Tel:+44 (0)20 7486 5888
Fax:+44 (0)20 7487 3686
DX 9025 West End W1
www.bdo.co.uk

55 Baker Street
London
W1U 7EU

Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
3rd Floor Spur 1
1 Victoria Street
London
SW1H 0ET

17 February 2017

Direct line: 020 7893 3228
Email: david.isherwood@bdo.co.uk

Dear Sir

BDO LLP response to BEIS Green Paper on Corporate Governance Reform (November 2016)

We are pleased to have the opportunity to comment on the Green Paper on '*Corporate Governance Reform (November 2016)*' (the Green Paper).

Notwithstanding that we believe corporate governance within the UK is generally held in high regard, striving to improve it for the UK's largest privately-held businesses is a goal with which it is difficult to disagree. Indeed, whilst the vast majority of businesses of this type are run well, the high profile governance failures of the few can have such a profound effect regionally or nationally and, as such, rightly act as a catalyst for such action. The challenge comes in identifying the appropriate, proportionate mechanism for changing the behaviour of the minority whilst not needlessly overburdening the majority. These factors need to be considered both in terms of the framework that will be applied and in the effective enforcement of it. Public companies, by-and-large, have a broad shareholder base, which is independent from management. These independent shareholders which to a large extent also often represent broader societal views, have an interest in and ability to drive governance aspirations and hold management to account, ultimately through their shareholder votes. Private companies are generally different as there is often no independent person (or persons) to drive good governance practice and hence no one with the power to initiate repercussions when practice falls below those expectations. Therefore, if a code were to be introduced for private companies, it would also need a mechanism that would encourage accountability against, or enforcement of (whether that be 'hard' or 'soft' enforcement) the strengthened framework. This might be achieved in ways ranging, for example, from the imposition of independent non-executive directors through to regulatory oversight.

Our strong view on corporate governance is that it needs to be thought about as a system which requires the key players, including directors, shareholders and other relevant stakeholders to have the right competencies and incentives to fulfil their responsibilities; clear rules, laws and codes for those stakeholders to follow; and adequate mechanisms for regulators and stakeholder to intervene where appropriate. A weakness in any one of these links will potentially undermine its strength as a whole.

The Green Paper focusses on a number of these areas but there is perhaps an opportunity to look more deeply in some other areas too. One area might be competence of directors: although directors of companies have quite extensive responsibilities set out in the Companies Act and other related laws and regulations, there is little, if any, focus on the prerequisite skills and competence that such responsibilities realistically require. Considering the value of principles, codes or regulation in this area would be a worthwhile exercise. Separately, and perhaps in our view even more critical, is a consideration as to whether the enforcement regime is adequate: although actions can be taken against directors, history shows that these are relatively rare in practice and generally take place in response to very significant failure. A regulatory environment that is more proactively focussed on the actions and behaviours of directors on an ongoing basis with a proportionate range of sanctions could be more effective. In this respect we note that the Financial Reporting Council (FRC) does have some ability to regulate directors, but only those who are accountants; this asymmetry might also be a valuable aspect to review.

Any enhancement here might be achieved through increasing the power of the FRC or BEIS to investigate companies whose standards are suspected to have fallen below expectations. Beyond this, it is our recommendation for all potential actions set out in the Green Paper is that the Government should where possible take a voluntary or ('comply or explain') code-based approach and to consider a legislative approach only in the last resort. In our view, whilst it may be slower to become established, practice developed through 'softer' means is likely to be more effective whereas that resulting from legislation is more likely to lead to a 'compliance-first' approach to adoption, which may ultimately lack substance.

We also believe that it is important to highlight the fact that many of the recent matters being aired, such as those relating to 'fairness' of directors' pay (as distinct to performance related pay matters), go beyond the current section 172 duties and start to imply that directors of large corporates have a wider 'social contract'. Such thinking suggests fundamental changes to the primacy of the members of the company which, if carried through, would require a more fundamental rethink of Section 172.

Our detailed responses to the questions asked in the Green Paper are set out in appendices 1-4 to this letter. If you wish to discuss any of the points further, please do not hesitate in contacting David Isherwood at the above address.

