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3 September 2018

Dear Ms Merrick,

I very much welcome the opportunity to participate in the proposed public consultation. I will provide a detailed analysis of the points raised in my presentation at the FRC event on the Wates Principles in Edinburgh on 29 May 2018 and will also offer some additional insights into the content of the Draft Wates Principles. I hope that this further contribution will be of benefit to the ongoing work of the Coalition Group.

Short Biography

Dr Konstantinos Sergakis joined the University of Glasgow as Senior Lecturer in Law in 2015. At the University, he has convened the LL.M in Corporate & Financial Law since 2016 and has acted as School International Lead since 2017. In 2017, he was elected as a member of the Executive Board of the International Association of Economic Law (AIDE). He is the author of *The Transparency of Listed Companies in EU Law* (Sorbonne - IRJS Editions 2013) and of *The Law of Capital Markets in the EU: Disclosure and Enforcement* (Palgrave Macmillan 2018). His research interests are related to Corporate Law, EU Capital Markets Law and Corporate Governance.

CONSULTATION QUESTIONS

1. The principles address effectively the key issues of corporate governance of large private companies. As I stated at the FRC event (<https://twitter.com/FRCnews/status/1001397396587368449>), 'corporate governance principles for large private companies should not try to tackle every issue. They should focus instead on the generally accepted common shared topics/challenges, and

be measured in their approach.’ The rationale behind such a stance can be explained as follows:

a) by focusing on the core challenges for private companies, the likelihood of the principles getting widely used and accepted while gradually effecting a transformational cultural shift is much higher. Simplicity and more targeted areas of consideration will attract more interest and appetite for voluntary adherence to these Principles.

b) the preference for a more succinct spectrum of governance issues is also justified in light of the proposed ‘apply and explain’ principle: if companies are presumed to apply the Wates Principles, once they sign up voluntarily to this text, and they also have to explain such application, the choice of including the most challenging governance issues will be much more beneficial in terms of the information disclosed since it will ensure flexibility and simplicity by avoiding a burdensome compliance mindset.

If the Wates Principles were to adopt the ‘comply or explain’ principle, the spectrum of themes could be enlarged in theory since, according to this principle, companies could also opt out of some Principles by explaining a particular deviation. Moving away from such a formalistic approach with the ‘apply and explain’ principle is a regulatory choice that will inevitably restrict the flexibility of justifying ‘non-compliance’ since companies will now be supposed to apply all Principles. It is therefore crucial to target only the basic areas to which companies will apply governance principles without expecting of them, at this embryonic stage, a larger exposure that may result in rendering the adherence to the Code problematic or simply undesirable.

c) corporate scandals (BHS, etc.) have inevitably rendered the current debate highly politicised. Therefore, the perils of rushed regulatory responses so as to confront such phenomena quickly and by covering all potential governance issues will most probably outweigh the benefits arising from such initiatives. Focused and simple principles will avoid this risk by reframing the debate around the real corporate governance matters and not exclusively the ones that emerged during the recent past in the UK. Be that as it may, this initiative should not endeavour to guarantee that corporate scandals will not recur, but should instead promote cultural change amongst private companies.

2. At this embryonic stage, Principles need to remain simple and flexible as mentioned above. Following this argument, there is no current need for them to be more specific. Compliance costs of an informationally stringent regulatory framework could be disproportionate and unreasonable compared to the desired outcomes. The Principles are also in line with similar initiatives in this area [OECD CG Principles, European Confederation of Directors’ Associations (CG Guidance and Principles), Baltic CG Code].

A few Member States have attempted to deal with corporate governance in private companies, such as Italy,¹ Belgium² and Slovenia³ with variable solutions (highly

¹ *Principi per il Governo delle Società non quotate a controllo familiar: codice di autodisciplina* (2017).

² Code Buisse III (2017).

³ The Corporate Governance Code for Unlisted Companies (2016).

detailed provisions, ambitious proposals, etc.).⁴ A comparative analysis clearly explains the benefits of the UK approach in terms of creating a document of reference that is succinct, simple and targeted to the most commonly shared challenges for private companies.

Nevertheless, the Coalition could consider making more specific Guidance-Principle Six by inserting some indicative options for demonstrating meaningful engagement with stakeholders and ‘how the company has undertaken effective engagement with material stakeholders and how such relationships have been taken into account in its decision-making’ (Guidance – Principle Six).

