

February 2017



**The Purposeful Company**  
Policy Report





## Foreword



When we started The Purposeful Company project we could not have predicted how relevant it would be today as we publish our Policy Report. The government has recognised the importance of striking a new bargain between business and society. Companies acting with purpose, for the long term, must be at the heart of this. We are delighted in this report to

present a set of rigorously researched, interlocking policies to help such companies flourish in the UK, leading a transformation of our economy for the good of all.

We would like to thank the extraordinary alliance which has worked so hard to take the evidence and push it into recommendations - the Task Force and Contributors have collaborated tirelessly to push and challenge the thinking. Our hope is that you too will now become part of making change happen.

Yours,



**Will Hutton and Clare Chapman**  
**Co-Chairs of The Purposeful Company Task Force**

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## The Purposeful Company

The Big Innovation Centre convened The Purposeful Company Task Force in 2015. The Task Force is a consortium of FTSE companies, investment houses, business schools, business consultancy firms and policy makers. It has been examining how the governance and capital markets environment in the UK could be enhanced to support the development of value generating companies, acting with purpose to the long-term benefit of all stakeholders.

The Steering Group, co-chaired by Clare Chapman and Will Hutton, oversees the work of the Purposeful Company Task Force. The views expressed in the recommendations section of this report are those of the authors, having taken input from the Task Force members and Contributors. While all Task Force and Steering Group members subscribe to the Statement of Overarching Aims and the Definition of a Purposeful Company set out in Sections 1 and 2 of the Policy Report, membership of the Task Force cannot be taken to represent an endorsement of every specific policy recommendation. Authors are acting in their personal capacity and the views expressed here may not be taken to represent the views of their organisation.

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## Section 1 - Introduction and Statement of Overarching Aims

The UK economy is at a critical juncture. Since the financial crisis, long-standing economic weaknesses have become more pronounced. UK investment has ranked in the bottom 10% of the industrialised world for 16 of the last 21 years, with a particular crisis in R&D which is the lowest, as a share of GDP, in the G7. Productivity growth is now 16% below trend, partly contributing to the stagnation in real wages, high current account deficit and among the highest disparities in regional wealth in advanced countries. Despite the strong record in job generation, these weaknesses have led to a decline in the public's confidence that capitalism can deliver, in the words of Prime Minister May, an economy that works for all. Moreover, the challenges posed by the digital and technological revolutions, and demographic and environmental change must be successfully navigated. Not to do so will only intensify the decline of trust in business, visible in Britain and across developed economies more generally.

There is substantial evidence – gathered in the [Interim Report](#) of The Purposeful Company Task Force (Interim Report) – that companies with a declared purpose, adhered to by their leadership teams and well understood by their stakeholders, perform better on key metrics over time than their less purposeful peers. Nevertheless, the British financial, regulatory and ownership ecosystem is more hostile to companies attempting to deliver purpose than many other countries. The members of The Purposeful Company Task Force believe that business and markets are fundamental to the country's wealth. But this ecosystem must change to enable and nurture purposeful companies so that the UK can deliver the productivity growth on which living standards across all regions depend. There is no one magic bullet – rather a series of initiatives, reforms, and change that will build on each other to create a better environment.

We welcome the government's support for this agenda in the recent twin publication of Green Papers on Industrial Strategy and Corporate Governance. We see our analysis and recommendations as the bridge between the two profoundly interconnected policy domains. A pre-requirement for a successful industrial strategy is companies that are governed and managed purposefully, ready to seize the possibilities so created and raise the bar for the rest of the system: equally a successful industrial strategy creates the ecosystem which rewards the pursuit of purpose. Thus it will be purposeful companies who, by pursuing high value-added strategies and investing in investors, employees, customers, suppliers, and society, will incentivise others to follow suit, for instance, in investing in their skills. They are similarly a source of demand for R&D and innovation, encouraging others to adopt similar strategies.

Brexit has raised the stakes. If UK business is to take advantage of the opportunities created, while managing the risks, our companies need to unleash their full capabilities over the long

term. There is now a growing consensus across business, finance, and government that there is a public interest in securing a more meaningful change in how our wealth creation system is organised. The reports of The Purposeful Company Task Force are aimed at illuminating that debate.

## Core Beliefs and Aims

Our [Interim Report](#) sets out an extensive review of the evidence on how purpose over the long terms enhances company performance. Based on this research, the Task Force shares the following common beliefs, which have guided the Steering Group's approach to the policy recommendations set out later.

- A company is more than a web of transactions. Purposeful companies contribute meaningfully to human betterment and create long-term value for all stakeholders.
- Long-term innovation, productivity improvement, and sustainable growth in the UK economy will require the development of more companies that are driven by the long-term pursuit of purpose.
- Over the long term, there is no conflict between acting with a clear purpose and delivering value for shareholders. Indeed, the evidence is that purposeful companies who balance the needs of investors, employees, customers, suppliers, and society deliver better value over the long-term for *all* stakeholders, including shareholders.
- The starting point for ensuring purpose is at the heart of the enterprise and is for boards, managers and shareholders to choose and steward that purpose consciously.
- The regulatory, ownership and legal system should, at the very least, not obstruct the creation of purposeful companies and, at best, actively encourage them. Companies should be free to go further and organise themselves around varying templates for the delivery of purpose while offering appropriate protections for minority shareholders.
- The promotion of purpose should become integral to company reporting as part of a general overhaul to improve the reporting of companies' intangible assets. This improvement will increase both firm's incentives to invest and transparency around the issues that matter to investors, employees, customers, suppliers, and society.
- National reporting on intangibles needs to be similarly improved and their contribution to productivity better understood.
- Company leaders should be better incentivised to deliver purpose over the long term. Concerns about the degree to which pay is deserved and related to contribution, and thus fair, need to be credibly addressed.

- Companies and their owners have an interdependent relationship. The purposes of investors should be consistent with those of the companies in which they invest to ensure they are as aligned as possible, supporting purposeful companies over time. This alignment, in turn, will improve long-term returns for its ultimate savers, who suffer from its current transactional bias and focus on short-term performance.
- The asset management's stewardship obligations, with a few notable exceptions, are in general poorly fulfilled. The obligation to support stronger and effective stewardship should be strengthened, and mechanisms introduced to avoid the problem of disengaged shareholders taking advantage of the stewardship efforts of a few.
- UK shareholding is more fragmented than shareholding in similar advanced economies. Any barriers to the creation of large non-affiliated investors – blockholders - who can support and challenge management in delivering purpose over the long term should be reduced.
- The UK needs to create improved flows of finance better to support the growth of purposed companies. There need to be better vehicles for long-term investors such as pension funds and private individuals alike to support purposeful companies across their life cycle.

There is no one measure that will create purpose - rather a series of reinforcing initiatives drawn from the overarching principles above. In some cases, companies can act themselves: in others, innovative new regulation may be required. But in many cases, the authors of the recommendations believe a better use of the UK Corporate Governance Code and other industry codes, such as those developed by the Financial Conduct Authority (FCA) and Financial Reporting Council (FRC), are the most appropriate mechanism to support purpose.

There are necessarily compromises involved, but the authors have sought to base all our recommendations on the very best evidence. We are keenly aware arrangements that are appropriate in one context may not be appropriate in another. Our recommendations are intended to be enabling rather than prescriptive.

By bringing together a Task Force from business, investors, academia, policy-makers, and business advisory firms, the Steering Group has necessarily developed policies taking into account a wide range of opinions. All our Task Force members subscribe to the core aims and beliefs above. However, there is a diversity of view and differences of emphasis depending on sector and business model. Nonetheless, this Policy Report represents a radical, practical, and coherent roadmap for creating a better environment for purposeful companies, thinking and acting for the long-term, to flourish for the benefit of the UK and all its citizens.

## Section 2 - Definition of a Purposeful Company and Why Purpose Matters

A purposeful company is inspired by a clear role in the world that offers it a reason for being – its purpose. Purpose informs its existence, determines its goals, values, and strategy, and is embedded in its culture and practice. The evidence gathered in our [Interim Report](#) strongly shows that a guiding purpose delivers improved performance. It is from delivering purpose that profit flows. So how is purpose defined, and how is it put into practice?

Purpose ensures that a company is more than a web of transactions. Instead, purposeful companies contribute meaningfully to human betterment and create long-term value for all their stakeholders:

- Concerning **employees**, purposeful companies recognise there is a reciprocal human contract. Employees are not short-term inputs into the production process; they are partners in and members of the organisation. Purposeful companies develop cultures based on trust and respect so that workplaces provide an opportunity for people to learn, contribute and thrive.
- Concerning **customers**, purposeful companies go beyond being customer-centric to thinking in terms of a covenant. They view a customer not as a transactional source of revenue, but as having a win-win mutual relationship centred on the long-term impact of a company's product or service on the customer's wellbeing.
- Concerning **suppliers**, purposeful companies aim to create a similar long-term mutual relationship of fair dealing. They pay their suppliers equitably and ensure that their relationship allows them to grow and develop.
- Concerning **wider society**, purposeful companies recognise there is a mutuality of interest. They act as responsible stewards for future generations, are good neighbours in the communities in which they operate, protect the environment, and ensure that their operations are sustainable.

Purpose creates and maintains a culture of trust, reciprocity, and integrity. These values encourage stakeholders to internalise the behaviours they want to promote. Traditionally, the company is viewed as no more than a network of contracts, with stakeholders responding rationally to incentives. This view is wrong for two reasons. First, contracts are necessarily incomplete, costly to enforce and subject to default. A guiding, shared purpose steps in to overcome these problems by motivating stakeholders to contribute to the firm even if not

explicitly rewarded in a contract. Second, even if companies could enforce actions through contracts, they would not wish to do so. It is unlikely that management has all the relevant knowledge to write the contracts that implement the best responses to all business challenges. A shared purpose allows management to build trust with other stakeholders, which then gives them more flexibility and discretion to create value, rather than enforcing their participation through contracts. This shared purpose, in turn, leads to a true commitment to the contribution to human betterment rather than mere compliance.

Once a purpose is agreed, it must go beyond a formal announcement and be embedded throughout the organisation, to ensure that all stakeholders believe in and act to promote that purpose. Purpose has to flow throughout the company. The board and leadership team need to consciously own the purpose, create the mind-set, spill it into decision making, and reinvent the operating model of the company where necessary. This includes winning a commitment from both internal and external stakeholders. Engaging with investors and employees is particularly critical so that they understand the strategic context behind company decisions and adjust their expectations accordingly. Doing so enables companies to capture the value from their investments in purpose and attract parties who are willing to look beyond short-term considerations.

The pay-offs to purpose are increasingly measurable and include superior innovation, investment, R&D, and recruitment and motivation of employees. They also include resilience to external shocks, lower cost of capital and less risk of exposure to regulatory fines. All of these, in turn, lead to stronger accounting and operational performance, and ultimately higher stock returns. An increasing body of evidence, spanning thousands of companies, across dozens of industries and countries, demonstrates a causal relationship between purpose and sustained competitive advantage rather than mere correlation.

To illustrate how real life companies develop purpose, the table below sets out six categories in which a selected cross-section have organised their purpose along with associated values. It is not exhaustive but highlights the varying range and character purpose may take. Optimal purpose, as can be seen, varies across companies depending on their industry and life cycle, and may vary within a company over time. Purpose has to be constantly under review to reflect changing times.

**Figure 2.1: Ways of creating purpose**

Sub-type	Definition	Companies	Values	Dangers / Issues
Universalization	To allow everyone to experience what the few have	IKEA Kingfisher Tata Wal-Mart	Fairness Equality	What do you do when you achieve your aim?
Innovation	To go where no one has gone before	ARM Holdings Illumina Samsung Tesla Motors	Pioneering Spirit	How to keep innovation engine going while making discoveries?
Fresh challenge	To challenge complacency and the 'big guys'	Motif Investing Ovo Energy Under Armour	Underdog Empathy	What happens when you become big yourself?
Excellence	To strive for perfection in one's art	Apple Bang & Olufsen BBC BMW HBO	Achievement Drive	Does not inspire everyone because of narrowness
Global Responsibility	To do business in a way that is sustainable and ethical	Nationwide Nestlé Statoil Unilever John Lewis	Community Spirit	People can question authenticity and realism
Human Values	To recognise the humanity of employees, suppliers and customers	Lush Southwest Airlines Starbucks Toyota	Human Concern	Potential conflict with profitability

Source: Bains adapted (2007)

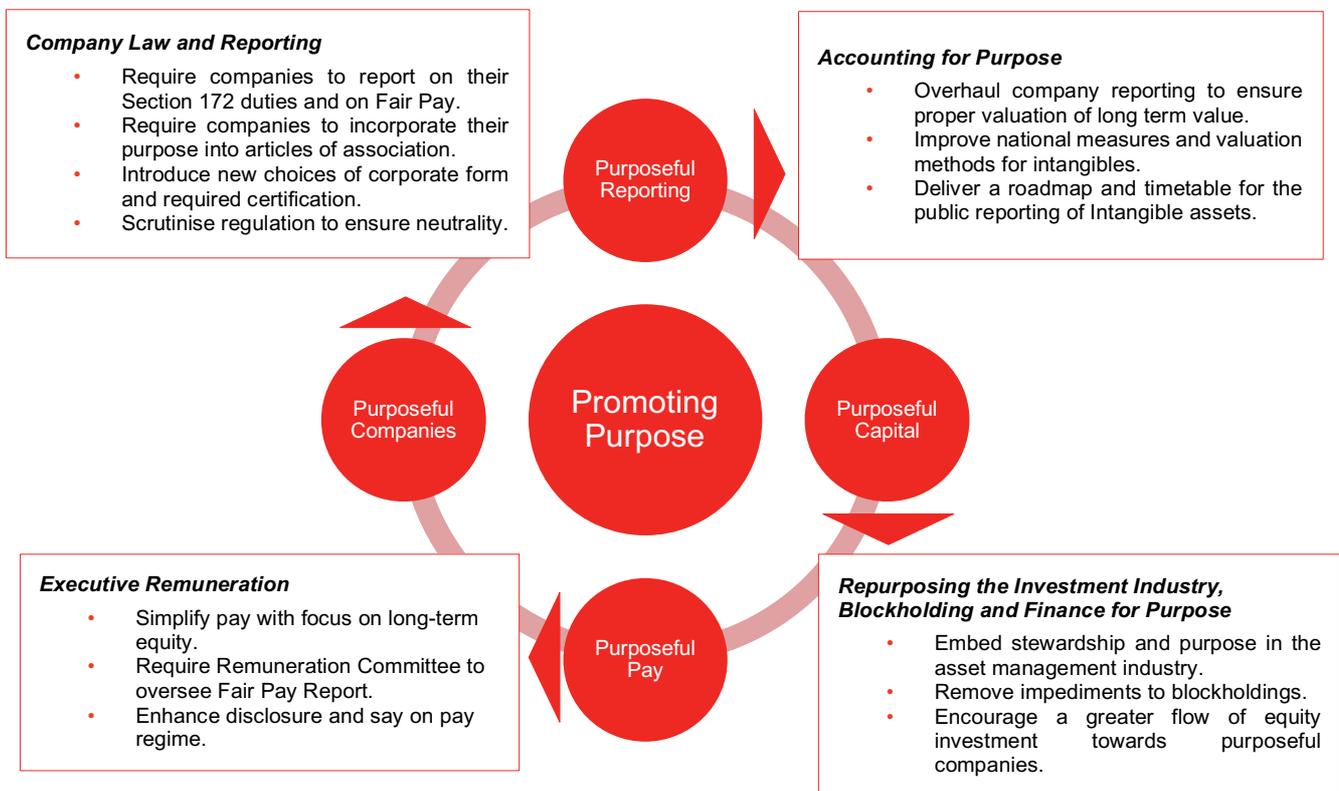
In sum, purpose is best nurtured if four elements are aligned in support: ownership, governance, the business model, and the ecosystem in which the company operates. We demonstrated in the [Interim Report](#) that all four dimensions are weak in the UK, and so need to be addressed as part of the evolving policies on industrial strategy and corporate governance.

Establishing a purpose and living it is not easy, but it is central to both the success of business and its contribution to society. Britain needs to organise itself so it can generate more purposeful companies – and the recommendations that follow are aimed at doing just that.

## Section 3 – Recommendations at a Glance

Based on the evidence gathered in our [Interim Report](#), the Steering Group of The Purposeful Company has developed 22 robust recommendations within six key policy areas, namely Company Law and Reporting, Accounting for Purpose, Repurposing the Investment Management Industry, Blockholding, Finance for Purpose and Executive Remuneration. This section provides a summary of these recommendations in the different policy areas.

**Figure 3.1: Recommendations at a glance of the Policy Report**



## 1. Company Law and Reporting

### **Recommendation 1.1: Report on purpose outcomes**

Directors must consider and report on how they fulfil their obligations under subsection 172(1) to 'have regard' to all stakeholders. They should also report on how they satisfy the standards of the Fair Pay Report, outlined in Subsection 4.6 on Executive Remuneration. The government should review the enforcement framework to ensure that companies are being led and managed to achieve success.

### **Recommendation 1.2: Purpose incorporation**

The articles of association should be amended to require companies to make clear and precise statements of their purposes in their articles. There will be a transition period of five years until 2022 during which existing companies will be able to incorporate around purposes; new business will be expected to incorporate around purposes from the outset.