Yours Faithfully

BDO LLP

BDO LLP

Appendix 1 - Executive Pay

Section A - Shareholder voting and other rights

Question 1

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

The interest by many stakeholders in the levels of executive pay is clear to see and the data shows that the growth in executive pay has far outstripped that of the general workforce. In light of this the 'social contract' that exists between big business and society at large is being tested. However, in our view, strengthening shareholders' powers in relation to executive pay through legislative action should only be considered to the extent there is evidence that shareholders are consistently making use of their current powers without effect. An example of this might be where a company acts against the wishes expressed by a majority of its shareholders in the advisory vote on the annual pay award.

We note that the Green Paper highlights that, in general, remuneration policies are approved with a significant majority on voting turnouts that are not dissimilar to those achieved at a General Election. We would also highlight that the current regime was only introduced for periods beginning on or after 1 October 2013, meaning there have been relatively few cycles of the process to for either a clear view of its effectiveness to be formed or for shareholders to fully get to grips with the powers that they now have. In consequence, although we understand current public sentiment toward executive pay and indeed pay inequality more generally, we do not consider there currently to be sufficient evidence to warrant imposing more frequent or more stringent voting requirements on the remuneration report (Options A(i), A(ii) and A(iv)). We also consider that companies should be left free to determine how they structure executive reward (subject to the binding remuneration policy vote). In consequence, we do not consider it appropriate to *require* companies to set an upper threshold for total annual pay (Option A(iii)). Instead, we would advocate an approach whereby upper thresholds for total pay are encouraged or recommended on a 'comply or explain' basis.

The principal challenge companies face in setting executive pay is maintaining the trust of their stakeholders that pay has been subject to adequate due process including the appropriate consultations with relevant stakeholders. In our view, this trust is best nurtured through transparency of reporting the extent of this due process and the extent of engagement with shareholders and other stakeholders. To this end, we would support Option A(v) in the Green Paper - to strengthen the corporate governance code to provide greater specificity on how companies should engage with shareholders on pay. The responsibility is not however one sided; we strongly believe that shareholders do have a responsibility to exercise these powers and hold the Directors to account for their decisions regarding executive pay.

The Financial Reporting Council's (FRC) UK Corporate Governance Code (the Code) is a good vehicle in which to seek to influence how companies should engage with shareholders on executive remuneration matters. The "comply or explain" approach adopted in the Code allows companies to approach governance matters in a manner that they consider to be appropriate to their own circumstances, whilst strongly encouraging certain corporate behaviours. We note that the Code already includes guidance on remuneration (Section D and Schedule A) and relations with shareholders (Section E). Of particular relevance is provision E.2.2 of the Code, which already includes a recommendation that, when a significant proportion of votes have been cast against a resolution at any general meeting, the company should explain what actions it intends to take to understand the reasons behind the vote result.

Related to the above point, we note that the FRC does not have delegated powers to monitor compliance with the reporting requirements related to the corporate governance statement and the remuneration report. Improved transparency and quality of reporting more generally might be achieved through extending the FRC's remit to cover those parts of the annual report.

Section B - Shareholder engagement on pay

Question 2

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

We would support initiatives that seek to educate shareholders as to the extent of their powers, their responsibility to use such powers, and encourage them into greater engagement with companies as stewardship is more than simply voting.

Shareholder stewardship is a critical component of good corporate governance and the need for greater engagement does not apply only to executive remuneration matters; it is also the case more generally. Through their involvement, investors can encourage a company to continually improve its approach to corporate governance, which is likely to lead to better overall corporate performance. Whilst shareholder engagement is generally good at the upper end of the market, albeit sometimes on a rather informal basis, this is generally not the case with smaller listed companies.

We would support the greater disclosure of fund managers' voting records at AGMs and the extent to which they have made use of proxy voting (Option B(i)). However, we note that such disclosures are already encouraged by the FRC's Stewardship Code (Principle 6) and we are of the view that the Government should resist taking a legislative approach until the results of the FRC's 2016 initiative to improve the quality of reporting against the Stewardship Code have been assessed. Strengthening Principle 7 of the FRC's Stewardship Code in respect of investors' disclosure of their stewardship activities may also encourage greater engagement.

Although the establishment of a formal shareholder committee to scrutinise remuneration and other key corporate issues (Option B(ii)) may help encourage and formalise greater shareholder engagement, as noted in the Green Paper, such a model may challenge the validity of the long-established unitary board structure. In our view, shareholders should not be taking responsibility for making decisions that ought to be taken by directors. Instead, any newly established committee should form part of a feedback mechanisms which allows shareholders to communicate more formally and effectively with directors. One key challenge with this approach, however, is that "shareholders" may not always share the same views and splits may form between institutional and retail shareholder groups or, indeed, within those groups. Some shareholders/shareholder groups may also speak with a disproportionally "loud voice". These factors might make a balanced and representative committee more difficult to achieve than anticipated and might ultimately be less effective than the current shareholder advisory vote mechanism. We would like to see more detailed proposals on this option before forming a firm view.

