely related to a variety of macroeconomic factors. Excessive additional regulatory burden that falls disproportionately on listed companies could accelerate this trend further. Some of the newly introduced requirements (specifically those on executive pay) indeed apply only to a subset of listed companies. However, other elements of the reform package, such as requiring large private and public unlisted companies to report on their governance arrangements work in the opposite direction, bringing large unlisted companies closer to the corporate governance reporting requirements already in place for listed companies. The estimated regulatory impact on an individual business is also unlikely to be substantial enough to influence any decisions around company structure. We do thus not think that this risk is in any way substantial.

*Unintended consequences and unforeseen regulatory burdens*

170. As evidenced in this impact assessment, the Department has consulted extensively, formally and informally, with affected parties and stakeholders. The proposals have been designed carefully to avoid any unintended consequences and to avoid disproportionate regulatory burdens on business.

171. For example, the pay ratio reporting requirements have been designed taking the incentives companies face into account by considering how different employment models would affect pay ratios. Where companies could in theory make undesirable adjustments to their employment practices to affect the pay ratio, the supplementary reporting requirements are designed to make this obvious. While the reporting requirement has been designed to mitigate against this potential risk, we do not consider it likely that companies would make such fundamental adjustments to employment models just in order to present what is seen as a slightly more beneficial pay ratio.

172. In summary, the Government has carefully taken concerns raised by all stakeholders during extensive consultation into account and has allowed for flexibilities to avoid unnecessary regulatory burden on companies where possible. We do thus think that the risk of unintended consequences and unforeseen regulatory burdens on business is limited.

Uncertainties in the economic assessment

173. This impact assessment has aimed to explain in detail the assumptions used within it. Based on our extensive stakeholder engagement process and comparing our measures to comparable measures we thus think that the range of potential impacts presented captures the most likely scenario. Most elements of the proposed statutory instrument

have been designed with simplicity and practicality in mind. Nevertheless, there always remains residual risk that, due to unforeseen complications, the impact on individual companies is higher than expected.

174. Estimates provided on scope of the individual measures (i.e. the number of companies affected), which are largely based on FAME data and information taken from the FCA Official List, are likely to be of good quantitative accuracy. However, due to the complex nature of company structures (i.e. many companies being part of the same group of companies) and the flexibility build into especially the s172 reporting requirement and the new requirement on some private and public unlisted companies to report on their governance principles, it is likely that many companies experience only a very limited burden in practice. We have tried to incorporate this into our estimates, providing a range of estimates for different assumptions. However, the precise degree to which this will be the case in practice remains uncertain.

## XIII. Post-implementation review (PIR) plan

**Basis of the review:**

It is our intention that these regulations will apply to reporting on company financial years beginning on or after 1 January 2019. The review of the changes will, in line with standard practice, occur five years after their commencement date to allow for the changes and their impacts to have been established sufficiently. The review will thus take place by the end of 2023. However, government is consistently monitoring the trends in this area, for example on executive remuneration structures and levels.

**Review objective:**

The objective of the review will be to assess whether the policy has delivered against the stated policy objectives:

- Better engagement between companies, shareholders and stakeholders which should ultimately lead to companies taking a wider selection of views into account.
- Companies taking more tailored approaches towards corporate governance and executive pay, taking into account the specific needs of their shareholders and stakeholders.
- Contributing towards halting the erosion of trust in business.
- Companies and executives focusing more on long-term performance.
- Improved governance standards among private companies, especially the very largest ones, reducing the risk of corporate scandals and excesses.

**Review approach and rationale:**

The review will largely analyse the experience of affected parties and analyse trends on executive remuneration specifically (see “Monitoring information arrangements”). We will consider, closer to the time, whether tailored ad-hoc evidence collection such as, for example, bespoke surveys to establish to what extent private companies have embraced good corporate governance principles is necessary and proportionate.

**Baseline:**

Establishing the correct counterfactual, i.e. identifying what would have happened in the absence of the proposed policy changes, will be challenging. Best practice in corporate governance changes frequently, and this area has been subject to a variety of previous and

related reforms. In addition, trends on share- and stakeholder relations, and on executive remuneration, will also be subject to societal changes and macroeconomic factors that are independent of the policy changes. However, the Department has, in the process of developing the policy, acquired a significant amount of evidence and data that summarises the status quo. It also intends to keep collecting the data for example on executive remuneration structures and levels to allow for an assessment in the future.

