Wates Principles on Corporate Governance for Large Companies - Mark Goyder's submission to FRC

Introduction

I am making these comments in a personal capacity as an individual member of the panel developing the Wates Principles. In that capacity I have made a number of comments and suggestions, some of which have already been taken up. My evidence to the FRC here builds on earlier analysis and on my further thought and research since. In addition, I also want to draw attention to a flaw in the criteria for selecting the companies covered by these principles.

I remain involved with the work of Tomorrow's Company as founder and trustee. Tomorrow's Company is making its own submission but we have mutually agreed that there will be more value in our respective submissions if we make these independently without any co-ordination.

A flaw in the government's secondary legislation – the threshold is wrong.

Because of the way the legislation has been drafted the good work of this group will not achieve the objective originally envisaged. I appreciate that it is beyond the immediate authority of the FRC and is a matter for BEIS but I would urge the chairman of the panel and the FRC to take this matter up with BEIS. Unless this flaw is rectified, it will undermine the reach and impact of the Wates Principles.

In its recommendations to the government before the setting up of this review, the House of Commons Business, Energy and Industrial Strategy Committee argued that '*those (companies) with a significant presence in the community should be required to report on non-financial matters for the benefit of employees and other stakeholders*'. Similarly, James Wates (Chairman of the FRC 'Coalition Group') says in his introduction: pr*ivate companies constitute a vast portion of the UK economy, and they must recognise that their actions can have a significant impact on their stakeholders.'*

The problem arises from the failure of the legislation to differentiate between size and impact. There are many organisations which have a huge impact upon hundreds of thousands if not millions of stakeholders, but which do not meet the size thresholds set by the legislation. The Appendix offers a recent example from the world of sport which brought this home to me, as a stakeholder. On reflection, it is strange that an initiative that was designed to hold companies accountable for their impact on their stakeholders makes no attempt to address community or public impact. It would be interesting to hear from government what attempt was made to do this in the process of drawing up the criteria. In the meantime, for the reasons given in the Appendix, I would urge the FRC and the 'Coalition' to ask government to change the criteria so that the qualifying threshold is **either** a turnover of more than £200m including shares in joint ventures **or** a balance sheet of more than £2billion but **not both**.

The principles

The content of the principles has improved over the lifetime of the group. In particular I welcome the move to ‘Apply and Explain’, and stronger emphasis on the role of the chair. Nonetheless they could still benefit from simplification. In his introduction, the chairman, James Wates, reminds us that the origins of the word governance are the Greek word for steersman of a ship. In order to perform their task, steersmen or captains need at least two things - a clear map, and clear authority and instructions about the destination. In their current form the principles and the associated guidance fail this test. The principles need to start with clarity of mandate - defining and agreeing the direction of the journey and rules for its conduct. The guidance needs to offer a coherent map of the corporate governance territory, and so be easy to navigate.

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

The natural starting point for the document is the legal duties of board members under Section 172 of the UK Companies Act. The principles should be prefaced by the following statement, derived directly from Section 172 of the Companies Act.

As a director of your company you must act in the way you consider, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—

(a)the likely consequences of any decision in the long term,

(b)the interests of the company's employees,

(c)the need to foster the company's business relationships with suppliers, customers and others,

(d)the impact of the company's operations on the community and the environment,

(e)the desirability of the company maintaining a reputation for high standards of business conduct, and

(f)the need to act fairly as between members of the company.

In reporting on how you have fulfilled these duties you should consider the following four principles of good governance and stewardship.

2. Are there any areas where the principles need to be more specific?

By starting with directors' duties under law, the principles would clearly set out the stewardship or custodianship role of the board. Section 172 would thereby offer a starting point and map for the principles and guidance that follow. The present draft, by contrast, is a medley of different assertions, not all logical or accurate, about 'good corporate governance' without ever defining what it is. For example:

- Principle One starts with purpose. Purpose is important. In all companies, however, purpose needs to be considered in its context. What is this business of which today's owners and directors are now joint stewards? Who founded the business? To do what? How has it evolved to where we are today? What is the character and brand of this company? What are its most important relationships? What have been the defining moments of our history? Where is it on its journey and what is our contribution, as a board, from where it is today, to steering it to where it needs to get tomorrow? In other words, the starting point is not purpose alone, but mandate, including purpose.