Finally, we would support any steps taken to ensure that retail investors are encouraged to exercise the existing rights they have and also to identify and assess the causes of significant divergence of opinion between shareholder groups (Option B(iii)). This may be achieved through a strengthening of Provision E.2.2 of the Code mentioned in our response to Question 1 above.

Section C - Role of the remuneration committee

Question 3

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

As we have already noted, we do not consider new legislation to be the most appropriate means for effecting change at this stage rather, as noted in our response to Question 1 above, we would recommend that the FRC be given powers to monitor and encourage compliance with the existing disclosure requirements in this area. In this regard we highlight that, under Paragraph 39 of Schedule 8 of the Large and Medium-sized (Accounts and Reports) Regulations 2008, Quoted companies must provide disclosure on consultations with employees when drawing up the directors' remuneration policies. We consider that that requirement, together with a recommendation in the Code that such consultations should take place, should be sufficient to encourage greater consultation with employees when preparing executive remuneration policies.

We have no objection in principle with a non-executive director being responsible for representing the workforce and wider stakeholder interests being recommended, on a comply or explain basis, under the Code (Option C(i)). However, it must be anticipated that such responsibilities could result in a conflict with their wider Companies Act 2006, section 172 (Section 172) responsibilities and put the director in an untenable position.

Similarly, we have no objection to encouraging, on a non-legislative basis, that remuneration committee chairs (or indeed the chairs of any key board committees) should have a minimum level of directly relevant experience (Option C(ii)).

Section D - Transparency of executive pay

Question 4

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

No, we would not support the introduction of a new pay ratio reporting requirement (Option D(i)). In our view, the publication of such a ratio would lead to a significant risk of 'headlines' which, by design or not, may be misunderstood, or even misleading, without significant added context. We would highlight that a company will generally have little or no control over the context of any such 'headlines', the inaccuracy of which could damage the trust that transparent disclosures are intended to build.

In our view, executive remuneration is a complex decision for companies the outcome of which can only be fully understood after taking into account the rationale for the many decisions that it involves. Although we understand the inherent desire for simplification, we have reservations as to the unintended consequences of doing so. This needs to be carefully considered; any enhanced disclosure requirements should ensure that any 'headline' is made in the context of the wider organisation. For example, the appropriateness of pay levels might more directly be addressed by requiring disclosures about the absolute amounts paid to the lowest paid employees, which could then be compared to minimum or living wage requirements. This might provide a greater insight into a company's treatment of its employees in industries that traditionally rely on a lower skilled workforce. Alternatively, or in addition, comparison could be drawn with remuneration levels of employees that report into the CEO. Significant disparities in those figures might be an indicator of autocratic leadership or poor succession planning and could be a signal of poor governance more generally.

Question 5

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

Consistent with our views expressed above, we would support a non-legislative approach in the first instance. In particular, as alluded to our response to Questions 1 and 2, we would support measures that encourage greater engagement between shareholders and companies in respect of corporate disclosures. We would also encourage stakeholder advisors to put pressure on companies to provide appropriately comprehensive disclosures (Option D(ii)).

Section E - Long-term executive pay incentives

Question 6

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

In our view, in many cases, it is appropriate for a significant proportion of executive directors' remuneration to be linked to long-term sustainable company performance. However, the structure of executive remuneration arrangements is rightly a matter for the directors to decide upon, taking into account their Section 172 responsibilities, which include views of its stakeholders. They should be appropriate to the particular and unique circumstances of the company in question; one size will certainly not fit all.

This point notwithstanding, it is not clear to us whether this is achieved by creating highly complex and opaque LTIP arrangements. The greater engagement between shareholders (and representative groups) and companies that we have advocated in previous responses, together with the use of the powers already available to investors, should be a sufficiently powerful non-legislative way of initiating change in this respect. We also have no objection in principle, on a comply or explain basis, for longer holding periods for shares and options, or stronger claw-back provisions, to be encouraged.