**Success criteria:**

- Delivery of the policy objectives. More specifically, these include:
  a) Better engagement between companies, shareholders and stakeholders as evidenced by feedback and evidence collected from these affected parties.
  b) Increased application of good governance practices by private companies.
  c) Help in halting the erosion of trust in business.
  d) Companies and executives focusing more on long-term performance. This can for example be evidenced by changes to remuneration structures and performance targets.
- Avoidance of unforeseen consequences and burdens on business.

**Monitoring information arrangements:**

The Department has established strong ties with affected parties (companies, investors, shareholders, stakeholders, regulators…) during the extensive consultation period. We intend to use these ties to gather feedback and evidence on the changes after implementation.

The Department will also continue to access data on remuneration levels and structures via its data subscriptions.

# Annex: Additional supporting evidence

### A: Trends in the level and structure of executive remuneration – further evidence

175. Roughly speaking, the economic literature breaks down into three strands (each with several sub-strands) that aim to explain the strong rise in the level of executive compensation over the last decades (in absolute terms, but also in relative terms as highlighted by the large increases in pay ratios). The first asserts that CEOs have become better at extracting rent; they are taking a bigger share of the pie. This could be, as suggested by Bebchuk and Fried (2005), either because CEOs have an increasingly large influence on boards and their own remuneration, or because they are in a better position when it comes to wage bargaining, for example because their general managerial skills have become more transferable and are thus more highly valued.[52]

176. The second explanation put forward in the literature is that society has become more accepting of high pay. This has led to policies, for example around taxation, and public attitudes that do not constrain high pay. This explanation is not specific to CEOs but is common in the wider literature on inequality in general.[53] Indeed, there is some evidence

[52] See, for example, Murphy and Zabojnik (2004) on this.

[53] Piketty, Saez (2011, 2013).

(Kaplan and Rauh, 2007) to suggest that the large increase in executive remuneration is not out of line with increases in other highly paid professions.

177. This observed general increase in pay at the top end of the income distribution is also related to the final main theory explaining the rise in executive remuneration, which suggests that CEOs are just more important than they used to be. In a globalised world with bigger companies and bigger markets, the value CEOs add has increased dramatically. Indeed, the size of a company is a strong determinant in CEO compensation, and Gabaix and Landier (2008) show that *"the sixfold increase of U.S. CEO pay between 1980 and 2003 can be fully attributed to the sixfold increase in market capitalization of large companies during that period*".

178. There is though limited evidence on a strong causal link between specific explanations and the development of executive pay levels.[54] The individual explanations put forward can explain some empirical observations, but it appears that none can explain observed trends consistently over time. The fact that the theories individually struggle to explain the trends in level and structure of pay simultaneously is shown in Frydman and Saks (2010), which assesses the development of CEO compensation in the US over a long time period, and emphasised in Frydman and Jenter (2010), which provides a detailed overview of the literature, both in terms of theory and empirical work.

179. On structure of pay, most of the economic literature tends to agree that there is a link between pay and performance of executive directors. As executive directors often receive a significant proportion of their pay in the form of shares and accumulate a significant shareholding over time, the link between company performance and the wealth of executive directors is also often more significant than the link to pay received within a specific year.[55] Assessments that do not find a performance link often use a narrow definition of executive pay. As CEOs tend to hold a significant amount of shares, poor performance in terms of a fall in the share price affects them directly via this shareholding. The link between pay and performance when measured by the share price is not surprising as it exists by design, with a large proportion of CEO remuneration being awarded in shares subject to share price targets.

180. There are still arguments though, and there is no especially strong consensus, about the strength of the link between pay and performance. This can be due to different ways of measuring pay, but also due to different ways of measuring performance, with many arguing that short-term share price changes are not a good measure of performance.[56] On the contrary, short-term share price targets can introduce harmful incentives. This is indeed shown to be true in some instances by Edmans et al (2014, 2016). Short-term targets can drive CEOs to publish corporate news selectively around the time of equity vesting and to cut long-term investment in order to create a short-term increase in reported earnings.

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[54] Though there exists some research. For example, Quigley, Crossland and Campbell (2017) show that market reactions to sudden deaths of CEOs have increased markedly, indicating that CEOs are indeed at least seen to be more influential and important than they used to be.

