Institute of Business Ethics

RESPONSE OF THE INSTITUTE OF BUSINESS ETHICS TO THE FINANCIAL REPORTING COUNCIL CONSULTATION ON THE WATES CORPORATE GOVERNANCE PRINCIPLES FOR LARGE PRIVATE COMPANIES

General comments

The Institute of Business Ethics is pleased to have been part of the coalition that drafted the Wates Principles. We are an educational charity whose purpose is to promote high standards of business behaviour based on ethical values. The Principles are consistent with this aim and their launch is timely, given recent turbulence in the corporate sector. We believe that conscientious adoption of these Principles will help build trust in business, enabling it to play a full part in sustaining our economy and society.

As a member of the coalition we believe it is right that the Principles should be subject to full public consultation. This is not only a question of due process. It is also true that, only by a process of iteration, can the wording be refined and a broad consensus established. Our comments should be seen in this spirit.

Our specific points are set out below, but the main points can be summarized as follows:

- The Principles would benefit from a clearer justification, incorporating a reminder that all company directors are subject to the duties set out in the Companies Act 2006 and that, if limited liability is indeed a privilege as the Government suggests, then it has to be earned. In return for this privilege society has a right to expect basic standards of behavior from companies. At the same time we strongly believe that the Principles should help unlisted company boards build more resilient businesses able to manage risk and exploit opportunities in a positive way.

- The Principles seem heavily focused on family businesses and private-equity controlled companies. They have less to say about subsidiary governance, even though the largest single group of companies affected will be subsidiaries of major listed companies, including the recently created ring-fenced operations in the banking sector. As they bed down there is an opportunity for the UK to develop greater understanding in the business community about subsidiary governance,

- which has hitherto been a neglected area. Issues include personal and corporate conflicts for the subsidiary directors between duty to the company and its stakeholders and their duty to the parent, related party transactions and transfer pricing.

- There is a danger in being too hung up on definitions as the lines between listed and unlisted companies are blurred. Listed companies with a controlling shareholder can operate rather like privately-owned companies, while privately-owned companies planning an IPO need to learn how to operate as a listed company. It would be sensible to ensure that the Wates Principles are seen as part of a seamless continuum so that transition from one framework to another is not a cliff-edge.

  One practical consequence of this is the need to emphasise that unlisted companies can follow other Codes if they choose to. The QCA Code, for example, contains much practical advice for directors which can also be useful to boards of unlisted companies, while also helping them prepare for listing. It is probably right at this stage that the Principles are high level and non-prescriptive. However, some directors would welcome more granular recommendations. Again, the QCA Code embodies a very useful format in this regard.

  Another consequence is that future revisions to the UK Corporate Governance Code should draw on the experience of the Wates Principles, and vice-versa. We point out below, for example that Section 172, 1 (f) of the Companies Act enjoins directors to act fairly as between members of the Company. It is important that both listed and unlisted companies refer to this in their Section 172 disclosures. Both the Principles and the Governance Code should reflect this.

- We believe that the Coalition with the support of the FRC should monitor the operation of the Principles and disclosures made against them for the first two years and use this experience to design permanent monitoring arrangements once the Principles have bedded in.

Specific Responses

1. *Do the principles address the key issues of the corporate governance of large private companies? If not what is missing?*

The Principles are broadly right. However they would be enhanced by a more robust justification at the outset. First, it needs to be made absolutely clear to the boards of large unlisted companies that they are subject in law to the same directors' duties as boards of listed companies. They will have to respond to the new regulatory requirement to report on the way they have taken account of Section 172 of the Companies Act 2006. Insofar as this new regulation implies a general determination to enhance the effectiveness of the law, unlisted companies have to step up to the plate as well. The Principles help them do so.

Second, the document makes reference to the *privilege* of limited liability, a term that has been frequently used by the government. Arguably this privilege is more valuable to owner-managers in the unlisted sector than to listed companies whose shareholders have the power to challenge managements and who appoint boards to do so on their behalf. There is much less scope for challenging owner-managers but they still benefit fully from the protection afforded by limited liability.