To that effect, the Coalition could add to the **Guidance – Principle Six** that *‘Companies might demonstrate such engagement in different ways: by introducing annual events and semi-annual updates with their material stakeholders (following the annual disclosure of the assessment of the company's position and prospects as recommended by Principle Six), by appointing one employee to a board or advisory committee or by forming an advisory committee composed by stakeholders in charge of any matters that are considered important in the company.’*

This addition will enable companies to have a better idea of what is expected of them in terms of stakeholder engagement and will allow for a better outcome in this area (facilitated stakeholder access to governance issues, holistic approach in decision-making processes, etc.).

3. The Principles and guidance should remain generic and flexible by taking account of the various private company profiles. The broadness in the formulation of these Principles is welcomed and should therefore be maintained at this first stage.

Nevertheless, although it is true that the Principles should mainly focus on the relationship between private companies and stakeholders (given the predominance of blockholders in private companies and the much less important role that non-controlling shareholders have in these companies), I would suggest revising them by adding some elements in relation to two areas:

a) Role of shareholders: *‘Controlling and non-controlling shareholders (if any, depending on the company’s ownership structure) should continue to engage with each other and with boards.’*

Controlling shareholders will most probably also sit on the board, so the engagement argument could be deemed pointless. But what is important for the Principles is to remind all types of shareholders that they must also act as responsible ‘owners’ while running the company or simply holding shares. In other words, shareholders should be encouraged to engage/develop dialogue with the company (if they are not on the board) or its stakeholders (if they are on the board and basically control the company). Of course, the board should be doing this already (**Principle 6**) but it should also be reiterated that shareholders have a role in this framework (most notably if they sit on the board as well). This can be justified by the argument that the Wates Principles could also endeavour to nurture an investment culture amongst shareholders while doing the same for boards in private companies. In this way, it will achieve a broader educational benefit.

⁴ The Hellenic Corporate Governance Council also proposed a Draft version on a Code for private companies in 2016 (Special Practices of Good Corporate Governance for Non-Listed Companies) but no further information is available to the author’s best knowledge.

Inspiration in that respect may be taken from the Belgian Code (Buysse III, 2017), which provides in Principle 7 - Engaged Shareholders (*my translation*): ‘**shareholders should formulate and communicate with clarity a vision of ownership. This vision is the expression of convictions and fundamental expectations regarding the company.**’ This could be a useful addition to the Wates Principles. Principle 7 of the Belgian Code is arguably very detailed and the Wates Principles could indicatively use some parts, such as the essential role that shareholders can play by respecting the competence of the board and of management, organising themselves appropriately in operating family companies, respecting shareholder agreements, taking their own education into account and competently preparing the next generation of shareholders while remaining engaged.

The same principle from the Belgian Code focuses on the role that the board must play to ensure engagement with minority shareholders via information and periodic communication to all shareholders throughout the year and not just in the light of the AGM. The chairman of the board is seen as a vital component in introducing this type of dialogue, according to the Belgian Code.

b) Ownership structures – the example of Private Equity (PE) firms: as mentioned at the FRC event on 29 May 2018, the Belgian Code in its Principle 7 is currently the only code that has provisions for PE firms (under the ‘shareholder role’ spectrum). The Code refers to the importance of such firms in private companies and focuses on the need to professionalise the governance of the company while adapting it to this specific context.

More specifically, the Code encourages companies (before embarking upon such operations):

- to have prepared themselves with a professional and realistic business plan,
- to look for an appropriate capital investment partner,
- to provide clear and written agreements that pertain at least to the role and the powers of such a partner, as well as on the terms and modalities of its exit from the private company,
- to have mutual respect and trust, as well as to engage with the capital investment partner.

If the Coalition decides to make specific reference to PE firms, I suppose that these provisions could be complemented by other provisions relating to the need for ‘**PE firms to maintain meaningful dialogue with stakeholders**’ (since the PE firm may present a considerable change for the governance arrangements of a private company and stakeholders may be less well informed about the future and the ongoing progress of the corporate entity, etc.).

Some of the above-mentioned proposals could be inserted in the **Guidance - Principle 3** or the same Guidance could refer to the fact that PE firms can also adhere to the BVCA Private Equity Code.

5. This would be a welcome provision but it may risk shifting the attention to how companies can better disclose the benefits from establishing stakeholder engagement instead of helping companies actually establish such dialogue and benefit from it at this stage. This may lead to the perception of such engagement as another ‘compliance’ exercise by diminishing the educational benefits that are purportedly sought in this framework (i.e. enabling stakeholders to be part of the decision-making process via different routes).