### **Recommendation 1.3: Introduce choices of corporate form**

Companies should be able to adopt one or more of the provisions of public benefit, stakeholder participation and privileged shareholder models.

### **Recommendation 1.4: Certify the delivery of purpose**

Certification procedures should be developed along the lines of existing initiatives and companies should be certified as fulfilling the delivery of their purposes, having in place structures and systems to achieve those purposes and compliance with alternative models of corporate form that they have chosen to adopt.

### **Recommendation 1.5: Scrutinise regulation to ensure neutrality**

Existing rules regarding the regulation of corporate ownership and corporate governance should be scrutinized for whether they violate a principle of neutrality regarding the adoption of particular corporate structures. Preventative regulation should be functional rather than institutional in nature and should avoid distorting companies' choices of their organisational form.

## 2. Accounting for Purpose

### **Recommendation 2.1: Accounting and reporting methodologies should be modernised**

The Chancellor of the Exchequer and the Secretary of State for Business, Energy and Industrial Strategy should investigate solutions with all relevant parties and propose a way forward as part of the White Paper on Industrial Strategy. Company reporting should be overhauled so that intangible assets – including purpose – are properly valued, at both a company and national level. This will increase both companies' incentives to invest and transparency around the issues that matter to investors, employees, customers, suppliers, and society. Such a solution should be piloted in parallel with current standards, but ultimately should replace them.

### **Recommendation 2.2: Intangible assets should be properly valued and nationally reported**

- The government should reform national income accounting, including improved measures of productivity and measures to create a better functioning market in IP.
- The Office for National Statistics (ONS) and Companies House should lead on the creating of national standards for the reporting of intangibles and publication of more disaggregated and more timely national statistics on intangibles.
- The government and FRC should work together to create a roadmap and timetable for requiring companies to report on their intangible assets publicly and to both Companies House and the ONS.

## 3. Repurposing the Investment Industry

### **Recommendation 3.1: Orientation around purpose at the asset manager level**

The investment management industry should be encouraged to incorporate and report on purpose within the framework set out in this policy report. In particular, every asset manager should at least:

- Set out a clear statement of its purpose. In line with the broader corporate sector, over time asset managers should be encouraged to declare purpose in their articles of association and have it independently certified each year.
- Report annually on how he or she has acted to fulfil its purpose over the year.

- Align executive pay practices with the principles outlined in Subsection 4.6 for companies, with appropriate use of deferral in own funds as well as equity for portfolio managers.

### **Recommendation 3.2: Orientation around purpose at the fund and mandate level**

The FCA should develop an improved framework for describing purpose at the fund and mandate level through clear investment objectives and reporting measures:

- Funds (and asset owners, e.g. pension funds, acting on behalf of ultimate beneficiaries) should produce a clear statement of purpose including a statement of investment beliefs and objectives, with particular reference to their stance on stewardship
- Funds (or asset owners setting a fund mandate) should pre-identify key measures that they will report each year, such as active share and tracking error, portfolio size and concentration, turnover, and cost, and set target ranges aligned to their purpose.
- Funds should report over three, five, and ten years and then over longer terms in 10 year steps before reporting any shorter term performance.

### **Recommendation 3.3: Embedding stewardship**

Investors' responsibilities concerning stewardship should be clarified, and the oversight strengthened in order to embed stewardship as a core function of UK capital markets.

- Strengthen Conduct of Business Rule 2.2.3 to require asset managers to set out their approach to Stewardship, including disclosing voting records, policy on stock-lending, stating reasons and alternative approach to engagement if not a signatory of the Stewardship Code.
- The FRC should establish a review to investigate mechanisms for independently reviewing stewardship quality, to strengthen their existing tiering activity in relation to the Stewardship Code
- The government should encourage the industry actively to scale collective engagement activity via the Investor Forum so that collective activity can move beyond extreme cases to more routine ones.
- The FRC should review the state of stewardship in 2020. If the review continues to reveal that stewardship is being neglected, consider introducing a stewardship levy to support increased scale of engagement activity (either through the Investor Forum or a newly created instrument) and commissioning of open-source analysis and research into effective stewardship, long-term engagement, and purposeful investing

### **Recommendation 3.4: Encouraging sources of purposeful capital**

Policy should support the development of Purposeful capital in four areas

- Remove impediments to development of blockholdings in UK companies (see Subsection 4.4)
- Accelerate the merger of sub-scale public sector pension schemes to create a strong voice for purposeful stewardship.
- Establish a UK investment fund to support development and growth of purposeful SMEs (See Subsection 4.5)
- Undertake a cross-disciplinary regulatory review with the intent of removing bias in favour of debt over equity.

## **4. Blockholding**

### **Recommendation 4.1: Disclosure relaxation**

Not impede block formation by relaxing disclosure requirements and bringing them in line with the EU and US.

### **Recommendation 4.2: Structured access**

Provide clarity on types of confidential information that can be shared in meetings between companies and shareholders, and consider creating a ‘safe harbour’ allowing blockholders to receive information without violating insider trading laws.

### **Recommendation 4.3: Collective engagement**

- Further clarify what types of collaboration between shareholders are allowed and not allowed, and what information can and cannot be shared in such collaborations.
- Relax any restrictions that may deter collective engagement.

### **Recommendation 4.4: Voting with borrowed stock**

Prohibit shareholders with a small, zero, or negative stake from voting with borrowed stock, but continue to allow blockholders to vote with borrowed stock.

### **Recommendation 4.5: Minority shareholder protection**

Ensure that any facilitation of blockholder monitoring and engagement from (1)-(4) above are not at the expense of minority shareholders.

## **5. Finance for Purpose**

### **Recommendation 5.1: Purposeful pension investment**

BEIS and the Department for Work and Pensions (DWP) should offer DC pension fund members the choice of either joining newly created social pension funds or earmarking part of their portfolio for investment in purposeful companies. Moreover, such earmarking could be part of the default pension fund allocation, creating a pool of up to £100 billion for such investment by 2030. Funds would either be invested directly in purposeful companies or bonds issued by the Business Growth Fund (BGF) and British Business Bank (BBB) (see below).

### **Recommendation 5.2: Purposeful collective investment**

DWP, working with BEIS and the Department for Communities and Local Government (DCLG), should set guidelines for central and local government pension funds to invest in purposeful companies and promote engaged stewardship, following the example of the Japanese Government Pension Investment Fund (GPIF).

### **Recommendation 5.3: Crowdfunding and digital platforms**

The UK Municipal Bonds Agency should investigate building a crowdfunding platform to attract local equity investors for purposeful start-ups and scale-ups, initially working on pilots with a panel of Local Enterprise Partnerships.

### **Recommendation 5.4: Purposeful investment bonds**

BEIS should investigate options to finance a scale-up of both the BGF and BBB. For example, both operations could be empowered to issue purposeful investment bonds, possibly supported by the government, to invest in new and growing purposeful companies – in particular purposeful SMEs where the need for more investment and engagement is particularly acute.

### **Recommendation 5.5: UK investment fund**

A UK Investment Fund, dedicated to investing in purposeful companies, should be considered. Financing and governance structures should be modelled with a view to creating a pilot fund.

## 6. Executive Remuneration

### Recommendation 6.1: Reform pay design

Shareholder guidelines and the UK Corporate Governance Code should enable companies to adopt simpler pay structures for CEOs based on long-term equity and debt holdings to encourage long-term behaviour and to avoid the unintended consequences of the excessive focus on performance-based incentives.

- Packages should be structured so that exposure to the long-term value of the company out-weighs the potential gains from performance-based incentives vesting in any year. This means CEOs should rapidly (e.g. within two years of appointment) build up shareholdings of at least 2x the value of a year's performance-based incentives, with a target to increase this to 2x total compensation over time.
- This should be achieved through an appropriate combination of reducing performance-based incentive plans in favour of long-term awards of equity; paying bonuses in shares; and making joining awards of equity to CEOs, vesting over long periods.
- Pay should be long-term, with shares released on a phased basis over periods of up to at least 5 to 7 years depending on the industry with at least half of the shareholding requirement applying for at least two, and preferably three, years after leaving the company. The release of equity for sale should be phased and block-release should not be triggered on any defined event (e.g. retirement).
- Performance-based incentives should balance unleveraged financial measures of growth and return and should include non-financial and strategic measures based on fulfilment of the company's purpose, to ensure that targets are aligned with how companies will deliver value over the long-term in line with that purpose.
- Bonuses based on financial targets should be paid in shares, with board discretion to vary the bonus up or down based on holistic judgement.
- Particularly in highly leveraged or volatile companies, boards should consider paying CEOs in unsecured debt (e.g. via deferred compensation plans) as well as equity.

### Recommendation 6.2: Strengthen board accountability for pay fairness

The UK Corporate Governance Code should be amended to broaden the role of the Remuneration Committee to oversee that business purpose is being translated into behaviour and decisions around reward, including in relation to pay fairness. The Remuneration Report should include a Fair Pay Report explaining the company's approach to pay fairness, and

including specified metrics including relative movements in CEO and employee pay over time. The company should establish a meaningful process for engaging with employees on the Fair Pay Report.

The Report should cover, supported by data where appropriate:

- The company's philosophy and principles on pay fairness across the population (including how fairness is defined), the approach taken to internal and external comparisons, covering the structure and level of pay, and the approach taken to linking pay with performance, including the principal characteristics of incentive plans used.
- Explanation of how the policy on pay for the wider UK workforce differs from that for the CEO and other executives in terms of the elements of pay offered, the quantum of opportunity under those pay elements, and the target positioning of pay against the market together with justification for such differences.
- Explanation of the extent to which it is the company's policy and practice to pay living wages in the territories in which it operates, and how these are established, statutory disclosures on gender pay, and broader philosophy and approach to equal pay issues.
- Explanation of the approach by which the company engages with employees on the Fair Pay Report and a summary of any themes emerging from the feedback on the prior-year's Report.
- Tabular disclosure over the last five years (building to ten over time) of the maximum annual pay opportunity for the CEO, the actual amount paid (on a statutory single figure basis) and average pay for all other employees, or an appropriate subset representative of at least the general UK workforce.
- Graphical representation of the above tabular disclosures formed by rebasing each pay element to 100 at the start of the period, and a narrative explanation of the comparative trend over time.

### **Recommendation 6.3: Improve transparency of executive pay and performance**

The Directors' Remuneration Reporting regulations should be updated to enable greater stakeholder understanding of a company's maximum pay and of the relationship between pay and performance.

- Within the remuneration policy, a clear monetary maximum should be stated and justified for each element of remuneration other than those linked to the value of shares, in which case the limit should be based on the initial value of shares awarded.

- The single figure table should disclose how much of the single figure arises from growth in share price on share incentives between the date of grant and measurement of performance and should show a separate total single figure excluding this amount.
- The single figure table should include the wealth impact on CEOs of the pre-tax change in value of previously granted equity over the year. This item should also be shown in the ten year history together with the absolute total shareholder return achieved by the company over each year.

#### **Recommendation 6.4: Enhance the binding vote regime**

A binding vote regime should be triggered when companies lose, or repeatedly fail to achieve a threshold level of support on, the advisory remuneration vote.

This could be implemented through legislation or changes to the UK Corporate Governance Code. If a company loses the advisory remuneration vote in any year or receives 25% or more vote against the advisory vote two years in a row then:

- The company should bring forward their remuneration policy for approval at the next AGM of the company as a Special Resolution requiring a 75% majority to pass.

At the same Annual General Meeting (AGM), a motion would be brought forward enabling shareholders to dis-apply, by simple majority, the requirement to pass the remuneration policy by a super-majority.

These 22 recommendations should be seen as a combined effort across multiple policy areas to generate change in the UK corporate system. We recognise that a sustainable change entails a long-term process and commitment from all actors, nevertheless, we anticipate some of these suggestions could be achieved in the near future, as it is shown in Figure 3.2.

**Figure 3.2. Promoting purpose at an early stage, in the medium- and in the long-term**

Promoting Purpose	Early wins	Medium-term wins	Long-term wins /Further consultation
Purposeful Companies	<p><b>Recommendation 1.1:</b> Directors to Report on how they fulfil their Section 172 duties and satisfy the Fair Pay Report</p> <p><b>Recommendation 1.2:</b> Incorporation by declaring purpose statement in articles of association</p>	<p><b>Recommendation 1.3:</b> Adopt incorporation templates of public benefit, stakeholder participation and privileged shareholder models</p> <p><b>Recommendation 1.4:</b> Certification process created to assess companies' delivery of purpose</p>	<p><b>Recommendation 1.5:</b> Review and reform system to ensure neutrality between incorporation and governance choices</p>
		<p><b>Recommendation 2.1:</b> Overhaul company reporting to ensure proper valuation of long term value and Intangible assets</p> <p><b>Recommendation 2.2:</b> Improvement of national measures and national valuation mechanisms of intangibles</p>	
Purposeful Reporting	<p><b>Recommendation 3.1:</b> Investment Management companies to declare and report on purpose</p> <p><b>Recommendation 3.2:</b> Improved framework for describing purpose at fund and mandate level through clear investment objectives and reporting measures:</p>	<p><b>Recommendation 3.3:</b> Tougher stewardship rules, strengthen stewardship quality assessment and promote engagement activity</p>	
Purposeful Capital	<p><b>Recommendation 4.1:</b> Relax disclosure requirements for block formation</p> <p><b>Recommendation 4.3:</b> Clarify types of information that can be shared between companies and investors</p>	<p><b>Recommendation 4.2:</b> By developing protocols for structured access, work towards 'safe harbours' for confidential information sharing</p> <p><b>Recommendation 4.4:</b> Only blockholders to vote with borrowed stock</p>	
	<p><b>Recommendation 5.2:</b> Newly formed collective investment vehicles to lead on stewardship</p> <p><b>Recommendation 5.3:</b> Creation of local crowd funding models</p> <p><b>Recommendation 5.4:</b> Expand mandate of Business Growth Fund and British Business Bank</p>	<p><b>Recommendation 5.1:</b> DC pension funds to adopt default allocation of a percentage of assets for UK purposeful investment, creating potential pool of £100bn by 2030</p> <p><b>Recommendation 5.4:</b> Develop purposeful investment bonds for issuance by Business Growth Fund and British Business Bank</p>	<p><b>Recommendation 5.5:</b> Consult on possible creation of UK Investment Fund</p>
Purposeful Pay	<p><b>Recommendation 6.2:</b> Strengthen pay accountability through remuneration committee accountability for overseeing pay fairness, publication of a fair pay report, and establishment of employee engagement mechanisms</p> <p><b>Recommendation 6.3:</b> Greater transparency and simpler exposition of executive pay and performance</p>	<p><b>Recommendation 6.1:</b> Companies to adopt simpler pay structures for CEOs based on long-term (5-7 year) equity and debt holdings</p> <p><b>Recommendation 6.4:</b> Enhanced binding vote regime based on an escalation mechanism to focus on repeat offenders</p>	

## **Section 4 – Policy Recommendations**

### **1. Company Law and Reporting**

#### **1.1. Introduction**

The law plays a central role in the purposeful company. Purpose should be the driver of corporate activity – its ownership, governance, management, activities and performance. The role of company law, therefore, is to promote corporate purposes and facilitate the adoption of different purposes by companies.

The subsection begins in 1.2 by proposing that boards of directors must consider and report on how they deliver on their purposes and the implications of this for the long-term success of the company, including investors, employees, customers, suppliers, and society. This is critical to ensuring that all companies meet minimum standards of acceptable conduct and practices. But companies should also be able to go well beyond these minimum standards.

Next, 1.3 suggests that companies should incorporate around their purposes and 1.4 describes three models from which companies can choose their structures to promote their purposes. These models provide firms with the basis on which companies can commit to their purposes around public as well as private benefits, governance and ownership arrangements that promote the interests of their employees and other stakeholders. They also provide and ownership structures that are conducive to companies' long-term development at the same time as the interests of minority shareholder interests, which would be strengthened.

In addition, key to the credibility of these choices around corporate form and the implication for the parties to the firm is certification. This is discussed in 1.5.

Finally, while the emphasis is on the law as an enabling device for the adoption of corporate forms that are conducive to purpose, 1.6 argues that care is required to ensure that the law and regulation are not inimical to purpose. This can arise from there being prescriptive rather than enabling law and regulation, thereby impeding the adoption of appropriate corporate form. The emphasis here is on enabling companies to choose structures that are suited to their purposes, not imposing rules and regulations that restrict them. Several examples of how in practice this occurs are described below.

## 1.2. Reporting

Companies should provide high quality disclosure on how their directors consider the interests of investors, employees, customers, suppliers, and society when making decisions to deliver long-term success for their company. It is incumbent on boards and directors to be able to describe how their decisions consider the long-term success of the company. It is the disclosure of how this duty is fulfilled that should be used to 'enforce' the duty to promote long-term success. Such reporting could be included in the strategic report that forms part of a company's annual report and therefore be subject to review of auditors to ensure that the statements are not materially incorrect.