- The guidance in Principle One sounds muddled because it does not start with this sense of where the company is on its journey. It is a static description of a dynamic process. For example, it says *'a well-defined purpose will help companies of all sizes and structures to define their business model'*. This is written as if the company whose board is being given guidance about purpose is considering the matter for the first time. And' *by effectively promoting a company's purpose, a board establishes a rationale for existence'*. This makes it sound as if a company which hasn't put its purpose clearly into words can never have established a rationale for existence. This isn't true. Some entrepreneurs and founders did so by their deeds and the force of their personality.

- in Principle Three it is asserted that *'Corporate Governance can guide decision-making powers, detail succession planning, and give clarity on the engagement between a company and its owners.'* A clear mandate and well written policies can do this. A good chair will ensure it happens. But it is meaningless to use the term 'corporate governance' here as if it were some kind of encyclopaedic handbook with detailed instructions for every board to follow, without using its own judgement. This language is symptomatic of a tendency of regulators and experts in recent years to over-complicate corporate governance. It can and should be kept very simple and deal with principles, not prescription.

- To take another example, the question of effective decision-making is currently addressed in four different places – Principle Two (Board Composition), Three (Responsibilities) Four (Opportunity and Risk) and Six (Stakeholders). Effective decision-making belongs in one principle, which is the one about board effectiveness.

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Four Principles – not Six

Having set out the duty of directors it would then be clear and simple to have four principles which cover everything the board needs to think about. First is its mandate: who has put it there and for what. Second is leadership – appointing the right leaders, planning for succession, reviewing their performance and ensuring the proper balance between results and behaviours, especially through the reward and recognition systems, and all the other policies and processes that support this. Third is the external environment, and the threats and opportunities therein, and what this means for future strategy and business model. This includes an understanding of and engagement with relevant stakeholders. Fourth is board effectiveness, starting with the composition of the board, and then going through its chairing and decision-making to its evaluation.

The table below compares the current six principles with a simplified four which would be preceded by the Section 172 statement setting out the stewardship responsibilities of boards.

Principle One and its associated guidance would help the board orient itself and identify where it is on its journey.

Principle Two is about leadership, performance and behaviours. Is the right leadership in place? How is the board managing to strike the balance between the focus on results and that on behaviours? Most corporate disasters occur when this balance is lost. This may happen where boards allow leaders take their eye of the ball in terms of financial performance, or conversely when they fail to make clear how they expect people to behave in achieving those results. This principle then logically goes on to cover how people are recognised and rewarded, collectively and individually for achieving success with the right behaviours. It is a mistake to pull remuneration away from this context and deal with it as a separate principle: it merely feeds the myth that the only thing that attracts and retains people is money.

Principle Three is about the board’s contribution to sensing and learning from the external environment – anticipating change, understanding competition, identifying opportunity and risk, testing the strategy and business model and capacities against these.

Principle Four is about the board’s own effectiveness, and how this is regularly reviewed. This includes the importance of the role of the chair, the processes for appointing and maintaining a board that is diverse, capable and continually learning so that it is able to steer the executive leadership and the company on the journey that has been described as a result of Principle One. How is the board chosen? Is the chair effective? What is the approach to decision-making? Is there the balance of skills and knowledge on the board; is there sufficient independent challenge? Is there a regular effectiveness review?

It leads on to issues of structure and process – board committees and advisory panels; independent directors; processes for hearing and learning from shareholder and stakeholder voices; the AGM and so on.