Appendix 2 - Strengthening the employee, customer and wider stakeholder voice

Question 7

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

There are many stakeholders who have an interest in the success of a company and many more that have an interest in how the company is conducting its affairs more generally. These different stakeholders will often have different, and potentially conflicting, interests. The boards of the vast majority of businesses in the UK take their responsibilities under section 172 of the Companies Act 2006 very seriously. Indeed, any business seeking to succeed over the longer term must have regard to the interests of the company's wider stakeholders (such as employees, customers, suppliers and the local community) and must consider the company's effect on the wider social and natural environments in which it operates. We also believe that it is important to highlight the fact that many of the recent matters being aired, such as those relating to 'fairness' of directors' pay (as distinct to performance related pay matters), go beyond the current section 172 duties and start to imply that directors of large corporates have a wider 'social contract'. Such thinking suggests fundamental changes to the primacy of the members of the company which, if carried through, would require a more fundamental rethink of Section 172.

A wholesale review of Section 172 will be a major undertaking, but in meantime we agree that, whilst the vast majority of businesses pay appropriate attention to all of their stakeholders, the high profile governance failures of the few can profoundly affect public trust in business. This will, in turn, have a detrimental effect on the many. In consequence, maintaining and enhancing stakeholder trust is key for all businesses that take a longer-term view. Transparency of reporting and engagement with shareholders and other stakeholders is in our view a key activity in nurturing this trust.

Similarly to the establishment of a formal shareholder committee suggested in Question 2 to the Green Paper, the establishment of a stakeholder advisory panel which might be consulted on key corporate issues (Option (i)) may help encourage and formalise greater stakeholder engagement. The challenges we identified regarding the composition and remit of a stakeholder advisory panel are the same as those we identified in our response to Question 2 above in respect of the shareholder committee, only amplified by the fact that there are very large range of stakeholders who have an interest in the success and conduct of a company. This may make creating a balanced, representative and effective panel even more difficult to achieve.

Our views on the designation of an existing non-executive director to represent key interested groups (Option (ii)) are similar to those expressed above in our response to Question 3. We have no objection in principle on the assumption that the overriding duty of any such director would be no different to any other board directors in the unitary board structure. The existence of a formally designated role may also be a route to the voluntary formation of a stakeholder advisory panel to support the NED in his/her role without needing to resort to formal regulation.

We would not support the imposition of a requirement to appoint individual stakeholder representatives to company boards (Option (iii)). Ultimately the composition of a board is a matter for the shareholders of a company. A board as a body, or individual directors, are free to take advice and seek views from others as they see fit and must also act in accordance with their statutory duty to have regard to the interests and needs of other stakeholders. In our view there are other less intrusive proposals set out in the Green Paper that will encourage wider stakeholder engagement more effectively.

Finally, the requirement for companies, other than those that meet the definition of a Quoted company, to report on these wider societal matters is at best implicit in the Companies Act (eg through the purpose of the strategic report set out in section 414C(1) of the Companies Act and through the requirement for a large company to consider the inclusion in its strategic report of an analysis using non-financial key performance indicators (KPIs) set out in section 414C(4)(b)). Transparency, and therefore trust, may be enhanced through more explicit requirements in this respect. If the Government does seek to strengthen reporting requirements related to stakeholder engagement (Option (iv)), however, great care will be needed to encourage concise, relevant disclosures and avoid overburdening companies with complex regulation which might result only in unhelpful "boilerplate" disclosures.

Question 8

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

There are already many examples where corporate reporting and governance rules are subject to different scope requirements. To take the strategic report and directors' report alone, disclosure requirements are based on whether a company is considered small, medium or large, whether it has a certain number of employees and/or whether it is a Quoted or Traded company. Certain exemptions apply to wholly owned subsidiaries of UK-incorporated companies and/or companies that are excluded from the small companies' regime only by virtue of them being in an ineligible group. Requirements recently added as a result of the implementation of the EU Non-financial Reporting Directive apply to large Public Interest Entities (PIEs) with more than 500 employees. This already represents a very complex set of scope requirements, even before one considers recent non-annual report disclosures such as modern slavery policy disclosures, which feature a different scope again.

We strongly encourage the Government to consider harmonising and reducing the number different scoping requirements that companies need to consider and, in consequence, we recommend that pre-existing scope requirements are considered in the first instance for any new requirements introduced as a result of the Green Paper. However, as alluded to in our response to Question 1 above, we are of the view that the Government should identify ways to better enforce existing requirements and use 'softer' approaches to affecting change prior to resorting to fresh regulation.