In its submission to the UK government's review of corporate governance, the FRC recommends that:

'There is scope to improve the way in which s172 operates. This could be achieved through more focused reporting on the elements of s172 to which directors should have regard in order to focus boards on their responsibilities in this area and how they have satisfied themselves on the effectiveness of risk management and controls. Such disclosure should be supplemented by reporting about related issues which are of key importance to shareholders and wider stakeholders, such as how the company allocates funds between pensions, dividends, directors' remuneration, investment and capital investment. This could be achieved through additional principles and provisions in the UK Corporate Governance Code which provide for disclosure in companies' annual reports and related changes to the FRC's Strategic Report Guidance... A future review of the UK Corporate Governance Code should examine whether the disclosures relating to board communication should be strengthened in order that shareholders and wider stakeholders might scrutinize them and challenge more effectively where necessary... The FRC is currently assessing the way in which it monitors the quality of UK Corporate Governance Code reporting, including the option of more direct contact with companies where explanations are not adequate, and publicising good and poor practice (FRC, Response to Select Committee consultation on Corporate Governance, 2016)

We concur with the recommendations of the FRC and suggest that in addition directors should be required to demonstrate how they satisfy the Fair Pay Report (see Subsection 4.6 on Executive Remuneration). We also support the FRC's proposals around enforcement. The FRC's evidence to the government's Select Committee on Corporate Governance in 2016 states:

'...The UK's corporate governance framework promotes the role of directors and shareholders to scrutinize and ensure that their companies are being led and managed to achieve success. Nevertheless, there is a need to encourage transparency and accountability to a wider range of stakeholders in order to promote

sustainable growth and help UK businesses to regain public trust.

While guidance and the role of professional bodies play an important part in holding directors to account there exists a complex regulatory framework under which a wide range of corporate investigations take place... This has the capacity to delay and dilute effective enforcement against misconduct'.<sup>1</sup>

The FRC, therefore, recommends that, '...the Government reviews the enforcement framework in order to establish an effective mechanism for holding directors and others in senior positions to account when they fail in their responsibilities'.

***Recommendation 1.1: Report on purpose outcomes***

***Directors must consider and report on how they fulfil their obligations under subsection 172(1) to 'have regard' to all stakeholders. They should also report on how they satisfy the standards of the Fair Pay Report, outlined in Subsection 4.6 on Executive Remuneration. The government should review the enforcement framework to ensure that companies are being led and managed to achieve success. .***

### **1.3. Incorporating Around Purpose**

Purpose should lie at the heart of incorporation of companies. This is a proposal to achieve that within the context of the existing UK legal framework. Companies should be required clearly to articulate their purpose in their articles of association and should be able but not required to adopt models of corporate form that allow them to go further in committing to particular classes of stakeholders and shareholders.

The background to this proposal is subsection 172(1) of the Companies Act 2006, which is sometimes described as being based on the principle of 'enlightened shareholder value'. The subsection states that:

'a director of a company must act in the way he considers, 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,

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<sup>1</sup> Financial Reporting Council. (2016). FRC Response to the BEIS Select Committee Corporate Governance Inquiry. Retrieved from <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/FRC-Response-to-the-BEIS-Select-Committee-Corporat.pdf>

- 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 other words, the purpose of a company is to act in the interests of the company for the benefit of its members (its shareholders) and in so doing to consider the long-term interests of its stakeholders' interests as well as its members. We believe that these are the right areas of focus for a director, but there are legitimate concerns about what can be expected under the description of having 'regard' to the broader aspects. We believe that it is appropriate for directors to consider and report on how they achieve these additional aspects and we return to this below.

Subsection 172(2) of the Act goes on to state that 'where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, subsection (1) has effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes.' In other words, companies can have purposes that go beyond those of the interests of its members and promote the success of the company through achievement of these purposes. As the explanatory notes to the Act explain:

'Subsection (2) addresses the question of altruistic, or partly altruistic, companies.. ...it is possible for any company to have 'unselfish' objectives which prevail over the 'selfish' interests of members. Where the purpose of the company is something other than the benefit of its members, the directors must act in the way they consider, in good faith, would be most likely to achieve that purpose. It is a matter for the good faith judgment of the director as to what those purposes are, and, where the company is partially for the benefit of its members and partly for other purposes, the extent to which those other purposes apply in place of the benefit of the members.' (Subsection 172(2) Companies Act 2006).

So subsection 172(2) permits considerable flexibility in the purposes of the company. They can extend beyond pure financial considerations to include altruistic or social and public as well as private benefits. However, to date, companies have not taken advantage of this to any measurable extent.

We propose that:

### **Recommendation 1.2: Purpose incorporation**

***The articles of association are to be amended to require companies to make clear and precise statements of their purposes in their articles. There will be a transition period of five years until 2022 during which existing companies will be able to incorporate around purposes; new business will be expected to incorporate around purposes from the outset.***

## **1.4. Model Companies**

Companies that want to go further can use one of three alternative corporate forms. This would enable them to raise external capital but operate in a fully purposeful manner where risks and costs are not externalised at the expense of environmental, societal and human capitals. This voluntary process could lead to a virtuous cycle where workers, customers and communities favour such entities because of their commitment to building shared value. This will inevitably lead to a 'push' factor in the market with more companies adopting governance that is better matched with their purpose in order to remain competitive in the labour, capital, product and service markets.

The three models of Corporate Form listed below enable the promotion of public and social as well as commercial purposes, relevant stakeholders as well as shareholder interests and long-term shareholder engagement. They can be combined as appropriate in the achievement of a rich variety of company purposes:

1. Companies can adopt a **public benefit 'model'** that requires the purposes to include specific reference to environmental, public and social benefits. In so doing companies will be required to take account of the interests of relevant stakeholders as well as their members and to act 'fairly' between them. Such companies will be designated as *public benefit companies*, and be identified by the abbreviation '*pbcc*'.
2. Companies can, in addition, adopt two other models that facilitate the achievement of their corporate purposes by reinforcing the interests of certain classes of stakeholders and shareholders. The first is the **stakeholder participation model**. According to this, relevant stakeholders will be granted at least one of the following rights to:
  - Purchase a minimum proportion of the voting shares of a company.
  - Representation or election to a certain proportion of seats on the main board of their company.

- Representation on a council or oversight body of the company with designated levels of authority.
3. The second is the ***privileged shareholder model***. This will promote engaged ownership by, for instance:
- Granting specific privileges to certain classes of shareholders to, for example, nominate directors or gain access to 'structured' information.
  - Strengthening the rights of minority shareholders.
  - Issuing shares that promote engaged shareholding.
  - Imposing limitations on votes of certain shareholders, for example, those who have acquired shares during a takeover.
4. The implementation of the models:
- Will be subject to ratification by a specified majority (for example, supra majority) of members.
  - May be subject to sunset provisions that specify a date at which the company reverts to the default provision of Section 172(1).
  - May grant minority shareholders particular rights to, for example, nominate and elect members of the board and be informed about and approve transactions involving controlling shareholders.
  - Will allow companies to seek variations from or adopt any combinations of the three models subject to ratification by the members of the company.
5. It is for the listing authorities to determine how different forms of Company structures should be treated for inclusion on the London Stock Exchange. For example, some companies may choose to adopt forms of privileged shareholder model that strengthen the rights of minority shareholders and therefore their claims for inclusion as Premium Listed Companies. Others may enhance the rights of certain classes of shareholders without reinforcing protections given to minority shareholders, thereby making a Standard Listing more appropriate. One of the attractions of the model form is that it makes transparent the rights and approvals of different classes of shareholders and therefore the appropriateness of different classifications of listing. .
6. In respect of the public and social benefits conferred by public benefit companies and to promote adoption of this company form, pbcs may be subject to lower rates of corporation tax than other companies at least over a transition period and for larger

companies where the social benefits may be particularly significant.

7. Consideration should be given to whether particular classes of companies that have a public or social remit by virtue of their licence to operate, such as regulated utilities, banks, public sector providers and companies with significant market power should be required to adopt a public benefit, stakeholder participation and/or privileged shareholder model.

Examples of how firms might employ these models are:

- Strategically important companies that might adopt public benefit and privileged shareholder models to commit to a public remit and discourage hostile takeovers from deflecting them from it;
- Networking companies with significant market power that might combine a public benefit with privileged shareholders retaining their long-term strategic vision; and
- High-end consumer good companies with skilled labour forces that incorporate stakeholder participation in their governance.

This approach, therefore, encapsulates all of the features of proposed stakeholder and commitment mechanisms, including B Corps, in a flexible form that allows both large and small companies to tailor their structures to the delivery of their purposes. For instance, the strategically important companies referred to above could discourage outcomes of hostile takeovers being determined by short-term arbitrageurs, as was thought to have occurred in Kraft's acquisition of Cadbury, by adopting a privileged shareholder model that disenfranchises shareholders who purchase their shares after a bid has been launched. The model form allows for such arrangements without requiring the imposition of similar prescriptive regulation on all companies, including those for which it would have undesirable side effects.

***Recommendation 1.3: Introduce choices of corporate form that can be adopted by companies as appropriate to promote their corporate purposes. Companies should be able to adopt one or more of the provisions of public benefit, stakeholder participation and privileged shareholder models.***

## 1.5. Certification

Once purpose has been formally incorporated then the method for certification can be under the FRC UK Corporate Governance Code (applying to accounting periods beginning on or after 29 June 2010) which is set out on a 'comply or explain' basis.

The principles in the Code are that:

- Boards should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted (Code reference B.6.1);
- Board evaluations of FTSE 350 companies should be externally facilitated at least every 3 years, and any other connections between external consultants and the company disclosed (Code reference B.6.2); and
- Non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of the executive directors (Code reference B.6.3).

Performance evaluations have been in the Code for some time but the three yearly external facilitation element is a relatively new provision and one with which listed companies must comply or explain. We propose that our criteria for corporate purpose be explicitly included in the triennial external assessment of boards that are required under the provisions of the UK Corporate Governance Code and the results made publicly available.

We also recommend that boards of both listed and unlisted companies should be required to issue a public statement annually describing both how they have taken into account Section 172 of the Companies Act 2006 in the priorities set and the decisions taken and also the details of their Fair Pay Report. Requiring this of unlisted as well as listed companies helps to address concerns about the governance of private companies expressed in the Green Paper on Corporate Governance.

This is important and was underscored in January 2017 by the letter sent jointly to the Prime Minister by the Institute of Directors, the Trades Union Congress, the International Corporate Governance Network and the Institute for Company Secretaries. The purpose of the letter was to request that the government finds a way to police legal obligations that everyone agrees are good ones but can be breached with impunity. They acknowledged that it is certainly the role of the investor to act as an owner and provide stewardship but it is not the role of the investor to police the law. The signatories to the letter wrote:

'...Section 172 of the Companies Act...requires directors to promote the success of the company for the benefit of shareholders, and in so doing have regard for the interests of workers, consumers and other stakeholders. However, there is no

effective mechanism for policing this law, which means that if companies – particularly private companies where there is little or no institutional shareholder oversight – do abuse the law, they are not always held to account.... Filling that gap need not result in undue constraint, or costly legal action. In other walks of life, a regulator exists to whom the aggrieved can make a complaint, and have that complaint adjudicated. Establishing a similar regime for companies would deliver economic benefits, as well as greater fairness...<sup>2</sup>

We agree with the proposals in this letter and until the gap in governance has been addressed, the issuing of an annual public statement and the inclusion of purpose outcomes in the triennial external assessment of boards is the minimum action that can be taken.

For the three other models of corporate form, they are accompanied with compliance requirements and the need to self-certify or certify via a third party and report on both activity and outcomes or to audit and formally report.

A credible approach to self-certification will need detailed definitions of the components of 'purpose' and the criteria which will be used to help guide the alignment of 'purpose' with existing and more conventionally commercial statements of business strategy and performance objectives. There has been considerable work conducted on this topic and the [Interim Report](#) sets out the definitions and measures that should be used in some detail. Despite this, we believe that more work is still needed to translate these definitions and measures into a credible self-certification process, so we limit ourselves here to a description of the frameworks already available.

We note that the B Corporation model already contains a proven corporate certification methodology. This combines measurement of social and environmental performance with a governance vehicle (the Benefit Corporation form) and is particularly relevant to the public benefit model, but with some amendments could also be applied to stakeholder participation and privileged shareholder models as well as companies that adopt none of these models but are nevertheless required to specify their purpose in their articles of association.

'B Corps' were launched in September 2015 with 118 UK founding B Corps that have a combined revenue of close to £0.8 billion and represent 13 sectors. Globally there are now 2000 B Corps. Companies and other business entities that wish to become B Corps in the UK need to adopt governing documents that include a commitment to a 'triple bottom line' approach to business. This is likely to mean having an objects clause that states that it exists both to promote the success of the business for the benefit of its shareholders and to have a material positive impact on society and the environment. The governing documents of B Corps

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<sup>2</sup> Pitt-Watson, D. (January 29, 2017). 'Some stakeholders seem more equal than others'. The Financial Times. Retrieved from <https://www.ft.com/content/d103d90a-e3ee-11e6-9645-c9357a75844a>

have to state that the board members of the company considers a range of 'stakeholder interests' including shareholders, employees, suppliers, society and the environment when making decisions and, critically, that shareholder value is not an overriding consideration but one factor amongst the many stakeholder interests which board members need to take into account when running the business.

Other ratings systems are also available for the purposes of measuring impact, for example:

- Standard specific frameworks for industries or sectors: e.g. the SASB framework.
- Principles of Responsible Investment & Global Compact (UN PRI initiative and the Global Compact) are sources of reference for best practice in impact reporting given their broad scope.
- IRIS rating system, which is a library of common indicators which can be used to describe an organisation's social, environmental, and financial performance. IRIS provides a wide range of metrics for organisations in different industries to choose from and seeks to standardise the definition of commonly used indicators.
- B Impact Assessment and GIIRS fund rating system uses IRIS metrics in conjunction with additional criteria to come up with an overall company or fund-level rating, as well as targeted sub-ratings in the categories of governance, workers, community, environment, and socially and environmentally-focused business models. This is the assessment that certifies B Corporations.
- Global Reporting Initiative is the original standard based on sustainability to assess the impact of behaviour on say, climate change.

***Recommendation 1.4: Certify the delivery of purpose***

***Certification procedures should be developed along the lines of existing initiatives and companies should be certified as fulfilling the delivery of their purposes, having in place structures and systems to achieve those purposes and compliance with alternative models of corporate form that they have chosen to adopt.***

## 1.6. Regulatory Neutrality

Promoting purpose requires companies to be able to commit to it. Regulation should not prevent it and instead, company law should facilitate it. There are numerous commitment devices, such as poison pills, dual class shares, voting right restrictions, loyalty shares, and staggered boards available to companies in other countries. However, the evidence on these is at best mixed. There are as many studies that report that they are detrimental as beneficial.

This argues firmly against requiring companies to adopt certain structures. On the other hand, it suggests that they should not be prevented from implementing them where they are beneficial to the delivery of their purposes. Unless there are compelling arguments to the contrary, regulation and the law should be neutral in not biasing the ownership and governance of firms. Listing, takeover, board rotation and rights issue rules should be scrutinized to ensure that they do not discourage firms from committing to their purposes through preventing companies from adopting share structures, takeover defences, board tenure and equity raising that may in some cases be justified and critical to the fulfilment of their purposes.

In this report we identify several examples of non-neutrality and in some cases suggest that responses are required to address them. In particular in Subsection 4 on Blockholding, we describe how the existing disclosure requirements may deter investors from taking large stakes. We suggest remedial responses to address the distortions.

As an illustration, it was suggested under the privileged shareholder model that one provision companies may choose to adopt is to disenfranchise shareholders who purchase shares during a takeover period. This provision stands in contrast to similar regulatory rules. The attraction of the former over the latter is that it allows companies that believe such provisions to be beneficial to the delivery of their purpose to introduce them, while not foisting them on other companies that do not. Purposeful companies require long-term stewardship and given that a change of control is a huge event for any company there should be provision for takeovers to be approved only by those with the company's long term interests at heart. The law needs to be changed, and the Takeover Code suitably amended, to enable companies to choose if they want to apply takeover restraints to restrict merger arbitrageurs. This would mean that shares acquired in the target company during an offer period (from the announcement of a possible bid to completion) would not carry voting rights.

To the extent that regulation and the law need to be prescriptive rather than enabling, they should be focused on function rather than institutional form. For example, rules relating to pension funds and life insurance companies, such as the statutory funding objective and Solvency II, have discouraged institutional holdings of equity. Stock exchange listing rules do not allow UK premium listed firms to issue dual class shares and rules regarding the annual election of directors prevent firms from adopting staggered boards. These may have had damaging effects on some companies' ability to pursue their corporate purposes by diverting institutional investors from corporate equity to government securities, preventing firms from

attracting and retaining engaged shareholders, and undermining continuity of their corporate boards. Instead, better protection to investors may come from enhanced minority rights in companies with dual class structures and staggered boards.

There should be a plurality of purposes and companies should be able to adopt diverse forms to deliver on them. Harmonizing on particular stakeholder models is as potentially damaging to corporate purposes as shareholder primacy. Legislation should be enabling rather than prescriptive in promoting diversity. While the UK Companies Act 2006 is suitably enabling, a combination of regulation and convention militates against it, and legal processes are not conducive to companies adopting unfamiliar models.