While it is right that the Principles are voluntary, the preamble should place greater emphasis on the legitimate expectations, both legal and social, now being placed on corporate leadership. Limited liability is a privilege. It should not be treated as an automatic right.

All this needs to be balanced by a clear statement that the Principles will also help boards of unlisted companies improve the quality and long-term prospects of the businesses they run. It is very important that directors see these Principles as ultimately helpful rather than an unnecessary regulatory burden. We consider that Section 172 exists both to remind directors of their broader responsibilities to stakeholders and to help build stronger, more sustainable companies. There is no conflict between the two.

2. *Are there any areas in which the Principles need to be more specific?*
3. *Do the Principles and guidance take sufficient account of the various ownership structures of private companies, and of the board, shareholders and senior management in these structures.*

The Principles refer rightly to three main forms of unlisted company: family businesses, private-equity controlled businesses, and large subsidiaries of unlisted companies. Each category needs governance arrangements which will promote robust decision-making, effective supervision of risk and accountability to a range of stakeholders. Companies in all three categories will need a clear set of values and a clearly-articulated purpose on which to base their business model. However, the governance challenges vary considerably between category.

In particular, the Principles appear light in the area of **subsidiary governance**. Larger listed companies based in the UK or overseas often have subsidiaries which are significant companies in their own right. The ring-fenced clearing banks in the UK provide a topical example, but other companies in sectors ranging from food-processing to energy and cars have large operational subsidiaries in the UK. Their boards would all be subject to the new disclosure requirements on Section 172. The social imprint of these subsidiaries is large, and, hitherto, little thought has been given to their governance as it is generally assumed they take their governance arrangements from their listed parent.

Particular issues arise because there is a potential conflict of interest between the subsidiaries and their parent. The ring-fenced banks were established to help ensure that big banks did not use guaranteed retail deposits as cheap funds for deployment in their investment banking activities. Yet the structure does not necessarily remove the conflict because they remain dependent on their parents for capital.

More generally, conflicts can arise in areas such as related party transactions, transfer pricing and the willingness of the parent to commit sufficient resources for stakeholder engagement and reputation management. Also, where the parent sets the remuneration policy for the subsidiary, performance conditions can be calibrated in such a way as to direct benefits to the parent rather than to the long term interests of the subsidiary itself.

None of these issues are straightforward, and governance needs to strike the right balance. Principle Three refers to **conflicts** of interest, but only in passing. More thought needs to be given to the nature of conflicts in unlisted companies and to the appropriate structures for dealing with them. Far from adding a layer of additional “regulation,” we believe that a careful formulation of the issues will help directors know what is expected of them in sometimes difficult circumstances.

Separately, the Principles need to take account of **hybrid companies** which are both listed and have a powerful controlling shareholder which makes them resemble privately-held companies. The investor protection rules around listing may not be sufficient to secure the interest of minority shareholders in these circumstances. In terms of the way they are run and governed, there may be little difference between these companies and ones which are wholly private.

It would be unreasonable to subject such companies to two separate sets of Principles or Codes. Equally, however, it would be wrong to say that there is a clear dividing line between listed and unlisted status. The Wates Principles should not necessarily end where the UK Corporate Governance Code begins, but they should support good governance in listed companies with a strong shareholder. Encouragement to this effect could be part of the preamble.

Specifically, Section 172 itself also enjoins directors to “act fairly as between members of the company.” It is important that both unlisted and listed companies disclose adequately against this clause. The Wates Principles should set out the expectation, bearing in mind that family companies and other privately owned companies may have different shareholders and different classes of shareholder. In due course, a corresponding expectation should be written into the governance code.