Current Logic of Wates Principles **Proposed logic (MG)**

	Principle	Guidance	Comments		Principle	Guidance	Comments
1	**Purpose** -effective board promotes purpose of company, ensuring values, strategy & culture align with it	Well-defined purpose helps companies articulate business model' ' By effectively promoting purpose a board establishes a rationale for existence 'the board is responsible for fostering & maintaining the company culture	Mistaken description of role of purpose. No understanding how purpose evolves from company origins. Or of stewardship role of board, accountable to owners. No acknowledgment of different character, contexts, ownership & business form? .	1	**Clarity of mandate** **Why** we exist; **to whom** and **for what** we are accountable; **what time horizon;** which **are our key stakeholder relationships; how** we will operate, **by what values** we will act as company & as a board? **What** is our approach to risk?	In its stewardship the board looks for coherence between purpose & character of the business as it has evolved to date, & the challenges of the future. The mandate sets out this essential character & distinctiveness. This becomes the basis for board discussion & its communications with shareholders & stakeholders.	The mandate facilitates better strategic engagement between executive directors and NEDs and also between the company and its shareholder(s) and stakeholders. Companies affected by this guidance differ. For many purpose is set above their heads. Defining their mandate applies to all and is an essential aid to navigating choppy waters.
2	**Composition** requires effective chair & balances skills,backgrounds,experience & knowledge. Size guided by company scale & complexity. This promotes strategic decision-making.	Consider appropriate size & balance. Accountability, effective thought, constructive challenge & effective decision-making.	Form follows function. No logic here connecting composition of board with its mandate inc its specific role & accountability.	2	**Leadership Performance & behaviours**	Well-led companies balance results & how they are achieved & rewarded. Do you have right leadership & culture? Are you reviewing behaviours & assessing health of key relationships?	Having the right CEO and top team is the board's most important decision, together with a continuous review of how that leadership balances its focus on results with that on behaviours.
3	**Responsibilities -** clear understanding of accountability & T.O.R. Decision-making and independent challenge	Establish practices that provide clear lines of accountability. Set out internal policies. Independent challenge.	This gets closer to mandate but drifts away into independent representation, kpis - management info, reporting	3	**External environment, opportunity, risk and strategy**	Looking outwards & ahead to opportunity & risk; learn from key stakeholder relationships; test & revise strategy against this	Primary focus of #2 is leadership & culture internally. #3 is about external radar & feedback, reading the trends, sensing threat & opportunity.

	Principle	Guidance	Comments		Principle	Guidance	Comments
4	**Opportunity & Risk** Board promotes long term success of the company, identifying opportunities to create value & oversight of risk	Consider how company creates value over long term – tangible & intangible sources and relevant stakeholders. Develop risk management systems	Logically this is where management info and kpis come in. It misses the wider 'radar' on 'VUCA' in markets & external environment	4	**Board effectiveness** and composition, diversity, effectiveness independence and challenge; quality of chairing, committee structure Independent; policy and process.	Does nomination process and chair ensure right balance of skills & input? Are outside voices heard? How do you review your own effectiveness?	This principle is vital for ensuring the board has enough challenge and independent thought. It should also deal with continuous learning and effective evaluation and feedback.
5	**Remuneration -** promoting remuneration aligned to the sustainable long-term success of the company, considering conditions elsewhere in company	Establish clear policy on transparency of remuneration structures that enable accountability to key shareholders.	Remuneration is not a principle. How about sharing benefits of success with those who contribute to it, consistent with right behaviours?				
6	**Stakeholders -** oversee engagement with material stakeholders, including the workforce & have regard to that discussion when taking decisions. Promote good stakeholder relationships based on the company's purpose	Identify stakeholder relationships that are integral to ability to generate value; demonstrate effective engagement with these. Present fair assessment of company's position and prospects. Develop methods to engage meaningfully with workforce	Stakeholders are not of themselves a principle. Engagement with them is. Section 172 offers the best basis for guidance on this and logically this engagement is part of Opportunity & Risk above.				

3. **Do the principles and guidance take sufficient account of the ownership structures of private companies, and the role of the board, shareholders and senior management in these structures? If not, how would you revise them?**

See comments under 1 above. The most important change would be the introduction of the mandate as the basis of Principle One. The current phrasing of Principle One - *'by effectively promoting a company's purpose, a board establishes a rationale for existence'*- takes too little account of the wide diversity of structures covered by these principles, and the span of time over which companies have evolved. In many cases the boards may well have no choice over the rationale for existence.

Companies are started by entrepreneurs who will have their own unique ways of thinking about purpose and values. By the time they have grown and introduced outside finance and formalised their governance, the company will be well past the point where the question is about establishing a purpose.

Purpose is important. But the variety of origins and context of companies covered by the principles means that it is impossible to generalise about the board's role in defining or promoting a statement of purpose or values. On the other hand, the question that all boards covered by these principles have to answer is: who put us here; what are we hear to do; what values will we operate by? In other words, the first principle needs to be about the clarity of mandate these very different organisations have. The full content of a board mandate can be found here.