***Recommendation 1.5: Scrutinise regulation to ensure neutrality***

***Existing rules regarding the regulation of corporate ownership and corporate governance should be scrutinized for whether they violate a principle of neutrality regarding the adoption of particular corporate structures. Preventative regulation should be functional rather than institutional in nature and should avoid distorting companies' choices of their organisational form.***

## 2. Accounting for Purpose

### 2.1. Policy Proposition

Traditional methods of reporting are now no longer enough for many leading companies if they are effectively to communicate their strategic intent and value to key stakeholders. In 1975, when the principles of modern corporate accounting were established, physical and financially accountable assets were the primary balance sheet components. In the past 30 years, tangible assets have reduced to comprise less than 50% of the true value of the average company, reflecting the new importance of knowledge, IP and data in company business models. Against the backdrop of these fundamental shifts in value creation, the IFRS has focused extensively on global standardisation but failed to address the changing shape of value. The absence of a pro-active intervention has resulted in multiple confusing initiatives in company law, sustainability reporting and strategic reporting. This has left many long-term investors with a series of proxies but little trusted information beyond the financial information. However, investors still rely on this value as a proxy for total value, driving increasingly short term behaviour. Investors, stakeholders and companies need a common language to articulate how both tangible and intangible assets are being used to create value. At a national level, we also need productivity measures to be re-defined properly to take intangibles into account.

Urgent reform is needed, and we call on the Chancellor of the Exchequer and the Secretary of State for Business, Energy and Industrial Strategy to investigate this with all relevant parties and propose a way forward as part of the White Paper on Industrial Strategy. **Company reporting should be overhauled so that intangible assets – including purpose – are properly valued, at both a company and national level supported by better mechanisms to value intangibles objectively. This will increase both companies’ incentives to invest and transparency around the issues that matter to investors, employees, customers, suppliers, and society. Such a solution should be piloted alongside existing accounting standards but with the ultimate aim of replacing them.**

### 2.2. Problem Definition

Physical assets – such as inventory, accounts receivable or plant and machinery – are prominently captured on corporate balance sheets, but many of the value creating resources are largely absent. Brands, IT, unique business processes, differentiating capabilities and skills or patents and big data are inadequately captured. In addition, for established enterprises, important operating indicators such as increases in customer ‘churn rates’, R&D pipeline effectiveness and customer and employee promoter scores are not routinely reported

to investors even where they are strategically important. Current accounting protocols and standards and the reporting on them are therefore part of the weakening of trust between investors, companies and society at large since the information stakeholders want is either not easily available or straightforward to validate and benchmark.

Lack of knowledge of the more intangible aspects of organisations' business models and their impact on product quality, business processes and general economic dynamism is pervasive in British business. Reported productivity and business performance measures are at best not embracing this new economy, and at worst are rapidly losing relevance. The debate on whether current accounting and reporting should recognise intangibles has been raging for more than 30 years, and it is clear that plans to change this remain elusive. Progress is made harder because the processes and mechanisms for the better valuation of intangibles are poor, resting on subjective assessments and few transparent benchmarks.

Given the amount of innovation still required in this area, the recommendations in this report remain at a high level. The government will need to commission open source research to develop solutions given the poor progress that has been made to date. But there is reason for hope. We feature in this paper the work of the UK government's Natural Capital Committee who are already piloting a system of corporate natural capital accounting, offering confidence that a different approach to accounting is possible. HM Treasury has also earmarked funds within its National Productivity Investment Fund for further research into the causes of the weakening growth of UK productivity. There is substantial evidence that existing productivity measurements are not capturing the impact of intangibles, which needs to be fully understood and addressed.

### **2.3. Modernising Reporting Methodologies – Learning Lessons**

Attempts have been made to solve the problem, but they have not resulted in a comprehensive solution, which is why action is now needed as part of the government's commitment to an industrial strategy. The Prime Minister has called for a 'grand bargain' between business and the public, and more transparent reporting of value created for relevant stakeholders is a critical pre-requisite to this.

There is growing agreement that traditional accounting and reporting methodologies, largely unchanged in their core principles since the industrial revolution and post-war assembly line paradigm, are no longer fit for purpose. There is an urgent need to create better protocols for assessing and reporting company value to a wide range of stakeholders.

Attempts to solve the problem to date have been through three broad approaches:

## 1. Additional reporting

Attempts such as Integrated Reporting and Sustainability Reporting have sought to solve the problem via new reporting frameworks. These initiatives have made a positive contribution but lack a consistent approach and are not meeting the needs of investors. As a result, there has not been widespread adoption of these approaches with many organisations viewing them as exacerbating the problem of voluminous and complex financial reporting.

Where there has been progress is in the area of natural capital. The UK government's Natural Capital Committee is piloting a system of natural capital accounting that reflects both the costs that companies impose in terms of remedying and restoring detriments to natural capital and the benefits they confer by enhancing it. It is structured to replicate traditional financial reporting so that it is familiar to both boards and investors. It has already been picked up by several companies and organisations and it is also consistent with the approach that the Office for National Statistics is following in producing UK natural capital accounts.

### 1. Creation of metrics/KPIs

New metrics and KPIs produced by initiatives such as the Dow Jones Sustainability Index have enabled organisations to communicate useful information to stakeholders and allow for them to be assessed on a wider range of measurements. As we also made clear in the [Interim Report](#), the Sustainability Accounting Standards Board (SASB) in the US is developing standards to help companies disclose factors that are material to stakeholders by sector in compliance with SEC requirements. Specifically, *'...central to this work is the creation of materiality maps that use a range of sustainability criteria to rank their materiality for any given industry. Maps now exist for 80 industries in 10 sectors and each goes through a rigorous process of internal staff research, industry working group and public consultation. As of February 2015, 2,360 experts representing \$23 trillion in AuM and \$9.8 trillion in company market capitalisation had participated in this process'*.<sup>3</sup>

This makes it clear that **there is not one set of generic metrics to assess the purposefulness of a company**. Rather, it is important that metrics are developed that reflect the organisations' chosen purpose and then enable reporting on outcomes in a way that identifies the most important issues for stakeholders, the business and its critics. They are also important internally for the companies themselves given that long term investment decisions need metrics that look at long-term as well as short-term business health. Metrics such as 10-year economic value added, R&D efficiency and multi-year assessments of returns on capital investments and environmental impact assessments may well be important. What is key is that companies, asset owners and asset managers make clear decisions on what to

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<sup>3</sup> The Purposeful Company Interim Report. (2016). Big Innovation Centre, pp. 35. Retrieved from [http://www.biginnovationcentre.com/media/uploads/pdf/ThePurposefulCompany\\_InterimReport.pdf](http://www.biginnovationcentre.com/media/uploads/pdf/ThePurposefulCompany_InterimReport.pdf)

measure.

Some leading companies are already experimenting with how to do this and a review of Annual Reports and Accounts demonstrates progress. For example, at SAP they state that they have sought to ‘...create a framework to establish concrete links between non-financial and financial performance.’ Particularly, the company took their efforts further and ‘determined how four social and environmental indicators – our Business Health Culture Index (BHCI), employee engagement, retention and emissions – impact SAP’s operating profit’. Their results were striking as they ‘offer hard data showing how an integrated strategy not only mitigates our environmental impact and enhances the wellbeing of employees but also boosts our business success... We act on this data both within SAP and our broader system of customers and partners. We are transparent in our methodology in the hopes of inspiring other companies... and we will use our results to evolve our own strategy and invest in tangible steps to create positive economic, social and environmental change’.<sup>4</sup>

It is clear, however, that there is a very long way to go before these types of purposeful metrics have become a requirement of the way that business is done in the UK. Nonetheless, the possibility created by them is further evidence of the increasing lack of relevance of existing financial accounting.

## **2. Collaboration and discussion**

Bringing together organisations and asset managers through initiatives such as the Coalition for Inclusive Capitalism and Focussing Capital on the Long Term has raised awareness of the issue and the need for organisations to report to a wider range of stakeholders. Whilst the discussion on this has been informative, the approach again has not resolved the fundamental problem of the growing lack of importance of financial reports.

Protocols that are developed need to map onto current accounting practices – and emerging reforms within the profession - so that the reporting framework is genuinely useful to companies in identifying their strategic assets and reporting on their use to their chief stakeholders such as investors, employees, customers, suppliers, and society. Current accounting largely focuses on financial and manufactured resources, but this needs to be broadened.

For instance, EY has consulted extensively over the past two years with academics, regulators, fund managers, business leaders and representatives of the Big Innovation Centre.

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<sup>4</sup> SAP 2015 Integrated Report Sustainability Content. (2015). ‘Integrated Performance Analysis: A holistic view of our performance’, pp. 37. Retrieved from <http://www.sap.com/docs/download/integrated-reports/2015/sap-2015-integrated-report-sustainability-content.pdf>

The consultation has identified six key requirements for purposeful reporting:

- a. The entity should be **clear about its purpose, strategy and business model** and this should be reflected in the reporting. In addition, the purpose of the organisation should be clear about the weighting of different stakeholder interests. This is important to facilitate the presentation of outcomes in accordance to the weighting for each stakeholder group;
- b. The information provided must be **material to the stakeholders**. One consistent criticism of alternative reporting methods is that it provided information that was overwhelming and of little interest to the important stakeholders;
- c. The information should contain an **assessment of contextual drivers** of the organisation. For example, for a pharmaceutical company, the prospect of 3D printing of medicine could have a significant impact on the current supply and distribution model. By providing an assessment of the likely impact of this trend and how the company plans to reallocate capitals over time will provide meaningful insight to material stakeholders.
- d. A **more complete view of value** should be presented. The way information is provided should shift the emphasis from inputs and activities to outcomes. The value created for each stakeholder through outcomes should be reported. This will be facilitated in large part through the use of advanced data and analytics;
- e. **It should be assured** to the same level of rigour as today's financial reporting. The biggest criticism of alternative reporting methods today from the investor and employee stakeholder groups is that the information is not assured and it is being used as a public relations exercise, rather than something that can be trusted; and
- f. **It should be simple to understand**. The current method of reporting is based on a push-model; it is not focused on the requirement of the user of the information. New technologies are widely used by social media providers to focus on the needs of the user of the information; the same should be done for corporate reporting.

Through this consultation process, they have developed a framework that focuses on the creation of **long term value** (LTV) and begins with identifying the organisation's purpose: the aspirational reason for being – what it is and why it exists. A clear purpose is needed in order for the organisation to identify its material stakeholders: who it creates value for, how important they are to the organisation achieving its purpose and, as a result, what outcomes the organisation needs to deliver in order to achieve its stated purpose.

The organisation's purpose and the way in which it generates value for its material stakeholders is influenced by the context in which it operates. The LTV framework allows organisations to rationalise and link their long term investment decisions to the current context

in which they operate, as well as the foreseeable changes in context, such as macroeconomic, technological and social trends. For further examples of the LTV framework, please refer to Appendix 1.

Once the organisation understands the outcomes required to achieve its purpose, it needs to develop a strategy to deliver those outcomes. This requires the identification of the critical assets necessary for effective delivery. These strategic assets are the combinations of resources and capabilities of the organisation that provide a sustainable competitive advantage. By understanding what strategic assets exist within the organisation, what needs to be developed and which ones need to be protected from internal or external threats, the organisation has a rational basis by which to allocate capital that is linked to purpose and stakeholder outcomes.

The outcomes created from the deployment of strategic assets are then measured from the material stakeholder's point of view, allowing the organisation to report on how they are creating value for them in line with their stated purpose. This feedback loop would enable the organisation to periodically adjust its strategy to deliver the required stakeholder outcomes, if necessary.

As part of this work to define and test protocols, the OECD framework defining intangible assets will need to be taken into account. This framework extends the input capitals into intellectual (computerised information and innovative property) and human (economic competences). There are early templates for how companies might extend their reporting of strategic assets, but so far little work has been undertaken into how it connects with better reporting of intangibles in the OECD's terms. This is important not only for intangible reporting, but also for a more broadly based attempt to better account for and use intangibles across the board – in national accounts, productivity, and the development of the trading and exploitation of IP. The OECD principles for intangibles accounting to avoid the danger of tax avoidance and evasion agreed in its base erosion and profits initiative (BEPs) will also need to be observed.

## **2.4. Emerging Needs of the Digital Economy**

In addition to overhauling how companies report on long term value to their stakeholders there is clearly also a need to address the issue of how to properly value Intellectual Property (IP) as identified in our [Interim Report](#). At present, IP is valued by specialist IP agencies and practitioners which results in subjective valuations that do not enable comparisons or independent validation. In the next phase of The Purposeful Company work, we will be exploring what is the most effective way for the government to pilot methods for the objective valuing of IP and for the creation of new markets for the trading of IP (One proto-type in development, for example, is the Big Innovation Centre's [www.IPExchange.global](http://www.IPExchange.global)).

Addressing this will then open up new possibilities for the UK in IP services, in particular insuring and underwriting IP so providers of finance can be more confident in the use of IP as financial collateral – thereby helping to plug the financing gap many IP intensive businesses suffer.

A further challenge to the development of purposeful companies is the revolution in the volume and new usefulness of personal and business data. This throws up additional questions, which the Task Force has started to explore, around how purposefulness is expressed in the ways that data is deployed. One estimate by the consultancy BCG is that applications created with personal data have the potential to generate as much as €1 trillion of value in Europe annually by 2020, with a third of the total flowing to private and public organisations and two thirds accruing to consumers. But for this value to be unlocked, consumers need to feel comfortable about sharing their personal information. Companies already need to address issues of conflict of interest, privacy and ethical issues and there will need to be proper redress when problems, transgressions or grievances arise.

Our expectation is that the UK will need to develop a Data Charter to codify the usage of personal and business data on the basis that it is presumed to belong to its owners, setting out the principles for data governance, fair use and redress for grievances. This Charter will need to incorporate the EU Data Protection legislation, with its important advances in transparency and protocols for the use of data. Our recommendations for a way forward on both the valuing of IP and the Data Charter will come from the next phase of The Purposeful Company Task Force's work.

## **2.5. Recommendations**

The technical issues surrounding intangibles are profound – including definition, treatment as a capital or revenue expense and if a capital item what an appropriate depreciation rate might be. Both the international accounting standards board and the FRC have in recent months been grappling with the accounting issues raised by intangibles. What is therefore required is enormous – technical, methodological and regulatory. To make any progress we propose:

### ***Recommendation 2.1: Accounting and reporting methodologies should be modernised***

The Chancellor of the Exchequer and the Secretary of State for Business, Energy and Industrial Strategy should investigate solutions with all relevant parties and propose a way forward as part of the White Paper on Industrial Strategy. Company reporting should be overhauled so that intangible assets – including purpose – are properly valued, at both a company and national level. This will increase both companies' incentives to invest and transparency around the issues that matter to investors, employees, customers, suppliers, and society. Such a solution should be piloted in parallel with current standards, but ultimately

should replace them.

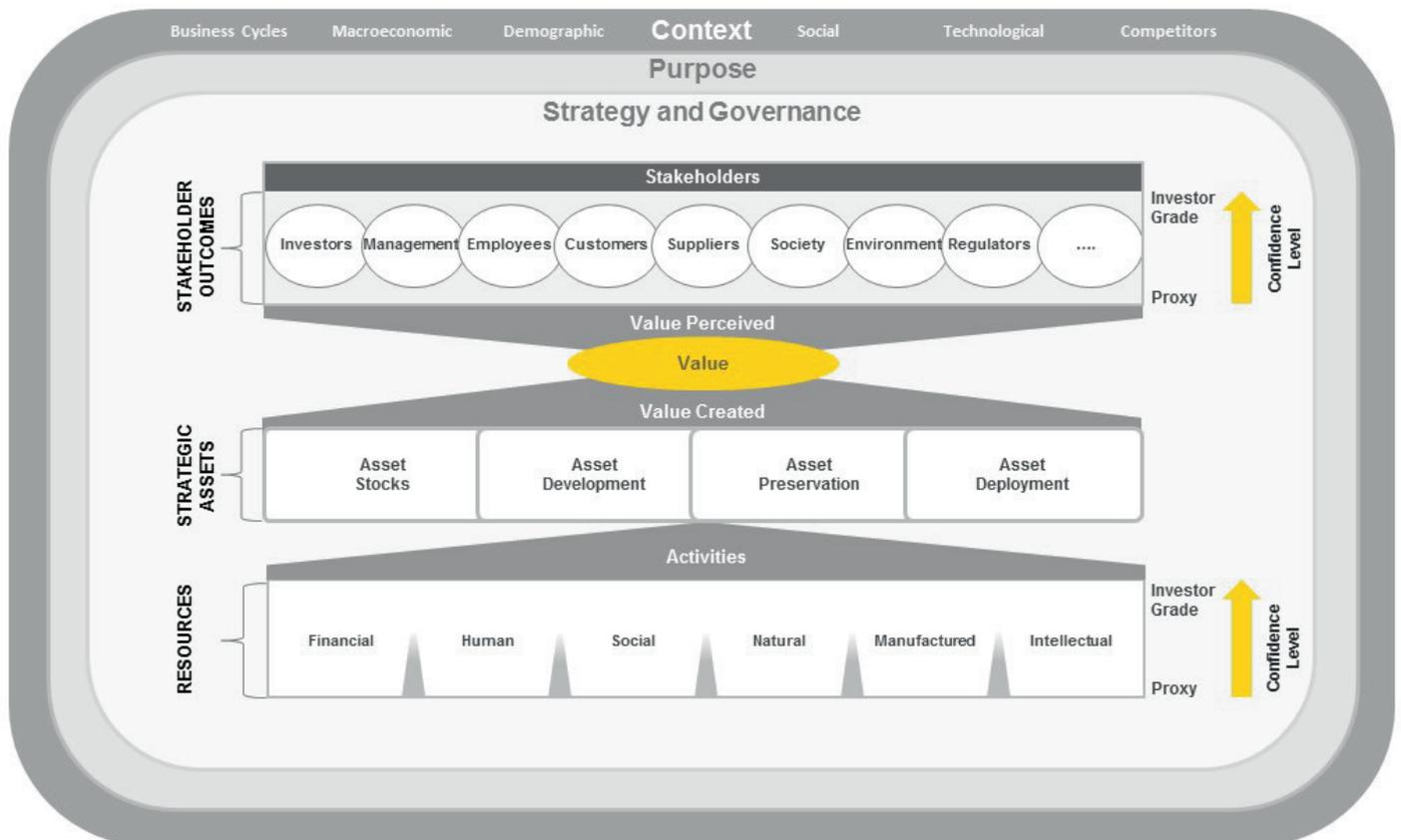
***Recommendation 2.2: Intangible assets should be properly valued and nationally reported***

- The government should reform national income accounting, including improved measures of productivity and measures to create a better functioning market in IP.
- The ONS and Companies House should lead on the creating of national standards for the reporting of intangibles and publication of national statistics on intangibles.
- The government and FRC should work together to create a roadmap and timetable for requiring companies to report on their intangible assets publicly and to both Companies House and the Office for National Statistics.