In other words, given the novel character of this initiative, attention has to be paid to the incentivisation of companies to establish stakeholder contact to improve decision-making processes. In light of this opinion, I would reiterate my proposal for making more specific **Guidance – Principle Six** as follows: *‘Companies might demonstrate such engagement in different ways: by introducing annual events and semi-annual updates with their material stakeholders (following the annual disclosure of the assessment of the company's position and prospects as recommended by Principle Six), by appointing one employee to a board or advisory committee or by forming an advisory committee composed by stakeholders in charge of any matters that are considered important in the company.’*

An additional proposal for **Guidance – Principle Six** would be to encourage companies to disclose good practices arising from such engagement as follows: *‘Companies are encouraged to include in their annual statement good practices that periodically emerge through stakeholder engagement’*.

6. Yes, but also see my proposals under Q.2 above so as to enable companies to explain the application of Principle 6 in a more concrete way to the recipients of the disclosed information.

7. I agree with the Coalition that there is a growing demand and need to move away from a formalistic/‘box ticking’ approach. The ‘comply or explain’ principle has proven to be an important and efficient tool to increase transparency and awareness, but its implementation has also been problematic at times.⁵ The formalistic ‘box-ticking’ approach and boilerplate statements show, in some cases, no particular attachment to meaningful compliance. It therefore becomes difficult to decipher the interpretation of compliance and of corporate governance systems. As experience has shown in this area, if companies decide to deviate from a provision by explaining this deviation (as expected according to the ‘comply or explain’ principle), market expectations may be rigid and compromise the benefits of providing (even meaningful) explanations since the latter are as seen as ‘failure’ to comply and not as an attempt to be transparent.

As an alternative, the ‘apply or explain’ principle is an ‘outcomes-based’ compliance that sets out what companies can achieve if corporate governance principles are implemented effectively: ethical culture, good performance, effective control and legitimacy are amongst these benefits. The only problematic aspect with this approach is that it may give the right not to benefit from this opportunity for more transparency by giving the option to explain. This approach has now paved the way for the ‘apply and explain’ principle;⁶ this is the same principle but application is assumed and the explanatory part is accentuated to allow the recipients of the information to have a more holistic view of the overall stance of companies.

To the extent that the ‘apply and explain’ mindset serves the same purpose within the Wates Principles framework (i.e. departure from ‘mindless compliance’), it should be adopted.

⁵ For an overview of these and other related topics, see K. Sergakis, ‘Deconstruction and Reconstruction of the “Comply or Explain” Principle in EU Capital Markets’ (2015) 5(3) Accounting, Economics and Law: A Convivium 233, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2516741.

⁶ See for example the King IV Report on Corporate Governance for South Africa.

An alternative to the above-mentioned options has been implemented in Malaysia:⁷ **CARE: Comprehend, Apply and REport**. The new element is ‘Comprehend’, namely understand and internalise the spirit and intention behind the principles and practices, including their intended outcomes (awareness, training programmes and continuous guidance from the FRC would be therefore crucial so as to ensure the effective applicability of this approach).

Whichever principle is adopted in this framework, appropriate guidance (additional guidelines by periodic educational events, continuous dialogue with private companies upon request and soft monitoring process as explained in Q.8 below) is needed by the FRC to assist large private companies in this new task. If such guidance is not provided, there are risks of subjective interpretation of the Principles and – ultimately – discrepancy in the desired outcomes (i.e. lack of consistent interpretation of outcomes).

8. Given the voluntary nature of the Wates Principles, there are two realistic ways of monitoring and enforcement, which should be ‘light touch’ at this embryonic stage. Indeed, the FRC should develop:

- a) a **dialogue framework** with private companies when clarification is needed (additional guidelines by periodic educational events, continuous dialogue with private companies upon request) and
- b) a **tiering exercise** in light of the experience gained with the Stewardship Code. This would enable the FRC to have a broader picture of the quality of the compliance rate of private companies with the Wates Principles so as to be able to decide periodically on the revision of their content as well as of its monitoring approach. At the same time, disclosing the names of companies belonging to the different tiers would in theory trigger social enforcement mechanisms stemming from various stakeholders (creditors, employees, customers, etc.). The discreet reinforcement of social sanctions through the use of tiering mechanisms would be a welcome change, but its ultimate efficiency will depend on the behavioural patterns of stakeholders. For social sanctions to take on a meaningful dimension and to act as a counterbalance to various ‘borderline practices’, stakeholders must already have the necessary education and evaluation skills to act responsibly when they receive any information related to stewardship (hence the need to make more specific Principle 6 as mentioned above in Q.2).