Question 9

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

Similarly to our comment in response to Question 8 above, we would encourage the Government in the first instance to ensure that current requirements are appropriately applied. This might be achieved through enhancing the powers of the FRC or BEIS[1] to investigate the affairs of a company. Beyond this, our consistent view for all potential actions set out in the Green Paper is that the Government should first seek a voluntary or 'comply or explain' code-based approach in the first instance and only to consider a legislative approach as a last resort. In our view, whilst it may be slower to become established, practice developed through 'softer' means is likely to be more effective whereas that resulting from legislation is more likely to lead to a 'compliance-first' approach to adoption, which may ultimately lack substance.

[1] Under section 432 of the Companies Act 1985

Appendix 3 - Corporate governance in large, privately-held businesses

Question 10

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

Strengthening the corporate governance framework for the UK's largest, privately-held businesses is a goal with which it is difficult to disagree in principle. Whilst the vast majority of businesses of this type are run well, the high profile governance failures of the few can have such a profound effect regionally or nationally that action can be justified.

The challenge comes in identifying the appropriate mechanism for affecting change. In our view, there are two key practical problems that must be overcome before enhanced standards of corporate governance can be applied more widely (Option (i)):

First, a strengthened framework of corporate governance, which is suitable for use in privately held businesses, must be developed. As noted in the Green Paper, the majority of existing governance codes are designed for use in public companies. In order for it to be fit for purpose, any corporate governance framework that is intended to be applied to private companies will have to:

- Cater for ownership structures and other circumstances that are unique to private companies;
- Offer easy transition to and from existing listed company governance codes; and
- Be scalable for the range of business sizes and complexities of companies that will fall within its scope as one size will not fit all.

Second, public companies, by-and-large, have a broad shareholder base which is independent from management. These independent shareholders have an interest in and ability to drive governance aspirations and hold management to account. Private companies are generally different as management and shareholders are often closely related (often literally) or one and the same person. There is no independent person (or persons) to drive good governance practice and hence no one with the power to initiate repercussions when practice falls below those expectations. Therefore, if a code were to be introduced for private companies, it would also need a mechanism that would encourage accountability against, or enforcement of (whether that be 'hard' or 'soft' enforcement) the strengthened framework. This might be achieved in ways ranging, for example, from the imposition of independent non-executive directors through to regulatory oversight

Question 11

If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

The point made in our response to Question 8 above regarding the proliferation complex array of scoping requirements that already exist in UK corporate reporting notwithstanding, in our view, at least in the first instance, formal and enforced frameworks are only important for businesses with dispersed ownership and/or significant regional or national importance. In consequence, in order to avoid overburdening smaller businesses with regulation, we recommend that the Government seeks to impose any new requirements on the most significant businesses. The scope of a formalised approach could then easily be extended, should the need to do so be identified.

Question 12

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

Consistent with the view expressed in our response to Question 9 above, we recommend that the Government first seeks a voluntary or ('comply or explain') code-based approach and only consider to a legislative approach in the last resort. In our view, whilst it may be slower to become established, practice developed through 'softer' means is likely to be more effective whereas that resulting from legislation is more likely to lead to a 'compliance-first' approach to adoption, which may ultimately lack substance.

Question 13

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?

Consistent with the view expressed in our response to Question 7 above, in our view transparency, and therefore trust, may be enhanced through a broader application of non-financial reporting requirements. In consequence, we consider that there may be a case for extending the scope of these reporting requirements. If the Government does seek to broaden the scope of these reporting requirements (Option (ii)), however, great care will be needed to encourage concise, relevant disclosures and avoid overburdening companies with complex regulation which might result only in unhelpful "boilerplate" disclosures. We also draw the Governments attention to our comments in response to Question 8 above regarding the increasing complexity of scoping requirements in corporate reporting generally.

Appendix 4 - Other issues

Question 14

Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

As alluded to in our responses to other questions raised in the Green Paper, we are supportive of voluntary and code-based approaches to improved practice and, in consequence, we are supportive of the current approach taken for corporate governance. We note, however, an increasing tendency to address perceived shortcomings through new legislative requirements, rather than through enforcement of existing requirements. We are also concerned that multiple locations for legislative requirements (eg Companies Act, Disclosure and Transparency Rules, Listing Rules, Competition and Markets Authority Orders and EU Regulations) has created significant and potentially unnecessary complexity. We would ask the Government to bear this in mind when considering its next steps.