## Appendix 1: A Worked Example from the EY Long-Term Value Model

The model that EY has developed and tested with different stakeholders meets the criteria identified by investors and employees:

Figure 4.2.1. Example of EY's long-term value model



**The reporting model requires an organisation to be clear about its purpose in a way that other stakeholders can understand it and the implications for those stakeholders:**

- The model identifies companies' respective purposes and their respective stakeholder groups. Their respective purposes determine the importance of their stakeholder groups (their materiality) and, therefore, which outcomes are material to them given the context in which they operate; and
- Using the six categories of purpose, as laid out by the Big Innovation Centre, we can start to gain an understanding of respective purposes.

**Figure 4.2.2. EY long-term value model: purpose, definition, examples, values**

Purpose	Definition	Examples	Values
Universalisation	To allow everyone to experience what the few have	Google, Kingfisher, Tata	Fairness, Equality
Innovation	To go where no one has gone before	Pharma B, Samsung, Tesla Motors	Pioneering spirit
Excellence	To strive for perfection in one's art	Apple, Bang & Olufsen, BMW	Achievement, Drive
Fresh Challenge	To challenge complacency and the 'big guys'	Ovo Energy, Uber, Under Armour	Underdog empathy
Global Responsibility	To do business in a way that is sustainable and ethical	Pharma A, Centrica, Nestlé	Community spirit
Human Values	To do business in a way which recognises the humanity of employees, suppliers and customers	John Lewis, Lush, Starbucks	Human concern

**A company does not exist in a vacuum; many decisions are impacted by the context of the organisation.**

- Organisations must respond to trends, such as macroeconomic, environmental, social, technological and political trends, in order to produce the outcomes required by the material stakeholders in the future;
- To respond to the predicted market trends and meet the expectations of its material stakeholders, an organisation must invest in its strategic assets today;
- The LTV model allows organisations to communicate and rationalise their long-term investment decisions in the strategic assets; and
- This will improve the ability of business leaders to effectively communicate their strategy for building and sustaining a long term competitive advantage.

**The new model of reporting should reflect the strategic assets, stakeholders and the outcomes that are generated for those stakeholders.**

- Once the organisation has identified the outcomes which its material stakeholders desire, management can invest in the strategic assets required to deliver these outcomes;
- Strategic assets identified can be validated using tools already available in the market, for example:
  - i. Events Analysis is one validation tool to identify investor priorities by linking market events to share prices movements;
  - ii. LinkedIn Global Trends report and data from Glassdoor are tools used to identify employee strategic resource priorities; and
  - iii. Supply Chain risk assessment tools used to identify areas for the organisation to focus their priorities on.

**Separate reports will be created to show the value added by the organisation from each material stakeholder's perspective:**

EY have created a multi-stakeholder reporting system in collaboration with Professor Baruch Lev. The report will show:

- **Strategic Assets:** A stockpile of the organisation's strategic assets;
- **Asset Investments:** How the organisation is investing in their strategic assets to meet the expectations of its material stakeholders and adapt to the context in which it operates;
- **Asset Preservation:** How the organisation is preserving its strategic assets to sustain its competitive advantage;
- **Asset Deployment:** How the organisation is deploying its strategic assets to create value;
- **Value Created:** The value created by the organisation throughout the period;
- **Value Perceived:** The value created by the organisation as perceived from the point of view of the material stakeholder.
- The boxes within the report represent quantitative information and the circles within the report represent qualitative information.

Figure 4.2.3. Example of an investor view report for a pharma company

STRATEGIC ASSETS	ASSET INVESTMENTS	ASSET PRESERVATION	ASSET DEPLOYMENT	VALUE CREATED	VALUE PERCEIVED																																										
<b>Employee Workforce</b> <ul style="list-style-type: none"> <li>Qualifications per employee</li> <li>Publications/citations per employee</li> <li>Alignment between salesforce and product pipeline</li> </ul>	<b>Innovation</b> <ul style="list-style-type: none"> <li>Internal R&amp;D (£B)                             <table border="1"> <tr><td>"R"</td><td>2.4</td><td>2.3</td></tr> <tr><td>"D"</td><td>0.7</td><td>0.8</td></tr> </table> </li> <li>Acquired R&amp;D, patents and in-line products (£B)                             <table border="1"> <tr><td></td><td>0.4</td><td>0.3</td></tr> </table> </li> <li>Strategic partnerships</li> </ul>	"R"	2.4	2.3	"D"	0.7	0.8		0.4	0.3	<b>Employee Behaviour</b> <ul style="list-style-type: none"> <li>Satisfaction with training                             <table border="1"> <tr><td></td><td>85%</td><td>72%</td></tr> </table> </li> <li>Employees hired (% workforce)                             <table border="1"> <tr><td></td><td>0.9</td><td>1.0</td></tr> </table> </li> <li>Attrition (% workforce)                             <table border="1"> <tr><td></td><td>(1.2)</td><td>(0.5)</td></tr> </table> </li> </ul>		85%	72%		0.9	1.0		(1.2)	(0.5)	<b>Revenues (£B)</b> <ul style="list-style-type: none"> <li>by business:                             <table border="1"> <tr><td>Vaccines</td><td>14.2</td><td>15.4</td></tr> <tr><td>Pharmaceuticals</td><td>11.8</td><td>14.0</td></tr> <tr><td>Consumer Healthcare</td><td>6.0</td><td>4.3</td></tr> </table> </li> </ul>	Vaccines	14.2	15.4	Pharmaceuticals	11.8	14.0	Consumer Healthcare	6.0	4.3	<b>Value Created in Period (£M)</b> <ul style="list-style-type: none"> <li>Cash from Operations                             <table border="1"> <tr><td></td><td>4,631</td><td>6,284</td></tr> </table> </li> <li>Plus:                             <ul style="list-style-type: none"> <li>Investments in income statement                                     <table border="1"> <tr><td></td><td>300</td><td>280</td></tr> </table> </li> </ul> </li> <li>Minus:                             <ul style="list-style-type: none"> <li>Capital expenditures                                     <table border="1"> <tr><td></td><td>(3,000)</td><td>(2,800)</td></tr> </table> </li> </ul> </li> <li>Minus:                             <ul style="list-style-type: none"> <li>Cost of equity capital                                     <table border="1"> <tr><td></td><td>(600)</td><td>(600)</td></tr> </table> </li> </ul> </li> <li>Equal:                             <ul style="list-style-type: none"> <li>Periodic value created                                     <table border="1"> <tr><td></td><td>1,331</td><td>3,164</td></tr> </table> </li> </ul> </li> </ul>		4,631	6,284		300	280		(3,000)	(2,800)		(600)	(600)		1,331	3,164	<b>Outcome created in the period</b> <ul style="list-style-type: none"> <li>Sustainable sales growth</li> <li>Market share growth</li> </ul>
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<b>Clinical Trials and Approvals Expertise</b>	<b>Human Resources</b> <ul style="list-style-type: none"> <li>Technical training (£M)                             <table border="1"> <tr><td></td><td>250</td><td>200</td></tr> </table> </li> <li>Ethics training (£M)                             <table border="1"> <tr><td></td><td>50</td><td>10</td></tr> </table> </li> </ul>		250	200		50	10	<b>Customer Demand (£)</b> <ul style="list-style-type: none"> <li>Public education                             <table border="1"> <tr><td></td><td>50</td><td>45</td></tr> </table> </li> <li>Joint Government initiatives                             <table border="1"> <tr><td></td><td>150</td><td>130</td></tr> </table> </li> <li>Sales &amp; marketing                             <table border="1"> <tr><td></td><td>400</td><td>370</td></tr> </table> </li> </ul>		50	45		150	130		400	370	<b>Customer Network</b> <ul style="list-style-type: none"> <li>Change in prescriptions                             <table border="1"> <tr><td>Specialist drugs</td><td>-34</td><td>-5</td></tr> <tr><td>Generic drugs</td><td>+103</td><td>+23</td></tr> </table> </li> <li>Net strategic alliances (gained/lost)                             <table border="1"> <tr><td></td><td>+10</td><td>-1</td></tr> </table> </li> <li>Customer intimacy metrics</li> </ul>	Specialist drugs	-34	-5	Generic drugs	+103	+23		+10	-1		<b>Strategic Capabilities</b> <ul style="list-style-type: none"> <li>Governance index                             <table border="1"> <tr><td></td><td>0.91</td><td>0.87</td></tr> </table> </li> <li>New drug contribution to pipeline                             <table border="1"> <tr><td></td><td>6%</td><td>4%</td></tr> </table> </li> <li>Workforce churn                             <table border="1"> <tr><td></td><td>10%</td><td>7%</td></tr> </table> </li> <li>JV revenue contribution                             <table border="1"> <tr><td></td><td>12%</td><td>9%</td></tr> </table> </li> </ul>		0.91	0.87		6%	4%		10%	7%		12%	9%						
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<b>Product Pipeline</b> <ul style="list-style-type: none"> <li>Products and stage of development</li> <li>Market share</li> </ul>	<b>Customers</b> <ul style="list-style-type: none"> <li>Sales &amp; marketing by product and geography</li> <li>Customer satisfaction indices</li> </ul>	<b>Pipeline Preservation</b> <ul style="list-style-type: none"> <li>Research facility investment (£M)                             <table border="1"> <tr><td></td><td>120</td><td>100</td></tr> </table> </li> <li>Engagement with regulators</li> <li>Patent Registrations</li> </ul>		120	100	<b>Pipeline Conversion</b> <ul style="list-style-type: none"> <li>Clinical trial success rate                             <table border="1"> <tr><td></td><td>70%</td><td>68%</td></tr> </table> </li> <li>FDA approval rate                             <table border="1"> <tr><td></td><td>95%</td><td>92%</td></tr> </table> </li> </ul>		70%	68%		95%	92%		<b>Material Stakeholder</b> <ul style="list-style-type: none"> <li>Customer trust index                             <table border="1"> <tr><td></td><td>0.95</td><td>0.89</td></tr> </table> </li> <li>Employee attractiveness score                             <table border="1"> <tr><td></td><td>80%</td><td>74%</td></tr> </table> </li> <li>Government trust index                             <table border="1"> <tr><td></td><td>84%</td><td>72%</td></tr> </table> </li> </ul>		0.95	0.89		80%	74%		84%	72%																								
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<b>Customer Loyalty</b> <ul style="list-style-type: none"> <li>Patient relationships</li> <li>Doctor relationships</li> <li>Market share</li> </ul>	<b>Other Investments</b> <ul style="list-style-type: none"> <li>Trademarks</li> <li>Production facilities</li> </ul>	<b>Major Lawsuits and Expected Regulatory Changes</b>	<b>Employees</b> <ul style="list-style-type: none"> <li>Change in engagement score</li> <li>Compliance exceptions                             <table border="1"> <tr><td></td><td>5,780</td><td>5,850</td></tr> </table> </li> </ul>		5,780	5,850																																									
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## 3. Repurposing the Investment Industry

### Introduction

Shareholders play a crucial role in supporting companies to embrace purpose and focus on long-term success. Shareholders with a long-term perspective can give companies the confidence and support to pursue actions for the long-term benefit of the company, even in the face of short-term pressures. In addition, committed and engaged shareholders can challenge management to pursue more effective long-term strategies, improve governance, and can promote the transformation of otherwise moribund businesses. In short, an effective, engaged investment industry is vital for purposeful companies to flourish.

However, with notable exceptions, the investment industry is currently poorly positioned to do this. Its heavily intermediated structure creates a transactional relationship between companies and their investors and between investors and their clients (i.e. savers). Competition for funds between asset managers, now the dominant intermediary, does not necessarily align with improved performance of companies in the wider economy.

The heart of this problem is that a fund manager's primary legal responsibility to their clients does not in all cases translate into strong stewardship. Different funds may have different stances on this depending on their proposition to clients, ranging from quant funds through index funds to active investors. On the one hand, client interest can be served by the availability of a range of investment products including those that may have no role for active stewardship. On the other hand, strong stewardship is a public good that benefits all market participants and the economy as a whole. Competition in the asset management industry is leading to reduced costs for investors. However, this is arguably proving more successful at minimising the slice of the pie that is consumed in charges than it has in enlarging the pie, through improved performance of UK companies as a whole

Our starting position is against a policy that imposes a blanket fiduciary responsibility for stewardship on asset management firms. This policy could have the unintended consequence of limiting client choice and increasing cost, while potentially leading only to increased levels of 'visible' rather than real stewardship. Nevertheless, policy should actively encourage the development of strong stewardship as a public good. If progress continues to be slow after a period of review of three years, more forceful action should be envisioned.

The FRC's Stewardship Code, introduced in 2010 following the Walker Report, intended to address the stewardship dimension of asset management firms' responsibilities. In many ways, this has been a success for voluntary code-based action. In their recent tiering exercise at the end of 2016, the FRC placed 88 asset managers in Tier 1 regarding their quality of

reporting on stewardship, up from 20 in their initial assessment<sup>5</sup>. Although a small proportion of UK asset managers by number, these firms represented 90% of assets under management by Investment Association (IA) members. According to the IA's annual survey<sup>6</sup>, this means that three quarters of the £6.9 trillion funds under management in the UK were being managed by Tier 1 Stewardship Code signatories.

The Investor Forum, established on the recommendation of the Kay Review<sup>7</sup>, has made a promising start. It has developed its Collective Engagement Framework (discussed in more detail in Subsection 4.4 on Blockholding) for facilitating collective engagements while retaining compliance with relevant laws and regulation<sup>8</sup> and facilitated seven engagement exercises. The fact that firms representing a large proportion of UK assets under management feel motivated to become signatories to the Stewardship Code and to support the Investor Forum suggests that there is a belief in the market in the value of stewardship for clients. This motivation gives cause for optimism that policies to improve stewardship can work with, rather than against, the grain of market sentiment.

However, the FRC's oversight is limited to reviewing policy statements rather than real engagement activity. There are concerns that engagement activity may shift from hidden to visible activity as asset managers seek to demonstrate stewardship externally. In addition, regulation is disjointed: while it is the FCA which requires asset managers to publish a statement of compliance with the Stewardship Code, it is the FRC which is the owner of the Code. As a result, the FRC has no meaningful scope for enforcement. The Investor Forum is still focused on the more extreme cases requiring engagement. In any case what is needed is to build on the still gathering momentum for asset managers to engage in stewardship themselves. Efforts to embed stewardship into day to day investment decision making need to be urgently accelerated, given the importance of the investment industry to supporting purposeful companies.

This subsection outlines several proposed changes intended to accelerate trends to better stewardship, give greater clarity of purpose to the investment industry, and ensure an alignment of interests along the length of the ownership chain. We suggest changes in the following areas:

- Orientation around purpose. Purpose should be placed at the heart of the investment management industry, as we are suggesting for companies, with a transformation of disclosure, pay, and governance arrangements to embed this. Purpose has relevance at the level of not only the asset manager and asset owner, but also at the level of the fund or mandate. Clarity of purpose, and the governance around purpose, will help

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<sup>5</sup> Financial Reporting Council (2017), 'Developments in Corporate Governance and Stewardship 2016'

<sup>6</sup> Investment Association (2016), 'Asset Management Survey 2015-16'

<sup>7</sup> The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report, July 2012

<sup>8</sup> The Investor Forum (2016), 'Review 2015-16'

hold fund managers accountable where strong stewardship is core to that purpose. This clarity will encourage firms to pursue a 'dual mandate' understanding their purpose as both to serve their clients direct interests and indirectly to create the public good of a growing economy, from which their clients also benefit, by stewarding vigorous purposeful firms.

- Embedding stewardship. Stewardship should be more strongly embedded as a core function of equity markets, which will include stronger stewardship obligations, disclosure, and scrutiny. The good early work on collective engagement by the Investor Forum should be nurtured and scaled. However, given the scale of the market shortfall on stewardship, more radical action, such as introducing a stewardship levy, may need to be considered if voluntary action does not show accelerated pace.
- Encouraging sources of purposeful capital. A range of policies is required to encourage the development of sources of capital – asset owners – who will act patiently with strong stewardship and encourage the growth of purposeful companies. We set out proposals in subsequent subsections, including work to encourage greater prevalence of larger independent block-holdings in companies. Merging subscale public sector pension funds would increase both their incentives and power to engage in stewardship. A UK Investment Fund should be considered to invest in purposeful SMEs. Finally, a review of biases in law and regulation favouring debt over equity financing should be undertaken to promote a reinvigoration and growth of UK equity markets, reversing the long-term decline in equity issuance.