[55] See Frydman and Jenter (2010) for an extensive literature review covering the trends in levels and structure of CEO compensation, focusing on the US. Bell and Van Reenen (2016) provide a recent study focusing on the UK.

[56] For example, in their analysis of FTSE350 companies, commissioned and funded by the CFS Society UK, Li and Young (2016) find a correlation between pay and performance as measured by earnings per share or total shareholder return. However, they do find at best weak links between pay and more long-term, value-based performance measures. Research available at: https://www.cfauk.org/media-centre/cfa-uk-executive-remuneration-report-2016

181. The underlying difficulty with providing efficient incentive-based remuneration in a world in which managers perform a variety of tasks, and have several objectives, has long been understood.[57] In such a setting, incentivising behaviour in one relatively easy to measure dimension, such as shareholder return, can lead to agents reallocating effort to those areas and away from areas in which success cannot be measured as readily. This might lead to an unhealthy focus on short-term measurable impacts. Performance-based compensation might thus be less suitable in such a setting.

182. However, Edmans (2011) also provides some evidence that share price is arguably still a good, single all-encompassing performance measure in the long run, as intangibles such as employee satisfaction ultimately reflect positively in the share price, with good places to work outperforming other companies over the longer term. This argument would thus suggest that measuring performance via the share price might not be problematic per se, but that this performance should be assessed over longer time horizons.

183. Finally, even if the incentives provided by current remuneration packages work to some extent, and there is some evidence that they do,[58] it is not clear that these incentives are truly needed or induce good performance at the lowest cost to shareholders and stakeholders. Many would argue that pay incentives are not the primary drivers for executives.[59] There is also a concern that the existing system attracts precisely those who react strongly to pay incentives, rather than those with more prudent management styles and intrinsic motivation, independent of the pay reward.

184. High levels of executive remuneration that appear unjustified, and large pay inequality within companies, can also have negative impacts on individual companies themselves. It can lead to a drop in staff morale, a fall in job satisfaction and reduced productivity among the wider workforce. For example, Card et al (2012) show that employees care not only about their absolute income, but also about their relative income, with those at the lower end being more likely to look for alternative employment. Evidence collected in a field experiment by Cohn et al (2013) suggests that workers often respond with a reduction in effort and performance if the wages of all workers are cut, but that this effect is much larger in a situation where only the wages for some are cut. This suggests that a fall in relative wages (compared to those higher up the pay range) could have negative consequences on effort and productivity among staff.

## B: Consultation process

Green Paper on corporate governance reform and the Government response

185. The government published its green paper on corporate governance reform in November 2016, which asked consultees about a variety of issues in the three identified main areas of potential reform. The Government received almost 400 substantive responses and engaged pro-actively with stakeholders. Table 3 provides a summary of the written responses.

[57] See Holmstrom and Milgrom (1991) for the seminal paper on moral hazard issues in a multitasking environment.

[58] Flammer and Bansal (2016) establish a likely causal link by examining shareholder proposals on long-term executive compensation that pass or fail by a small margin of votes. They find that those companies in which these votes ‘just’ passed outperform those where they did not; furthermore, these companies tend to invest more into long-term strategies.

[59] High Pay Centre/IoD survey: Only 13% of surveyed IoD members saw ‘financial reward’ as the most important driving force for executives, with 54% identifying ‘building a successful company’ as the most important factor.

186. The government response to the green paper consultation[60] provides extensive detail and analysis of the consultation responses, focusing also on the responses by respondent type. Some of the key themes highlighted by table 3 are:

- Strong support among those answering the relevant questions for taking steps to increase the effectiveness of remuneration committees and for the notion that LTIPs could be better aligned with long-term interest of companies and shareholders. The support for the latter was universal across type of respondent, while listed companies mainly raised concerns around practicality and effectiveness of formal requirements. On LTIPs, a very common viewpoint was that LTIPs were too focused on share price, too short term and overly complicated, making it difficult for investors to understand what pay the CEO was awarded and why.
- A small majority, largely driven by strong support among 'individuals', of those responding to the relevant question were in support of the introduction of pay ratios, mainly as a tool for companies and remuneration committees to explain their overall approach to pay across the company to investors and employees. Those opposed to pay ratios mainly raised concerns about potential additional burdens if the pay ratio reporting was to require additional data collection. They also thought that such a requirement would add little value and that it could lead to unfair comparisons between companies in different sectors and of different sizes.
- Very strong support for the idea that the stakeholder voice should be strengthened at the board level across all respondent types. The support was strongest to implement this mainly via Code-based and voluntary changes, while there was some opposition especially amongst listed companies and investors to require specific methods of stakeholder engagement by law.
- A very large majority of those responding to the relevant question supported the idea that there is a case for strengthening the corporate governance framework among private companies. While many respondents acknowledged that private companies are different in nature and felt that a largely voluntary approach might be more appropriate, respondents across all categories felt that there was some scope/need to help increase governance standards among private companies.