4. *Do the Principles give key shareholders sufficient visibility of remuneration structures in order to assess how workforce pay and conditions have been taken account in setting directors' remuneration?*

Principle 5 sets out expectations of behaviour but makes no mention of disclosure. This may be because the key shareholders referred to in the Principle as the presumed audience will normally be fully conversant with remuneration policy and may even set it. So there is no need for disclosure.

However, the issue is not whether key shareholders are able to assess the relationship between directors' pay and that enjoyed by the rest of the workforce, but whether key stakeholders can have confidence in the basic structure. This Principle needs to include an encouragement to disclose in a more granular way than a simple confirmation that the Principle has been met. Such an expectation is entirely consistent with Section 172.

5. *Should the draft Principles be more explicit in asking companies to detail how their stakeholder engagement has influenced decision-making at board level?*
6. *Do the Principles enable sufficient visibility of a board's approach to stakeholder engagement?*

The draft as it stands should be sufficient, but the FRC should monitor disclosures to ensure they are sufficiently detailed.

7. *Do you agree with an 'apply and explain' approach to reporting against the Principles?*

Yes.

8. *The Principles and the guidance are designed to improve corporate governance practice in large private companies. What approach to the monitoring of the Application of the Principles and guidance would encourage good practice?*

The Principles are both new and voluntary. It would be sensible for any monitoring arrangements to be transitional with final arrangements only decided two to three years after they have entered force.

Because of their voluntary nature, it is not desirable for the explanations contained in disclosures to be subject to regulatory compliance oversight, but that raises questions about the effectiveness of the Principles. Unlike the Governance Code, there are no obvious group or groups of people to adjudicate on the validity of the explanations. A similar enforcement problem situation existed with the Stewardship Code at the time of its launch in 2010. As that has evolved, the asset owners have taken a greater role in holding asset managers to account for their engagement. This was supplemented both by an annual report from the then Investment Management Association and also by the FRC's annual report on Developments in Corporate Governance which have helped encourage peer pressure on organisations to raise their standards.

We suggest that, in the first instance, the Coalition, with the support of the FRC in its standard setting role, should be responsible for monitoring disclosures and publishing an annual report on progress. The leading role taken by the Coalition would reflect the voluntary nature of the Principles. The report should take account of the new disclosures required in connection with directors' duties under Section 172 and offer a judgement as to whether the Section 172 disclosures had been enhanced by the Principles or whether disclosure under the Principles had amplified the Section 172 reports.

After two years the Coalition should:

- Draw on its research to make recommendations for revision of the principles, including on the need for differentiation between different types of unlisted company,
- Make recommendations on permanent monitoring arrangements, and
- Make recommendations on the degree to which the Principles should remain voluntary or how far they should become compulsory.

9. *Do you think the correct balance has been struck by the Principles between reporting on corporate governance arrangements for unlisted versus publicly listed companies?*

The agency problem means listed companies will always be subject to more regulation than unlisted companies. However, in recent years much regulation applying to listed companies, for example around diversity, environmental disclosure and remuneration, has been more focused on public policy objectives rather than the agency problem itself. Arguably this has led to a burden on listed companies which has helped fuel the downward trend in stock market listings.

We consider it would be a mistake to judge the Principles on the basis of whether they address this imbalance, although the shrinkage of the listed sector is an important issue which needs addressing. Instead they should be judged on whether they enhance the corporate sector by strengthening governance and management in unlisted companies in ways that reduce unnecessary risk, protect their long-term franchise from reputational and financial damage, and enable them to pursue lucrative opportunities for the long term.

10. *We welcome any commentary on relevant issues not raised in the questions above.*

Separately we note that the relevant Paragraph (26) from the new regulations requires companies to report on their adoption of a Code, whereas paragraph 12 of the consultation document says the Principles are an appropriate framework for reporting. There is some tension between these two positions because the Principles are not actually a Code. We have no objection to companies using the Principles as a reporting framework, but it would be sensible to draw companies’ attention to the possibility of using other codes. In this context the QCA Corporate Governance Code can easily be adapted to unlisted companies.