## Orientation around Purpose

The Kay Review<sup>9</sup> highlighted the importance of trust and behaviour, beyond contractual commitments, in a highly intermediated industry such as the investment industry. Purpose provides the potential context for this trust and behaviour to flourish. Asset managers should have a clear purpose, just like the companies in which they are investing.

To support purposeful companies, we need engaged asset managers and asset owners conducting high quality stewardship. Acting in line with purpose does not necessarily equate to acting as strong stewards – as outlined above there are client propositions that may not emphasise stewardship. However, an asset manager focused on purpose is likely to develop clarity about its priorities and to embed governance, disclosure, and incentive approaches in

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<sup>9</sup> Kay, J. (2012). The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report. Retrieved from [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf)

support of these. Purpose in this context applies at both the asset manager level and at the mandate/fund level.

***Recommendation 3.1: Orientation around purpose at the asset manager level***

***The investment management industry should be encouraged to incorporate and report on purpose within the framework set out in this policy report. In particular, every asset manager should at least:***

- a) Set out a clear statement of its purpose. In line with the broader corporate sector, over time asset managers should be encouraged to declare purpose in their articles of association and have it independently certified each year.

The danger is that purpose becomes too generic: what is required is that fund managers set clearer and more specific fund objectives and a timeframe over which performance is to be assessed.

- b) Report annually on how the asset manager has acted to fulfil its Purpose over the year.
- c) Align executive pay practices with the principles outlined in Subsection 4.6 for companies, with appropriate use of deferral in own funds as well as equity for portfolio managers.

Orientation around purpose has the same benefits for the asset management industry as for companies generally, as set out in Subsections 4.1 and 4.2. As with companies, asset managers should have freedom to choose their purpose. But, whatever their purpose is should be clearly stated and embedded throughout the organisation – being tightly aligned with their governance, disclosures, and pay philosophy. A potential taxonomy of purpose is given below.

**Figure 4.3.1: Spectrum of fund purpose**

Speculative	Index, passive	Engaged
<ul style="list-style-type: none"> <li>Tactical shareholder</li> </ul>	<ul style="list-style-type: none"> <li>Long-term shareholder</li> </ul>	<ul style="list-style-type: none"> <li>Fundamentals-driven shareholder</li> </ul>
<ul style="list-style-type: none"> <li>Trading decisions driven by assessment of short-term financials and stock price movements</li> </ul>	<ul style="list-style-type: none"> <li>Formulaic trading to minimise tracking error</li> </ul>	<ul style="list-style-type: none"> <li>Trading decisions driven by assessment of long-term value. Ignore fluctuations in short-term stock price or profits</li> </ul>
<ul style="list-style-type: none"> <li>Focused on predicting market sentiment and behaviour of other investors, exploiting arbitrage opportunities</li> </ul>	<ul style="list-style-type: none"> <li>Engagement is the main mechanism for pursuing stewardship</li> </ul>	<ul style="list-style-type: none"> <li>Focused on finding firms with long-term potential and helping them achieve this potential</li> </ul>
<ul style="list-style-type: none"> <li>Generally short-term holdings</li> </ul>	<ul style="list-style-type: none"> <li>Only trade to maintain index weights</li> </ul>	<ul style="list-style-type: none"> <li>Likely to have long-term holding positions, but may not – key factor is trading decisions based on long-term value</li> </ul>
<ul style="list-style-type: none"> <li>Diversified positions to maximise liquidity</li> </ul>	<ul style="list-style-type: none"> <li>Fully diversified</li> </ul>	<ul style="list-style-type: none"> <li>Concentrated positions</li> </ul>
<ul style="list-style-type: none"> <li>Limited stewardship, except to increase short-term financials (e.g. payout). Do not wish to receive inside information as this will restrict ability to trade</li> </ul>	<ul style="list-style-type: none"> <li>Increasingly likely to engage. Activities likely to be general (board structures, pay norms, corporate governance) than company specific (strategy, leadership, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>Active engagement on value issues (strategy, leadership) as well as corporate governance. Willing to receive inside information if this will help them engage</li> </ul>

Asset managers should clearly set out their stewardship approach and report on how they have fulfilled it over the year.

Recommendation (c) is for funds to avoid short-term performance bonuses and instead offer long-term incentives based on performance horizons extending out to at least five years at the most senior levels. Since the average business cycle lasts approximately five-six years, this ensures that fund managers are not rewarded for simply the undeserved good luck of happening to be in post at the top of a business cycle. The creation of long-term incentives will also ensure that fund managers are effectively co-invested alongside savers in the funds that they manage, leading to aligned incentives. US Investment research company Morningstar, for example, finds that manager investment in fund shares is a key pillar of stewardship, but that only a fifth of US asset management firms has high manager ownership. It is a similar story in Britain.

More widely commission structures need to be better aligned with the interests of the ultimate providers of the assets under management (AUM). The emergence and growth of index tracking funds are in part because of their low fee structure accompanied by low investment in bespoke, company specific stewardship (see our comments later), with savers distrusting higher fee structures in which there is no penalty for poor performance against chosen benchmarks. Fee structures which better align the interests of fund manager and investor in

stewardship and long term performance, in which for example managers' fees were more contingent with long term outperformance, could address this problem<sup>10</sup>. We note that the Woodford Patient Capital Trust charges fees only after it has delivered a cumulative net asset value return in excess of 10%. One of the advantages of requiring asset management firms to declare their purpose is that it would open up a better conversation about aligning fee structures and incentives with the real interests of asset owners.

EU regulation has moved along some of these dimensions, but there is an opportunity to develop an enhanced approach that is tailored to the UK industry.

Many asset managers run funds of different styles and investment philosophies, and potentially with different stewardship stances. Therefore, orientation around purpose at the firm level needs to be complemented with orientation around purpose at the fund or mandate level.

***Recommendation 3.2: Orientation around purpose at the fund and mandate level***

***The FCA should develop an improved framework for describing purpose at the fund and mandate level through clear investment objectives and reporting measures:***

- a) Funds (and asset owners, e.g. pension funds, acting on behalf of ultimate beneficiaries) should produce a clear statement of purpose including a statement of investment beliefs and objectives, with particular reference to their stance on stewardship.
- b) Funds (or asset owners setting a fund mandate) should pre-identify key measures that they will report each year, such as active share and tracking error, portfolio size and concentration, turnover, and cost, and set target ranges aligned to their purpose.
- c) Funds should report over three, five, and ten years and then over longer terms in 10 year steps before reporting any shorter term performance.

Best practice requirements for fund objectives and Statements of Investment Principles should be revisited to set out clear choices between investment styles, particularly beliefs in relation to long-term investment, sustainability, stewardship, risk, and cost. This revision would enable clients to make better informed decisions over fund choices and to hold managers to account. The spectrum of purpose in Figure 4.3.1 may be relevant at the fund level if an asset manager runs funds of different styles.

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<sup>10</sup> Clare, A., Motson, N., Payne, R., and Thomas, S. (2014): 'Heads We Win, Tails You Lose. Why Don't More Fund Managers Offer Symmetric Performance Fees?'. Retrieved from <https://ssrn.com/abstract=2525545> or <http://dx.doi.org/10.2139/ssrn.2525545>

Key metrics explaining fund characteristics also need to be reviewed. There is currently excessive focus on short-term performance relative to a market benchmark. The use of such benchmarks creates incentives for active funds to be ‘closet trackers’ and discourages funds from creating sizable holdings in individual companies, as doing so deviates from such benchmarks and creates tracking error. As a result, many supposedly actively-managed funds behave as expensive index funds, at great cost to savers. This approach also militates against active engagement and purposeful investing. For example, even an investor with a positive holding in a company may choose not to engage if it is under-weight and engagement will benefit rival investors more. Instead, funds should report measures of portfolio concentration. These are more linked to stewardship since large stakes give investors both the incentives and power to govern (see also Subsection 4.6)<sup>11</sup>.

In particular, the metrics that are reported should be tightly linked to the fund’s purpose. This will help ensure that the purpose is far more than a statement but is embedded throughout the fund. In addition, it will allow investors and regulators to evaluate whether the fund is acting in accordance to its stated purpose. Figure 4.3.2 suggests some potential metrics that funds should report, and how these might be linked to the purpose in Figure 4.3.1. These partially overlap with the Investment Leaders Group’s metrics for Long-Term Responsible and Sustainable Investment.

**Figure 4.3.2: Reporting metrics and link to purpose**

Metrics	Speculative	Engaged
Portfolio size	70-80	20-30
Portfolio concentration	Low	High
Tracking error / active share	Low	High
Benchmark	Market	Unconstrained
Turnover	High	Low
Frequency of management meetings	Low	High
Resources devoted to stewardship	Low	High
Voting record	Follow proxy advice	Independent
Stock lending	Unconstrained	Constrained

Requiring disclosure against a set of metrics of this type, and in particular requiring funds to set out their policy for where in the range these metrics should lie, would help create

<sup>11</sup> There are number of potential measures of portfolio concentration. One is simply the number of stocks held, which is currently often reported. However, two funds that hold the same number of stocks may have very different concentration measures: fund A with a 10% holding in each of 10 different stocks is less concentrated than fund B with a 91% holding in 1 stock and 1% in each of 9 other stocks. The second measure is the Herfindahl index, a very common measure of concentration used in practical applications (e.g. to measure industry concentration). It is the sum of the squared holdings. For Fund A, it would be  $10 \times 0.1^2 = 0.1$ ; for Fund B it would be  $0.91^2 + 9 \times 0.01^2 = 0.829$ . Importantly, it is independent of fund size, and thus comparable across funds of different size.

accountability for fund characteristics, while also encouraging active managers to set out a clear path to ensuring long-term value. Funds showing structural features misaligned with the purpose could readily be identified.

## **Embedding Stewardship as a Core Function of Equity Markets**

The Kay Review asserted that stewardship is a core function of equity markets. According to the Law Commission<sup>12</sup>, however, neither the current law directed towards pension schemes (e.g. the Pensions Act) nor the law directed towards financial services firms (e.g. the Financial Services and Markets Act) contain an explicit duty to engage with investee companies nor exercise their voting rights, although it is arguably implicit within a trustee's fiduciary duty towards their beneficiaries.

At the same time, the Treasury is supporting the investment management industry through tax-advantaged savings wrappers such as ISAs and pensions. The goal is not only to reduce individual dependence on state support but also to increase the savings rate to help boost UK investment and productivity. It is reasonable for the government to expect that these funds are effectively stewarded so that they do indeed contribute to productivity growth.

However, importantly, evidence demonstrates that engagement does result in sustainable out-performance, which would benefit savers, companies, and economies alike<sup>13</sup>. Surveys suggest savers themselves wish to see stewardship activity undertaken on their behalf<sup>14</sup> and the FRC has attempted to promote stewardship through the UK Stewardship Code. The introduction of the UK Stewardship Code coupled with client pressure has had the beneficial impact of a minority of (predominantly larger) investor firms directing resources towards stewardship. Annual reviews undertaken by the Pensions and Lifetime Savings Association (PLSA) and the IA show that while the scale of resources directed towards stewardship in the UK has increased questions remain about the quality and impact of that engagement.

To encourage greater focus on meaningful compliance with the Code, the FRC, in November 2016, tiered the signatories to the Stewardship Code to signal more clearly the funds that are evidently committed to the Code's Principles and those who are less so (or remain on a journey). The FRC noted<sup>15</sup> that the quality of statements by signatories to the Code was

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<sup>12</sup> The Law Commission (2015), 'Fiduciary Duties of Investment Intermediaries'

<sup>13</sup> Becht, M. Franks, J. Mayer, C. and Rossi, S. (2009), 'Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund', *Review of Financial Studies*, 22, 3093-3129; Carleton, W. Nelson, J. and Weisbach, M. (1998), 'The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF', *Journal of Finance*, 53, 1335-1362; Dimson, E. , Karakas, O., Li, X. (2015), 'Active Ownership', *Review of Financial Studies*, 28, 3225-2368.

<sup>14</sup> National Association of Pension Funds (2014), 'NAPF Engagement Survey: Pension Funds' Engagement with Investee Companies'

<sup>15</sup> FRC (2017), 'Developments in Corporate Governance and Stewardship 2016'

improving. While welcome, the tiering is an illustration of the disjointed nature of regulation in this area. While it is the FCA which requires its regulated firms to publish a statement of compliance with the Stewardship Code, it is the FRC which is the owner of the Code. As a result, the FRC has no meaningful scope for enforcement.

Any proposals on stewardship need to reflect the reality of the market move towards index funds, which shows no sign of abating in the short term. Such funds have created client benefits in terms of low cost access to a wide range of investment markets. Nevertheless, the growth of index funds does have the potential to change the nature of stewardship activity.

Any proposals on stewardship need to reflect the increasing prominence of index funds, which shows no signs of abating. Stewardship is far from the exclusive preserve of active funds – indeed, the lack of ability to sell arguably creates an incentive for index funds to engage, as found in practice<sup>16</sup>. However, index funds will likely engage in a different type of stewardship to active funds. Given their objective is to match the market, there is clearly a risk that there is less incentive to enhance market returns overall than to minimise costs. Public and client pressure is leading index funds to invest in more corporate governance capability. However, evidence suggests that this engagement, because of resources necessary to effectively monitor and engage with the number of holdings in the index, is more likely to be generic than company specific in nature, focusing on general matters of corporate governance (independence of Chairs and Boards, executive pay structures, and so on) as opposed to strategy-oriented interventions<sup>17</sup>. Indeed, active managers who adopt ‘closet-tracking’ strategies are also less likely to have the incentives to undertake bespoke stewardship. Highly bespoke stewardship necessitates more concentrated and low turnover portfolios than is typical and is presently too often the preserve of more specialist active funds and activist investors.

However, evidence also suggests that activist managers can use large index holdings as a source of voting support for activist intervention. In effect index block holdings can be ‘won-over’ by activists holding smaller stakes<sup>18</sup>, which suggests that the problem of stewardship needs to be viewed on a system-wide basis as well as at the level of the asset manager and that mechanisms for collective engagement may be particularly important.

Overall, while commitment to stewardship appears to be improving, progress is too slow, and quality of engagement is too variable. There is also a risk of a focus on evident rather than effective stewardship as funds seek to demonstrate that they are doing more. We thus

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<sup>16</sup> Appel, I., Gormley, T., and Keim, D. (2016): ‘Passive investors, not passive owners’. *Journal of Financial Economics*, 121, pp. 111-141. Retrieved from: <http://www.sciencedirect.com/science/article/pii/S0304405X16300319>

<sup>17</sup> Schmidt and Fahlenbrach (2016); ‘Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?’, *Journal of Financial Economics* (forthcoming). Retrieved from [https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=2177699](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=2177699)

<sup>18</sup> Appel, I., Gormley, T., and Keim, D. (2016); ‘Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism’, SSRN, Retrieved from: [https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=2693145](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=2693145)

recommend the following:

***Recommendation 3.3: Embedding stewardship***

***Investors' responsibilities concerning stewardship should be clarified, and the oversight strengthened in order to embed stewardship as a core function of UK capital markets.***

- a) Strengthen Conduct of Business Rule 2.2.3 to require asset managers to set out their approach to Stewardship, including disclosing voting records, policy on stock-lending, stating reasons and alternative approach to engagement if not a signatory of the Stewardship Code.
- b) The FRC should establish a review to investigate mechanisms for independently reviewing stewardship quality, to strengthen their existing tiering activity in relation to the Stewardship Code
- c) The government should encourage the industry actively to scale collective engagement activity via the Investor Forum so that collective activity can move beyond extreme cases to more routine ones.
- d) The FRC should review the state of stewardship in 2020. If the review continues to reveal that stewardship is being neglected, consider introducing a stewardship levy to support increased scale of engagement activity (either through the Investor Forum or a newly created instrument) and commissioning of open-source analysis and research into effective stewardship, long-term engagement, and purposeful investing

Since December 2010 all UK-authorized asset managers are required under the FCA's Conduct of Business Rules to produce a statement of commitment to the Stewardship Code or if not a signatory to explain their alternative investment strategy. This should be supported by enhanced disclosure rules under Conduct of Business Rule 2.3.3 with equivalent requirements by the Pensions Regulatory in relation to pension trustees. This disclosure requirement would extend to explaining why they were not signatories to the Code and to explaining how they viewed their stewardship obligations aligned with their purpose and how they fulfilled those stewardship obligations in an alternative fashion.

In practice, realism is required as to what can be achieved through formal regulation. Instead, we favour building on and accelerating existing voluntary mechanisms. The Stewardship Code has made a useful start in influencing the activity of the largest fund managers. However, the focus is on reporting quality rather than true stewardship quality. This runs the danger of emphasising focus on visible rather than meaningful stewardship activity. Note that levels of engagement in mid-market companies are particularly problematic. We are therefore recommending that the FRC undertakes a review into how its review of adherence to the Stewardship Code could be enhanced so as better to measure underlying quality of

Stewardship.