[60] Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf

**Table 3: Summary of green paper responses**

| | | Business representative bodies | Individuals[a] | Investors (institutional and retail investor groups) | Listed companies | Privately-held businesses | Professional advisers – accountancy, law, others | Professional associations - ICAEW, ICSA etc | Think-tanks and academic responses[b] | Trade unions and wider society bodies | Other | **Total** | *Response rate[c]* |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Overall consultation responses** | | 46 | 113 | 27 | 44 | 14 | 41 | 11 | 32 | 32 | 15 | **375** | *n/a* |
| **Breakdown of responses to key questions[d]** | | | | | | | | | | | | | |
| **Chapter 1 – Executive pay** | | | | | | | | | | | | | |
| Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? | Yes | 16 | 53 | 15 | 4 | 3 | 9 | 2 | 9 | 9 | 4 | **124** | *61% (227/375)* |
| | No | 11 | 11 | 10 | 32 | 3 | 20 | 3 | 7 | 5 | 1 | **103** | |
| 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? | Yes | 15 | 37 | 14 | 15 | 4 | 14 | 3 | 10 | 9 | 5 | **126** | *46% (172/375)* |
| | No | 10 | 5 | 7 | 10 | 0 | 8 | 0 | 4 | 2 | 0 | **46** | |
| Do steps need to be taken to improve the effectiveness of | Yes | 16 | 48 | 19 | 8 | 3 | 22 | 8 | 17 | 12 | 7 | **160** | *55% (205/375)* |
| | No | 8 | 4 | 3 | 19 | 2 | 9 | 0 | 0 | 0 | 0 | **45** | |

| Question | | | | | | | | | | | | Total | % |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| remuneration committees and their advisers? | | | | | | | | | | | | | |
| Should a new pay ratio reporting requirement be introduced? | Yes | 11 | 29 | 11 | 6 | 1 | 11 | 5 | 11 | 12 | 5 | **102** | *51%* |
| | No | 17 | 7 | 10 | 26 | 4 | 14 | 3 | 5 | 2 | 0 | **88** | *(190/375)* |
| Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? | Yes | 11 | 12 | 16 | 7 | 2 | 11 | 4 | 5 | 8 | 4 | **80** | *41%* |
| | No | 12 | 8 | 6 | 22 | 2 | 14 | 2 | 4 | 3 | 0 | **73** | *(153/375)* |
| Could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? | Yes | 14 | 28 | 15 | 16 | 3 | 11 | 4 | 13 | 12 | 6 | **122** | *40%* |
| | No | 2 | 5 | 4 | 9 | 1 | 4 | 0 | 1 | 0 | 1 | **27** | *(149/375)* |
| **Chapter 2 – Stakeholder voices** | | | | | | | | | | | | | |
| Should the stakeholder voice be strengthened at board-level?(e) | Yes | 25 | 60 | 18 | 22 | 7 | 23 | 8 | 23 | 20 | 4 | **210** | *65%* |
| | No | 6 | 8 | 3 | 9 | 1 | 4 | 0 | 0 | 1 | 1 | **33** | *(243/375)* |
| Should this be taken forward via: | | | | | | | | | | | | | |
| a) a legislative approach? | Yes | 9 | 21 | 0 | 3 | 1 | 8 | 3 | 13 | 14 | 6 | **78** | *53%* |
| | No | 21 | 17 | 16 | 21 | 7 | 15 | 5 | 9 | 6 | 2 | **119** | *(197/375)* |
| b) a code-based approach? | Yes | 15 | 9 | 12 | 17 | 4 | 18 | 6 | 14 | 7 | 5 | **107** | 38% |
| | No | 9 | 3 | 4 | 4 | 1 | 6 | 2 | 1 | 6 | 0 | **36** | (143/375) |
| | Yes | 25 | 13 | 7 | 13 | 7 | 9 | 4 | 8 | 4 | 2 | **92** | *39%* |

| | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| c) voluntary measures? | No | 4 | 5 | 8 | 3 | 0 | 8 | 3 | 8 | 12 | 4 | **55** | *(147/375)* |
| **Chapter 3 – Large private companies** | | | | | | | | | | | | | |
| Is there a case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? | Yes | 22 | 47 | 13 | 14 | 6 | 18 | 7 | 16 | 15 | 6 | **164** | *51%* |
| | No | 6 | 6 | 4 | 1 | 4 | 6 | 0 | 1 | 0 | 0 | **28** | *(192/375)* |
| Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business? | Yes | 9 | 22 | 9 | 6 | 4 | 10 | 3 | 13 | 12 | 1 | **89** | *27%* |
| | No | 3 | 0 | 2 | 0 | 3 | 2 | 1 | 0 | 0 | 0 | **11** | *(100/375)* |
| **Chapter 4 – Other issues** | | | | | | | | | | | | | |
| Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? | Yes | 12 | 34 | 5 | 15 | 1 | 9 | 3 | 3 | 3 | 2 | **87** | *37%* |
| | No | 6 | 17 | 3 | 1 | 0 | 4 | 1 | 7 | 9 | 2 | **50** | *(137/375)* |

(a) For the purpose of this table, the "individuals" category includes responses by a number of individuals with private business expertise. For example, responses that were received from business addresses, or from individuals who are directors in small companies, have been treated as individual responses unless the submission gave a clear indication that the views contained were company views rather than views held by the individual.

(b) Includes responses submitted by academic institutions and individual academics and experts on corporate governance and law.

(c) Due to the wide scope of the green paper many respondents focused on answering questions that are most relevant to them. The "response rate" shows how many of the overall respondents opined on this specific question.

(d) Excludes "did not comment". For an indication of the number and share of respondents that commented on this question, please see the provided "response rate".

(e) The Green Paper did not ask this question as such, but focused on how the stakeholder voice could be strengthened, testing different policy options. Officials applied some judgment in their analysis of responses to provide this breakdown.

BEIS Select Committee

187. The BEIS Select Committee held an enquiry into corporate governance and published its findings and recommendations in its third report of the session 2016-17.[61] In the report, the Committee explained that this enquiry "*followed the evidence that this Committee found in 2016 of major corporate governance failings at BHS and Sports Direct*". The Committee further welcomed "*the Prime Minister's commitment to improving behaviour by big business, as demonstrated by the publication of its Green Paper containing options for reform.*"

188. Many of the elements of this proposed reform package are in line with either specific recommendations made by the Committee, or have not specifically been covered by the BEIS Select Committee, but would appear to be in line with the wider concerns expressed by the Committee. For example:

- The BEIS Select Committee supported pay ratio reporting. However, it recommended to implement this via Code changes developed by the FRC. The Committee also recommended that "*the Government should legislate to ensure that all FTSE 100 companies and businesses publish their workforce data, broken down by ethnicity and by pay band*".
- The Committee expressed a strong preference for deferred stock rather than LTIPs as best practice in terms of incentivising long-term decision making and states. It also made clear its strong preference for clearer pay structures. The Government will not introduce legislation that sets out how companies should structure executive compensation, but the requirement to provide more information on the impact of share price changes on remuneration levels should help to explain the complexities of executive compensation and provide more clarity.
- The Committee made a variety of recommendations with the aim to increase stakeholder and employee engagement. It favours a code-based approach, stating that It recommends *"that the FRC amends the Code to require informative narrative reporting on the fulfilment of section 172 duties. Boards must be required to explain precisely how they have considered each of the different stakeholder interests, including employees, customers and suppliers and how this has been reflected in financial decisions"* and "*that the Code should be revised to require a section in annual reports detailing how companies are conducting engagement with stakeholders*".
- The Committee supported the development of a new Governance Code for private companies, recommending *"that the Financial Reporting Council, Institute of Directors and Institute for Family Business develop, with private equity and venture capital interests, an appropriate Code with which the largest privately-held companies would be expected to comply. They should contribute to the establishment of a new body to oversee and report on compliance with the Code."*

189. The BEIS Select Committee made several further recommendations. However, many of these sit with the FRC and concern making adjustments to guidance, the Corporate Governance Code and the Stewardship Code. The recommendations affecting the FRC include:

- "*that the Financial Reporting Council works with business organisations to develop appropriate metrics to inform an annual rating exercise. This should publicise examples*

[61] Available at: https://www.publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/702.pdf
A summary of recommendations can be found on pages 60 to 67 of the report.