Another solution for monitoring purposes is **collaboration with a research agency or university** to examine compliance rates and content of explanations, as is the case in the Netherlands.⁸ In this way, a number of resources are optimally used by third parties working closely with the Committee. Such initiatives could be used more extensively in the UK.⁹

⁷ Malaysian Code on Corporate Governance (for listed companies).

⁸ Monitoring Committee Corporate Governance Code – Final document (unofficial translation), December 2017, p. 16, available at <https://www.mccg.nl/?page=5787>.

⁹ For a more general analysis on monitoring and enforcement powers related to the FRC’s review, see my consultation response to the ‘Independent Review of the Financial Reporting Council (FRC)’ led by the Department for Business, Energy, and Industrial Strategy (BEIS), July 2018 available at https://www.gla.ac.uk/media/media_601148_en.pdf

9. Yes. Flexibility and proportionality in this framework are key issues to ensure maximum visibility and attractiveness of this new initiative. In future revisions, this stance can be re-evaluated, after having examined the responsiveness and overall compliance rate of private companies.

10. Additional comments

- **Advisory committees:** I would like to emphasise the importance of advisory committees that I publicly proposed at the FRC event on 29 May 2018 (<https://twitter.com/FRCnews/status/1001399130885943297>) and that the Coalition has since included in the Draft Principles as an option for private companies.

Private companies currently feel under pressure to respond to public expectations of governance that includes a wider range of market actors and stakeholders. Board committees that go beyond the traditional governance issues (e.g. remuneration, audit and nomination) are perceived as onerous when they aim to oversee much more novel or complex/wider issues (e.g. sustainability). I am therefore convinced that my proposal for the establishment of advisory committees is better suited to the following company profiles:

- a) companies with little experience on engagement with stakeholders on crucial issues (e.g. sustainability)
- b) companies adopting, for the time being, an experimental approach as to the diverse composition of such committees in most governance areas (e.g. remuneration, nomination, etc).

In both scenarios, what my proposal seeks to achieve is to offer a more flexible framework for a more inclusive interaction and engagement on governance matters between companies and other constituencies. Advisory committees should not be seen as an effective excuse for giving less power to stakeholders; on the contrary, they should be seen as a first and experimental approach of private companies, with no prior experience or less experience in certain governance issues, to widen the dialogue spectrum with different stakeholders. It is not the form/title the committee that counts but its composition and the topics discussed that will allow private companies to enhance their corporate governance culture and make a real difference in the long-term.

Having said that, the creation of board committees is also a viable option for companies with more experience and could be in charge of any of the above-mentioned governance areas. Some private companies may show signs of confusion while preparing to sign up to this Code voluntarily, by considering board committees as more complex/formal/onerous. Although this impression may be exaggerated in some cases (since it is ultimately a question of efficient design, composition and objectives that will make any committee efficient and not other formalities surrounding its creation), advisory committees can help companies to avoid these initial impediments by offering an equally satisfactory and less complex route to engagement and dialogue.

- **Interesting provisions from the Slovenian Code:** I would also like to draw the Coalition's attention to two elements of the Slovenian Corporate Governance Code for private companies:

- a) Supervisory body needs to have at least 20% of each gender represented on the board and at least one independent member (at the company's discretion)
- b) A training programme should be provided for members of the supervisory body, which is adopted by the supervisory body every year.

If the first provision may be seen unnecessarily restrictive in relation to the proposed UK framework approach (at least at this embryonic stage), the second provision could be a useful addition to the **Guidance – Principle 2** in the following fashion: 'Companies should demonstrate a commitment to the ongoing professional development of their board, and directors should engage with such opportunities. *Companies might, for example, provide for training programmes for members of the board or any other board or advisory committee to so that members of such boards have all the knowledge necessary to exercise their role.*'

I hope the comments provided in this letter are of interest for the Consultation's purposes.

Should you require any further information on the points raised above, please do not hesitate to contact me at Konstantinos.Sergakis@glasgow.ac.uk.

Yours sincerely,

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