Stock lending improves market liquidity, reduces the risk of failed trades, and generates revenue for investors. Nevertheless, it can lead to votes ending up in the hands of ‘investors’ with a small, zero or even short position who are thus misaligned with company value and do not vote in accordance with the company’s long-term interests. We believe responsible investors have a duty to see that the votes associated with their lent stock are not cast in a manner contrary to their stated purpose – if there is even a small risk that they may be, the stock should not be lent.

In Subsection 4.4 we propose specific rules on voting with borrowed stock. For this subsection, we recommend that asset managers:

- Are transparent about their stock lending policies (see also Section 6 on restrictions on voting with borrowed stock in certain circumstances).
- Ensure that stock is not lent to ‘investors’ who may vote in a manner inconsistent with the asset manager’s stated purpose.

### **Supporting collective engagement**

In our [Interim Report](#), we highlighted the importance of blockholders in supporting development and growth of purposeful companies. In Subsection 4.4 we set out how development of blockholdings could be encouraged in the UK. However, realistically the size of the UK market relative to its economy and the diversity of investing institutions, both UK and overseas, means that holdings in the UK market are likely to remain relatively fragmented. Moreover, particularly in the largest companies, such block holdings as there are will frequently reside in the holdings of index funds. Given the trend from active to index investing, this state of affairs is likely to become more prevalent.

The prevalence of index funds as blockholders has positive and negative impacts. There is evidence that index funds are more likely to focus on lower cost ‘generic’ governance activity as opposed to company-specific engagement<sup>19</sup>. In extremis, there has been recent evidence that prevalence of index fund blockholders can inhibit the extent to which companies compete aggressively and management are held to account<sup>20, 21</sup>. Set against this, index funds can

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<sup>19</sup> Schmidt and Fahlenbrach (2016); ‘Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?’, *Journal of Financial Economics* (forthcoming). Retrieved from [https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=2177699](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=2177699)

<sup>20</sup> Azar, J., Schmalz, M., and Tecu, I. (2016), ‘Anti-Competitive Effects of Common Ownership’ (July 2016), Ross School of Business Paper No. 1235

<sup>21</sup> Anton, M., Ederer, F., Gine, M. and Schmalz, M. (2016), ‘Common Ownership, Competition and Top Management Incentives’ (August 2016), Ross School of Business Paper No. 1328

provide a mechanism to amplify the impact of activist investors<sup>22</sup>.

It is almost impossible to legislate for high quality stewardship, as opposed to visible stewardship. The returns to deeply active stewardship are likely only to justify the costs for the most active of managers, with relatively small and focused portfolios. This suggests that the emphasis should be on encouraging good stewardship overall but also amplifying the impact of the good stewardship that exists. Enhancing mechanisms for collective engagement may, therefore, be particularly important in the UK market. One option is that third parties wishing to deliver the stewardship activity on behalf of those (passive) investment firms which opt to delegate would need to be certified, with certification being exercised by an independent board to assess quality.

The Investor Forum's Collective Engagement Framework, has been successful for intensive and wide-ranging engagements. The industry should be encouraged to support the expansion of the Investor Forum's activities to routine and specific engagements. This can provide a mechanism for active stewards to garner support from other major investors in the UK market, in particular, index funds.

### **Towards a Stewardship Levy?**

The IA's Productivity Action Plan, published in March 2016, highlights the need for a membership fee to support the ongoing activity of the Investor Forum, which currently has funding for three years. This voluntary mechanism should be given time to develop.

However, the industry should be put on formal notice of a review into the quality of stewardship in 2020. If progress towards strong and active stewardship across the market remains slow, then consideration should be given to adopting a stewardship levy.

There are a variety of mechanisms through which a stewardship levy could operate and we suggest that this should be the subject of consultation. One route would be to introduce a transaction levy on certain trades in the securities of companies whose shareholders benefit from the ownership activities funded by the levy (as per the Panel on Takeovers and Mergers levy). Alternatively, the levy could be linked to funds benefiting from beneficial tax treatment by the UK government, such as ISAs or pension funds. The logic would be that government support, via taxation, should be in exchange for investment activity that raises the UK's long-term productivity. This requires strong stewardship.

The mechanism that we propose would be:

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<sup>22</sup> Appel, I., Gormley, T., and Keim, D. (2016); 'Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism', SSRN, Retrieved from: [https://papers.ssrn.com/sol3/papers2.cfm?abstract\\_id=2693145](https://papers.ssrn.com/sol3/papers2.cfm?abstract_id=2693145)

- The introduction of an annual charge invoiced to UK authorised funds. The charge would be folded into the annual fee collection exercise presently undertaken by the FCA (in order to fund itself as well as the PRA, FOS, FRC, MAS and others).
- The annual charge would be levied on an ad valorem basis (based on investments in UK equities or, potentially, funds benefiting from UK tax-favoured treatment) and in monetary terms would likely be a fraction of a basis point.
- The collected monies would be overseen by an independent Stewardship Body comprising representatives from the chain of ownership. This body could naturally take the form of an expanded version of the existing Investor Forum, although its character should be open to consultation.
- The Stewardship Body after covering its own costs, would use the monies to:
  - Support the infrastructure behind the Stewardship Body's collective engagement activity.
  - Fund enhanced scrutiny of the quality of compliance with the Stewardship Code and oversee the accreditation of engagement and voting service providers.
  - Fund in-depth primary research into long-term investment, stewardship, and purpose, which would be made freely available to the market, with the aim of increasing demand for long-term purposeful investing activity.

We have considered having a levy that investment managers could avoid if they undertook a minimum quality of stewardship activity themselves. It is possible that at some point in the future, the definition and measurement of good stewardship may be sufficiently robust in order to allow this. This would incentivise firm-specific stewardship functions. Nonetheless, the concern at present would be that such a mechanism would encourage visible rather than effective stewardship (for example 'show voting' against resolution). Therefore, in the first instance, were a levy introduced, we suggest it be levied on all funds. In practice, those funds demonstrating more commitment to stewardship would, in any case, be likely to benefit more from the collective engagement activity and research funded through the levy.

Overall we do not believe that the levy should be an immediate policy response, but should be held in reserve as a mechanism for catalysing market activity if progress is otherwise unsatisfactory.

## Encouraging Sources of Purposeful Capital

Purposeful companies need the support of purposeful capital. That is capital that is patient, engaged, and long-term in outlook. Note that patient does not mean complacent. And long-term reflects a state of mind as much as a holding period. The fragmentation and increasingly transactional nature of the UK equity market have led to a decline in long-term investment perspectives. Recent initiatives have started to act on this trend but would be accelerated through encouraging pools of capital that support purposeful business.

### ***Recommendation 3.4: Encouraging sources of purposeful capital***

#### ***Policy should support the development of Purposeful capital in four areas***

- a) Remove impediments to development of blockholdings in UK companies (see Subsection 4.4)
- b) Accelerate the merger of sub-scale public sector pension schemes to create a strong voice for purposeful stewardship.
- c) Establish a UK investment fund to support development and growth of purposeful SMEs (See Subsection 4.5)
- d) Undertake a cross-disciplinary regulatory review with the intent of removing bias in favour of debt over equity.

### **Accelerating the merger of subscale pension funds**

The FCA's study identifies the low and variable levels of investment expertise on pension fund trustee boards as a particular challenge, particularly for smaller funds. It suggests that the FCA, with the government, should explore the benefits of greater pooling of pension scheme assets – a recommendation we fully support.

Regulation needs to be better designed not to disempower trustees and their executive functions. In order to compensate for the lower than ideal level of knowledge and expertise amongst trustees, UK pensions law compels pension funds to obtain expert advice when taking investment decisions. Although well-intentioned, this approach leaves a number of problems unaddressed. For example, board and management capabilities remain weak so that trustees and executives, having contracted out advice to experts, are less equipped to question prevailing practices e.g. excessive diversification and assess investment manager performance rigorously. Consequently, many fall back on crude performance metrics e.g. quarterly return against a pre-selected market benchmark. Short termism and lack of engagement remain unaddressed.

One solution is to require greater scale. Our [Interim Report](#) cited evidence to show that

pension funds in the UK, of which there are at least 6,000 Define Benefit (BF) funds and a multiple more Define Contribution (DC) schemes, do not have the scale to deliver on beneficiary interests. Scale is critical to achieving value and the evidence from Canada and Australia demonstrates the efficiencies that greater scale can deliver. Scale reduces fees and the number of distorting principal-agent relationships, including diminishing the need for external advice, and provides the ability to move investment teams in-house. UK asset owners currently lack this scale, and the shift from DB to DC could make this worse.

We suggest that:

- The UK should follow Australia's example and introduce a positive duty on trustees to consider annually whether the fund has sufficient scale to deliver value for money as measured by long-term net returns.
- Such explanations could be reported to and considered by the Pensions Regulator (TPR). In addition, TPR could be provided with the tools to force mergers of schemes where performance is poor and/or recovery plans are not likely to be met.

### **Reviewing regulatory bias against equity**

The Kay Review noted the decline in equity issuance as a source of funding for UK listed companies, coupled with the decline in number of firms listed on UK stock markets. At the same time, UK institutional ownership by pension funds and insurers has declined in response to regulations that encourage matching of long-term liabilities with bonds. In addition, the tax shield on debt favours debt over equity.

Deep liquidity of equity markets is essential to fund innovative companies and to fund the intangible assets that are essential to long term innovation and purpose. While rules to protect pension and insurance beneficiaries against insolvency of providers is clearly of the utmost importance, we have to consider whether the reduced use of equity to fund long term liabilities in fact, over the long term, inhibits economic growth and hence our ability to meet those liabilities.

Accordingly, we recommend a wide ranging review of legislation favouring debt over equity including, but not limited to: the tax deductibility of debt financing; pensions regulation; Solvency 2 and its UK implementation.

### **Accelerating existing efforts**

There are no simple solutions to the complex questions surrounding the structure, incentives and purpose of the asset management industry. However, both regulators and the industry itself recognise the need for change, with the FCA and IA both publishing important reports in

2016<sup>23, 24</sup>. The interim report of the FCA's ongoing Market Study of the Asset Management sector, published on the 18th November 2016, raised questions over the transparency, competitiveness, and value for money in pricing, particularly of actively managed funds. It found that fund objectives are not always clear and performance is not always reported against an appropriate benchmark. It also identified conflicts of interest in parts of the investment chain, particularly in relation to investment consultants.

The IA's Productivity Action Plan, also identified a number of barriers to an efficient capital cycle, covering company reporting, investor stewardship, incentives in the investment chain, diversity of capital, and tax and regulation.

The recommendations in both reports overlap with our own proposals<sup>25</sup> and we welcome the growing acceptance that reform is an imperative.

But change needs to happen at an accelerated pace, given the importance of the investment industry to supporting purposeful companies. We believe the proposals and recommendations outlined in this subsection, building on the changes already in train and applying our conceptions of purpose to this industry as we would to the rest of business, promise the acceleration that is needed.

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<sup>23</sup> Financial Conduct Authority (2016), 'Asset Management Market Study Interim Report', MS15/2.2

<sup>24</sup> Investment Association (2016), 'Supporting Long-term Productivity with Investment – The Investment Association's Productivity Action Plan'

<sup>25</sup> For example, as well as suggesting simplification and improved transparency of fee and cost structures, the FCA recommends a strengthened duty on asset managers to act in the best interests of investors. This includes reforms to hold asset managers to account for how they deliver value for money, and improvements to the clarity with which fund objectives are communicated to savers and performance against those objectives demonstrated. The FCA also recommends exploring the potential benefits of greater pooling of pension scheme assets. The IA report also makes recommendations that provide support for a number of the proposals in this report, for example: improving reporting of strategic drivers, capital management, and intangibles; enhancing stewardship and engagement; and simplifying incentives in the investment chain.

## 4. Blockholding

### Policy Proposition

This subsection aims to provide a framework to incentivise blockholders (large, non-affiliated shareholders) both to form in the first place and to promote purpose by active engagement and monitoring post-formation. These policies build on the current FCA regulatory landscape and the activities of the Investor Forum, and are as follows:

#### ***Recommendation 4.1: Disclosure relaxation***

- The FCA should facilitate block formation by relaxing disclosure requirements and bringing them in line with the EU and US.

#### ***Recommendation 4.2: Structured access***

- The FCA should provide clarity on the distinction between confidential and inside information, to guide companies on what information they can share with shareholders without them being classified as insiders. It should also consider creating a 'safe harbour' whereby blockholders can receive inside information if this facilitates engagement, and they agree not to trade on this information.

#### ***Recommendation 4.3: Collective engagement***

- The FCA should (3a) further clarify what types of collaboration between shareholders are allowed and not allowed, and what information can and cannot be shared in such collaborations, and (3b) relax any restrictions that may deter collective engagement.

#### ***Recommendation 4.4: Voting with borrowed stock***

- We propose prohibiting small shareholders and non-shareholders from voting with borrowed stock. At present, small shareholders – and even shareholders with a short position – can borrow stock to acquire enough votes to swing an outcome in their favour, even though their interests may be misaligned with the firm. However, we recognise that voting with borrowed stock can be beneficial if the votes are borrowed by blockholders, whose large stake ensures both that (i) their interests are aligned with the firm, and (ii) they have incentives to become informed about the correct decision. Thus, we propose to continue to allow blockholders to vote using borrowed stock. This policy can potentially be expanded to include other likely informed investors, e.g. those categorised as Tier 1 by the FRC's Stewardship Code.

In addition to the above specific proposals, there is one additional dimension for further research:

***Recommendation 4.5: Minority shareholder protection***

- Ensure that any facilitation of blockholder monitoring and engagement from (1)-(4) above are not at the expense of minority shareholders.

We believe, as we argue in our [Interim Report](#), that encouraging blockholdings may substantially improve a company's purposefulness in two ways:

- 1) Engagement/Voice. A shareholder intending to engage with a firm suffers from a free-rider problem: she bears the full costs of engagement, but only enjoys a fraction of the benefits. A fragmented shareholder has too little 'skin in the game' to make engagement worthwhile. In addition to insufficient *incentives* to intervene, small stakes give her too little *power* to intervene – her few votes mean that she is unlikely to win a shareholder proposal, and the threat of selling her shares, if management is intransigent, is weak. In contrast, blockholders' large stakes give them both the incentives and power to intervene based on objective assessment.

It is important to note that engagement can involve not only disciplining management (e.g. curbing excessive pay or empire building), but also advising management (e.g. acting as an investor sounding board, proposing new strategic directions, devising ways to build corporate culture or customer loyalty, and using their business contacts to benefit the firm (such as introductions to potential business partners)) – i.e. need not be hostile or confrontational. Blockholders are allies of management, not just adversaries.

- 2) Monitoring/Exit. A fragmented shareholder has too little 'skin in the game' to analyse a company's intangible assets. Analysing a firm's corporate culture, brand strength, or innovative capabilities is costly, and her small stake does not justify the cost. She will thus evaluate the firm based on freely-available short-term earnings (or broker recommendations often based on short-term earnings) – hence the adage that 'the market sells first and asks questions later.' In contrast, blockholders' large stakes give them the incentives to ask questions first. If a firm has delivered low earnings due to investment in purpose, blockholders will not sell (and may even buy more). Informed blockholders insulate managers from the need to cater to short-term profit pressures, and free them to focus on long-term purpose – again, they are allies of management. This is Warren Buffett's investment strategy: take large stakes in firms and free them to build their business model for the long term.

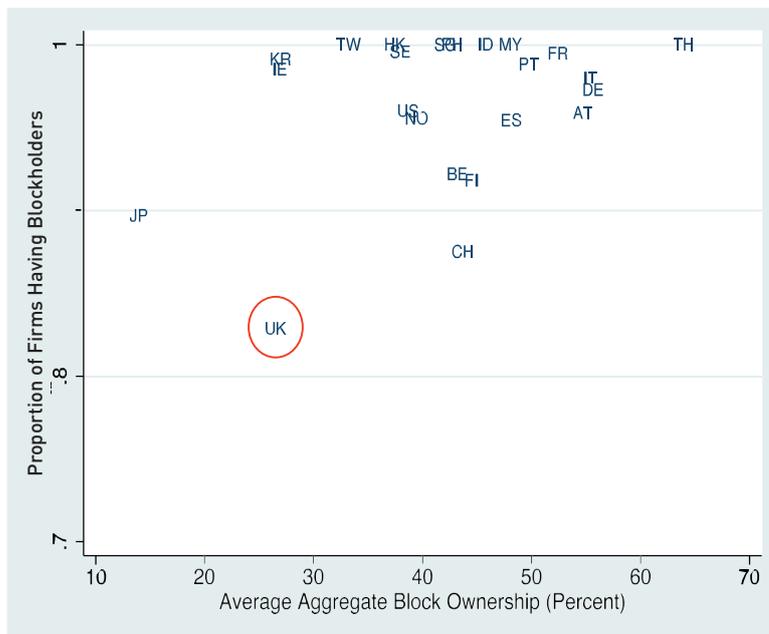
In addition to freeing managers to pursue the long term, blockholders also discipline managers against pursuing the short term. With fragmented, uninformed shareholders, a manager might cut investment to inflate short-term profits. An

informed blockholder, who evaluates a firm's intangible assets, will notice such myopic behaviour and sell her stake. The threat of such disciplinary 'exit' deters a firm from acting myopically, to begin with. Note that, key to exit is that the blockholder displays *conditional*, not unconditional loyalty. A blockholder who remains with the firm, even if it destroys purpose (such as Volkswagen's affiliated shareholders), will not exert good governance. Indeed, Buffett sells his stake if the firm has not enhanced its business model after several years. Moreover, in addition to being a governance mechanism in itself, exit enhances voice. Voice is strengthened if shareholders have the ability to sell if management is non-compliant – just as customer voice is powerful since customers have the ability to vote with their feet.