*of good and bad practice in an easy to digest red, yellow and green assessment. Companies must be obliged to include reference to this rating in their annual reports*";

- "*that companies should set out clearly their people policy, including the rationale for the employment model used, their overall approach to investing in and rewarding employees at all levels throughout the company, as well as reporting clearly on remuneration levels on a consistent basis. The FRC should consult with relevant bodies to work up guidance on implementing this recommendation for inclusion in the Code*";
- "*that the FRC reviews its Stewardship Code with a view to providing: more explicit guidelines on what high quality engagement would entail; a greater level of detail in terms of requirements; and an undertaking to call out poor performance on an annual basis*";
- "*that the FRC includes in its revised Stewardship Code stronger provisions to require the disclosure of voting records by asset managers and undertakes to name those that subsequently do not vote*";
- "*that the FRC includes best practice guidance on professional support for non-executive directors when it updates the Code and that companies include training of board members as part of reporting on their people or human resources policy*"; and
- "*that the FRC updates the Code to provide guidance on how companies should identify clearly and transparently the roles of non-executive directors where they have particular responsibilities and how they should be held to account for their performance*".

190. The Committee also makes further recommendations, some on a new revised Code, some including legislative elements, on wider issues such a boardroom diversity that go beyond the immediate scope of this reform package. These include:

- "*that the aims and targets of the Hampton-Alexander Review should go further and, in support of the Equality and Human Rights Commission's objective, we recommend that the Government should set a target that from May 2020 at least half of all new appointments to senior and executive management level positions in the FTSE 350 and all listed companies should be women. Companies should explain in their annual report the reasons why they have failed to meet this target, and what steps they are taking to rectify the gender inequality on their Executive Committees*";
- that "*directors should not be appointed to the board solely on the basis of one particular background or area of expertise. Greater cognitive diversity promotes more effective challenge and more informed decision-making and we recommend that the FRC works with others to provide improved guidance on this aspect of diversity in the context of board membership*";
- that "*the revised Code should have the issue of board diversity as a key priority and there should be a public explanation of the reasons why members are part of the board. The Code should require boards to cover in their annual reports information diversity on their boards and in the workforce, covering diversity of gender, ethnicity, social mobility, and diversity of perspective. Annual reports should be required to include a narrative on the current position, and an emphasis on what steps the company has taken, and will continue to take to enhance the diversity of the executive pipeline, with agreed targets. This narrative should include how accurately the board mirrors the diversity of both the workforce and the customer base*"; and
- *"that the FRC embeds the promotion of the ethnic diversity of boards within its revised Code. At the very least, we recommend that wherever there is a reference to gender, the FRC should include a reference to ethnicity, so that the issue of ethnic diversity on*

*boards is made explicit in the revised Code, and is given as much prominence as gender diversity*".

191. We thus assess that the proposed measures are in line with the BEIS Select Committee's proposals and that some of the individual measures have its explicit support. Those recommendations that are not addressed by this reform package rely on the FRC revising the Corporate Governance Code, or they refer to elements such as boardroom diversity that, although relevant and related, go beyond the scope of this immediate reform package.

192. There are two exceptions main proposals that the BEIS committee supported, but which the Government is not pursuing at this stage. The first was to make shareholder voting on executive pay compulsory. This was felt to be disproportionate as shareholders already hold a binding vote on pay policy at least every three years. On balance, the evidence that giving shareholders an annual binding vote on the actual pay outcome (rather than the current advisory vote) would likely lead to significant improvements was insufficient. The current shareholder voting powers were seen as sufficient to drive changes in behaviour. However, the Government has invited the Investment Association to create its public register of companies that faced significant shareholder dissent. The other proposal was to provide the FRC with additional enforcement powers. On this, the Government has decided to consult the FRC, Companies House and the FCA first to determine if new powers for these three bodies are necessary and would avoid overlap.

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