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

The emphasis on the relationship between directors and workforce remuneration is welcome. But the connection that is missing in the principles is the link between reward and recognition, and the consideration of both as part of the totality of the leadership of the company. The extremes of director remuneration in some listed companies have been unjustified. Remuneration needs monitoring. But not in isolation. The unintended consequence of public pressure and government action on remuneration in the UK has been to cause a damaging isolation. People start treating pay and benefits as the only motivator. The board's proper focus is the totality of how an organisation is led, and all the different elements of motivation and attraction and retention of talent. In listed companies' boards and remuneration committees and institutional investors tell me that they wasted days on the minutiae of remuneration at the expense of discussion of leadership, behaviours and risk and opportunity. 'Remuneration' by itself isn't a principle. Hence the best place for it is in the context of leadership, performance and behaviours.

5. **Should the draft principles be more explicit in 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 Principles currently include a separate 'principle' simply entitled 'stakeholders. Nowhere in the Principles or the Guidance is the term clearly defined. Does it cover all the non-shareholder relationships of the company? Does it include or exclude minority shareholders whose voice often needs protecting? I would define stakeholders as all those key relationships other than shareholders.

The text of the principle on stakeholders refers to the board's *'responsibility to oversee meaningful engagement with material stakeholders'* and *'a responsibility to foster good stakeholder relationships based on the company's purpose*'. There are two, overlapping, sides to stakeholder engagement. One is about contribution to wealth creation and the other is about impact on society. The opportunity side is the stakeholder relationship as an essential contribution to the success of the business. These relationships need nurturing as part of the task of promoting the success of the company – employee engagement; customer loyalty; supplier collaboration being obvious areas of long term if not short-term self-interest. The other side, not always easy to separate, is stakeholder relationships as areas of impact - waste, emissions, noise, traffic congestion. Here the relationships concerned may not of themselves add value, but can certainly lead to cost and liability if badly conducted. Many key relationships combine both features and the most intelligent leadership is always looking for new ways of turning relationships previously seen simply in terms of risk into opportunity.

In the current draft Principle Six appears to ignore the first. This lopsided approach underestimates the importance of stakeholder relationships as a central part of value creation. In my suggested four principles part of the role of leadership is to engage with stakeholders and learn from them as part of promoting the success of the company (Principle Two). At the same time engagement with external stakeholders on whom the company may have think that it has no impact at present is part of the 'radar' function of the board is understanding change, risk and opportunity (Principle Three). Finally, good governance implies that independent and challenging voices are introduced in and around the board, and this is dealt with as a part of board effectiveness.

7. **Do you agree with an ‘apply and explain’ approach to reporting against the principles? If not, what is a more suitable method of reporting?**

Yes. Together with Tomorrow’s Company, and prompted by the example of Judge Mervyn King in South Africa, I have advocated this for some time.

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

The government has declared its commitment to hold private companies of a qualifying size to account in their work to fulfil section 172. It has mandated the reporting of their activities, but left companies to follow their own route. The Wates Principles are but one of the criteria against which they choose to report. Nonetheless the Secretary of State in his announcement said that he had appointed James Wates to ‘*lead this step change in the way large private companies are run*’. He also specifically referred to the need to address concerns that ‘*some companies are stepping out of line by ignoring employee concerns*’.

This raises expectations that there will be an effective process leading to changes in behaviour by the end of the review period around 2022. The onus for this falls logically on the FRC or a successor body. But the creation of the so-called ‘Coalition Group’ leaves things unclear. The fact that the role of the FRC is currently under review makes things event less clear. Is the FRC responsible for monitoring and enforcement? Or is BEIS? Does the FRC plan to ask for monitoring by the ‘Coalition Group’? Where will the resources come from? This is an unsatisfactory state of affairs. It risks discrediting all the work being put in to develop the Wates Principles. By the time of the announcement of the final Wates Principles, if not before, it is important that between BEIS and FRC and the Chairman himself there is a clear statement of how the companies covered by the statutory instrument will be monitored so that the Secretary of State’s concerns about private companies ‘stepping out of line’ are dealt with.

The most obvious route would be for there to be one overall monitoring exercise using a common template addressing the Secretary of State’s concerns. The Spanish experience on this is particularly relevant. The Institute de Consejeros-Administradores (the ICA, the Spanish organisation for company directors) has vast experience, having developed its own ‘Principles of Good Corporate Governance for Unlisted Companies and Family Businesses’ in 2005. It has suggested setting up a standard reporting model, where the same key questions are asked of all private companies covered by the legislation. If an electronic reporting format were used, the FRC or BEIS or the appropriate body could then publish a periodic review based on these responses, providing enough time was spent and judgement used to interpret the answers well.

It would also be worth looking g at the basis on which the South African King principles have been kept under review. Here Mervyn King as their originator has himself been involved in review the application of the King principles. Another possible approach, which I have not studied in detail, would be to follow the example set by some of the sector groupings who have reported under the Global Reporting Initiative. Here there has been a steady growth in sophistication of voluntary reporting by companies in, say, extractive industry. If government does decide to stand back perhaps the gap could be filled by similar clusters drawn from groups such as companies owned by private equity, family business, employee-owned companies, mutuals, national subsidiaries of international companies, sporting organisations, and so on.

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

The development of these codes is an evolutionary process. The move towards ‘Apply and Explain’ is something that I would advocate also for listed companies. In general, the UK Governance Code needs to move towards more of a principles basis, and provided the current process evolves into something g more coherent than the present six principles, it could prove to be an exemplar which listed companies then follow. At present board are spending far too much time on compliance with the Governance Code. ‘Comply or explain’ has become ‘Comply and Complain’. Both codes need to start by recognising the stewardship role of the board, and use Section 172 as their starting point.

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

I would commend the Spanish ICA evidence as being wise and relevant, given their experience over the past decade.

Appendix – A flaw in the government's secondary legislation – the threshold is wrong.

A flaw in the way the secondary legislation was drafted threatens to undermine the impact of the Wates Principles. In its recommendations to the government the House of Commons Business, Energy and Industrial Strategy Committee argued that *'those (companies) with a significant presence in the community should be required to report on non-financial matters for the benefit of employees and other stakeholders'*. The Chairman of the FRC 'Coalition Group' reinforces the importance of this point in his Foreword to the consultation, saying *'private companies constitute a vast portion of the UK economy, and they must recognise that their actions can have a significant impact on their stakeholders.'* This intention is not satisfactorily achieved. The threshold suggested by BEIS and currently adopted by Parliament ignores the criterion of 'significant presence in the community' and is limited to either more than 2000 employees or a combined, and very high, threshold of turnover in excess of £200m and a balance sheet of more than £2billion. This excludes, for example, the many major football, and rugby clubs and other sporting institutions which may have lower turnover, balance sheet and even employee numbers but major presence in and impact on the community with tens and often hundreds of thousands of supporters and stakeholders. Take an example which has been in the news over the summer and which brought the issue to my attention.

Arsenal Football Club is now 100% owned by a single overseas owner. Its turnover is over £400m but its balance sheet easily fails to meet the minimum test. Yet by any common-sense assessment it cannot be regarded as a small private company. Its activities and decision-making have a major impact on the lives of hundreds of thousands of people. Public transport and policing in the capital undergoes disruption every time a match is held at the Arsenal ground in North London. Decisions on scheduling – admittedly not entirely within the club's control, but subject to its influence - affect fans from other clubs. To take one example of impacts, in 2017, at the insistence of Sky TV, the Premier League scheduled an evening home fixture against Liverpool in North London on Christmas Eve finishing at a time after public transport services were due to have ceased. This showed no consideration to the home fans, let alone those who had to make the journey home to Liverpool, or their families.

An initiative that was designed to hold companies with a significant presence in the community accountable has been built on shaky foundations. The qualifying threshold makes no attempt to assess community or public impact. It would be interesting to hear from government what attempt was made to do this. In the meantime, in the absence of any acceptable measure of 'significant presence in the community' I would urge the FRC and the 'Coalition' to ask government to change the criteria so that the qualifying threshold is **either** a turnover of more than £200m including shares in joint ventures **or** a balance sheet of more than £2billion.I acknowledge that the question of coverage was not decided by the FRC or this panel, but given the exclusion of so many companies which have a significant presence in the community I would recommend that the Chairman and the FRC make it clear to the Secretary of State that this threshold should be revised at the earliest opportunity. A statement by government of this intention will encourage the voluntary adoption of these principles by such organisations.

Mark Goyder September 2018