In this subsection, we will use 'governance' as an umbrella term to refer to both engagement and monitoring.

Despite the benefits of blockholders, British companies stand out internationally in that they have significantly fewer blockholders than international firms. Figure 4.4.1 below shows on the y-axis the proportion of firms having a blockholder of at least 5%, and on the x-axis the average aggregate size of the blocks of shares held by these blockholders. The UK is an outlier on both dimensions, which is a critical issue that must be addressed.

**Figure 4.4.1: Large-block common stock ownership at public corporations in the United Kingdom and 22 other countries<sup>26</sup>**



<sup>26</sup> Holderness, C. (2009). 'The Myth of Diffuse Ownership in the United States'. *Review of Financial Studies*, 22(4), 1377-1408.

Note that, while the common definition of a blockholder is a '5% shareholder', an investor's incentives and power to intervene increase continuously with the size of her stake and do not suddenly jump when the stake crosses from 4.9% to 5.1%. Thus, a shareholder does not switch from being 'non-governing' to governing when crossing this threshold. Shareholders with stakes below 5% can also significantly promote purpose. The goal of this policy is to encourage shareholders to take larger stakes, not necessarily 5% stakes, and to facilitate governance by all shareholders, regardless of their stake.

However, we do recognise that a definition of 'blockholder' is necessary if blockholders are to be conferred additional rights, e.g. the ability to vote with borrowed stock and structured access to information. (This is similar to how a threshold is needed to define a financial institution as 'systemically important', even though an institution does not jump from being completely unimportant to being completely important when crossing this threshold). To the extent that a definitional threshold is useful, it is not clear whether the threshold should be in *percentage* terms (as commonly believed) rather than *pound sterling* terms.<sup>27</sup>

- A **percentage** threshold makes sense if investors have a *pound sterling* effect on firm value that is independent of firm size. For example, if an investor prevents the firm wasting £10 million on perks, this is £10 million saved regardless of whether the firm is large or small. If her stake is 1%, her saving is £100,000; if it is 5%, her saving is £500,000. Thus, her incentives depend on her *percentage* stake.
- A **pound sterling** threshold makes sense if investors have a *percentage* effect on firm value that scales with firm size. For instance, if an investor proposes a new strategic direction that adds 1% to firm value, the value created is increasing in firm size. If her stake is £10 million, her value created is £100,000 thousand; if it is £50 million, her value created is £500,000.

While some investor actions may well have fixed effects on firm value, it seems that those most related to the promotion of purpose have percentage effects. Thus, the pound sterling stake may be at least as relevant as the percentage stake. As a result, even investors with small percentage stakes in a firm may have strong incentives to govern, if the firm is sufficiently large that a small percentage stake translates into a large pound sterling stake. Intuitively, in a large firm, engagement and monitoring (if scalable) have a large pound sterling effect on firm value, and so even investors with percentage stakes of less than 5% have strong incentives to govern.

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<sup>27</sup> Edmans, A., Holderness, C. (2017). 'Blockholders: A Survey of Theory and Evidence'. *Handbook of Corporate Governance*, forthcoming.

Overall, a blockholder is a 'large' investor with incentives to govern. How 'large' an investor has to be will depend on many factors, such as firm size. Moreover, governance incentives increase continuously with block size, rather than suddenly jumping when block size crosses a certain threshold. Thus, the bulk of the policies in this section do not focus narrowly on increasing stake sizes from below to above 5%, but encouraging a movement from dispersed, fragmented ownership to concentrated, purposeful ownership in general. However, for some policies, it is necessary to define a 'blockholder', and it is only for these policies that we will propose definitional thresholds.

## Policy Mechanics

The Disclosure Relaxation policy (1) involves:

- Adopting the EU minimum thresholds for notification. These are 5%, 10%, 15%, 20%, 30%, 50% and 75% and currently apply to non-UK-incorporated companies listed in the UK.
  - The current threshold for UK-incorporated companies is 3% and each whole percentage point after, which is more stringent than the EU minimum requirements.
  - The FCA's DTR 5.1.5 allows the less-stringent EU minimum requirements to apply to asset managers acting as agents, but they do not apply to asset managers acting as principals, nor individual or corporate investors. We propose adopting the EU minimum requirements across all investors – i.e. treating all investors equally. Indeed, one respondent to the FCA's consultation document (PS 15/26) also suggested this harmonization.<sup>28</sup>
  - Currently, 46% of FTSE-100 companies have one or two investors with a 2.9% stake, suggesting that the 3% disclosure threshold significantly constrains block ownership. Consistent with the principle to encourage a general increase in holding sizes, this relaxation will now remove the artificial barrier at 3% (as well as 4%, 6%, etc.)
  - This relaxation is also consistent with the principle of Regulatory Neutrality

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<sup>28</sup> HM Treasury's *Implementation of the Transparency Directive Amending Directive (2013/50/EU) and other Disclosure Rule and Transparency Rule Changes including feedback on CP15/11 and final rules* contains "One respondent suggested that it would be beneficial to amend the vote holder notification thresholds to reflect the EU minimum thresholds of 5% and 10% and above rather than maintaining the current UK super equivalent thresholds at 3% and 1% thereafter. This suggested amendment would harmonise the rules across the EU."

discussed in Subsection 4.1 on Company Law and Reporting, by ensuring that regulations do not deter block formation.

- Lengthening the window between crossing a threshold and notification to 20 trading days. The current window is two days for a UK company and four days for a non-UK company (DTR 5.8.3).
  - At present, these windows are stipulated by the EU Transparency Directive Amending Directive. Post-Brexit, the UK will be able to deviate from these windows.
- Creating a relaxed disclosure requirement (90 rather than 20 days) for investors who cross the 5% threshold but do not intend to exercise control, analogous to a Schedule 13G filing in the US.

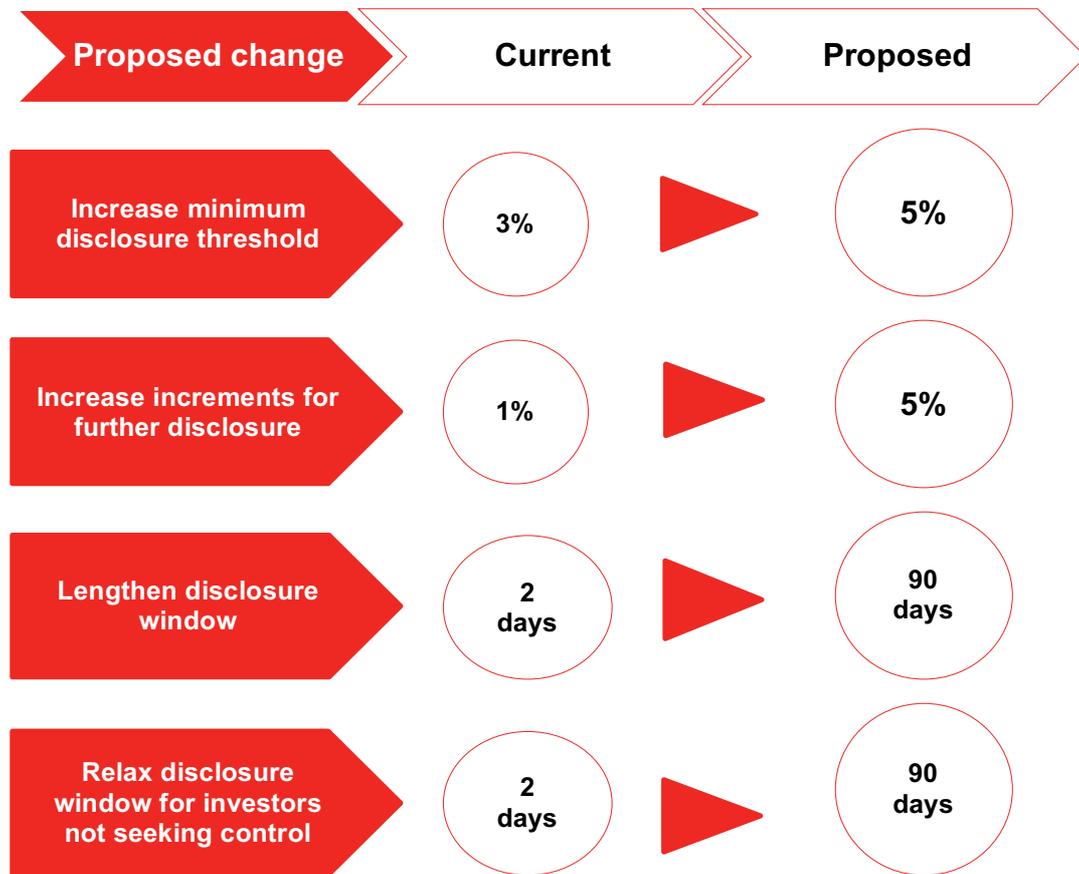
Previously, in the US, an investor acquiring a stake exceeding 5% was required to file a Schedule 13D within ten days. Item 4 of Schedule 13D requires the investor to state the 'Purpose of the Transaction', including any activist intent (e.g., to launch a proxy fight or try to acquire a board seat). A change in the ownership stake of 1% or more must be filed within ten days.

The US introduced Schedule 13G filings to ease the disclosure requirements for investors without activist intent. If the investor 'can certify that they did not purchase or do not hold the securities for the purpose of changing or influencing control over the issuer', she may file a 13G. This is a shorter form that requires less information; in particular, there is no equivalent of Item 4. More importantly, the disclosure window is much wider. 'Qualified institutional investors' may file within 45 days after the end of the calendar year, unless their stake crosses 10% in which case they must file within ten days at the end of the month. Moreover, re-filings are required only for changes of 5% or more, versus 1% or more with a 13D.<sup>29</sup>

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<sup>29</sup> For further details, see Edmans, A., Fang, V. and Zur, E. (2013). 'The Effect of Liquidity on Governance'. *Review of Financial Studies* 26, 1443-1482, particularly Appendix A.

Figure 4.4.2: Proposed relaxation of disclosure rules



Note (2)-(4) are complementary to (1) in that facilitating engagement and monitoring once the block has been formed will also encourage blockholders to form in the first place.

The Structured Access policy (2) aims to enhance investor access to information and company management to facilitate both engagement and monitoring. When meeting with firms, investors are often unclear on what information can be shared. The current rules allow firms to share confidential information with a significant shareholder, but not unpublished/inside information.<sup>30</sup> The legal distinction between ‘confidential’ and ‘inside’ information is that the latter is price-sensitive, i.e. a reasonable investor would be likely to use it as part of the basis of her investment decisions. However, whether a piece of information is price-sensitive is often

<sup>30</sup> Firms can disclose inside information to shareholders, for example for ‘market sounding’ (Article 11 of the Market Abuse Regulations), i.e. gauging the market’s likely reaction to a potential transaction. This is permissible only if the failure to disclose the information more generally is unlikely to mislead the public, and both the firm and recipient ensure the confidentiality of the information. Moreover, the shareholder receiving such information is typically deemed to have “crossed the wall” and become an insider, hindering trading until the information has been publicly announced. Thus, many shareholders choose not to receive inside information even if they could, as doing so leads to liquidity constraints. They often sign statements attesting that they do not wish to receive information in a meeting with companies.

(inevitably) ambiguous, and so firms and investors typically err on the side of not sharing information, at a potentially significant detriment to engagement and monitoring.

Thus, this policy recommends that the FCA clarify what information is considered ‘confidential’ (and thus shareable), and what information is considered ‘inside’. Below is a non-exhaustive list of types of information that the FCA could ratify as confidential but not inside information (similar to the ESMA’s ‘White List’ of activities that do not constitute acting in concert).

**Figure 4.4.3: Types of information**

Type of information	Examples
Strategic direction	<ul style="list-style-type: none"> <li>Sales and marketing plans</li> <li>New product or regional market plans</li> <li>Comments on drivers of financial performance</li> <li>Interim progress on long-term investments (e.g. in R&amp;D, human capital, or brand)</li> <li>Recent changes in supply/distribution chains</li> <li>Major IT/system/licensing changes</li> <li>Company insights on broker reports &amp; research</li> </ul>
Changes to company organisation	<ul style="list-style-type: none"> <li>New senior hires</li> <li>Major shareholder sales and purchases, and motivation behind these</li> </ul>
Conduct and culture	<ul style="list-style-type: none"> <li>Employee and customer satisfaction</li> <li>Relationships with suppliers and regulators</li> <li>Conduct events and potential conduct risks</li> <li>Behavioural change initiatives</li> <li>Update on ongoing legal action (not including cost quantifications)</li> <li>Security breaches</li> </ul>

Clearly defined policies would need to be in place to stop the sharing of confidential information slipping into the sharing of inside information. The agreed ground rules for acceptable subjects of discussion would be circulated before each meeting.

Moreover, in addition to clarification of existing policies, the FCA should consider creating a ‘safe harbour’ whereby blockholders can receive inside information. One potential definition of a blockholder is an investor who owns either at least 5% or £200 million<sup>31</sup> of the firm’s stock. Under Article 11 of the Market Abuse Regulations, investors can already receive inside information for ‘market soundings’ (to gauge their likely reaction to a particular transaction), as long as they have given their consent to receive it, agree to keep it confidential, and agree not

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<sup>31</sup> This suggested threshold is based on the fact that £200 million corresponds to an approximation 5% stake in companies at the bottom of the FTSE-100. Alternative thresholds can be considered.

to trade on it. Nonetheless, blockholders may engage with the firm in many ways outside of advice on a potential transaction, for example proposing new strategic directions, devising ways to build a corporate culture or customer loyalty. Inside information may be useful for such engagements. In order to protect minority shareholders, investors in receipt of inside information should generally be prohibited from trading on it. Note that Article 9 of the Market Abuse Regulations does allow for trading if the investor is executing orders on behalf of third parties, or established 'Chinese walls' so that the persons receiving inside information for engagement are separate from those making trading decisions. This alleviates investor concerns that receiving inside information would render them vulnerable to a liquidity shock.

We caveat that clarification by the FCA would only help governance by UK investors. US investors would also be bound by the Securities and Exchange Commission and the Bank Holding Company Act if the company has multiple listings (even if only of debt securities); the latter explicitly considers many of the types of information in Figure 4.4.3 as 'inside information'. Thus, it may not be possible for a UK regulator to give the confidence that international investors may require.

In addition, we recommend that companies schedule meetings with large shareholders to discuss the firm's strategic direction (in contrast to, say, Capital Markets Days which are perceived to be dominated by analysts and focused on short-term financial forums). This policy is similar to the Stewardship and Strategy Forums that the Investor Forum is recommending.<sup>32</sup> Many are already doing so, but this practice is not universal. In order to alleviate concerns of market abuse, the firm could make public all presentations plus a transcript, similar to for investor calls.

The Collective Engagement policy (3) aims to both clarify and, if necessary, weaken restrictions on shareholders collaborating. At present, institutional investors are wary about such collaboration. For example, collaboration may (unintentionally) lead to the sharing of information, and thus an institution being classified as an insider and restricted from trading; forcing alliances to pressure the board may lead to it resigning and the alliance being considered as a party acting in concert.

The source of such wariness is unclear. Conversations with investors suggest the following:

- Some are unclear about the rules. Note that the UK regulators have taken significant steps to clarify the rules. For example, the Takeover Panel's Practice Statement 26, issued in 2008<sup>33</sup>, is clear that a party is only deemed as 'acting in concert' (and thus

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<sup>32</sup> See The Investor Forum. Stewardship & Strategy Forum Primer. Retrieved from [https://media.wix.com/ugd/1cf1e4\\_4ccfaa9726d749f8bf7acd8f67f11595.pdf](https://media.wix.com/ugd/1cf1e4_4ccfaa9726d749f8bf7acd8f67f11595.pdf)

<sup>33</sup> The Takeover Panel. (2009, September 9). Practice Statement No 26 on Shareholder Activism. Retrieved from <http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/11/ps26.pdf>

subject to the mandatory bid requirement) if its combined ownership crosses 30% and it makes a resolution that seeks control of the board. In turn, the note is clear that a resolution will only be deemed as ‘board control-seeking’ if it aims to replace the majority of directors (rather than one or two) *and* that the directors to be appointed are affiliated with the concert party. Similarly, the FSA’s 2009 letter to the Institutional Shareholders Committee<sup>34</sup> clarifies the rules on market abuse, disclosure of major shareholdings, and changes in control. The European Securities and Markets Authority has a ‘White List’ of activities that investors can engage in that will not, in and of themselves, lead to a conclusion that they are acting in concert.<sup>35</sup>

Despite these steps, it is clear that some investors are still unaware of these clarifications. While investors for whom collaborative engagement is a core activity will be willing to hire the legal resources to ensure both knowledge and compliance, doing so may be too costly for others.

- Some are clear about the rules but still err on the side of caution given the ambiguity of how they might be interpreted and applied (in the absence of the Investor Forum’s Collective Engagement Framework, described shortly). For example, pressure on a minority of directors may unintentionally lead to a majority of the board resigning and trigger ‘acting in concert’ rules. Alternatively, an investor may commit to a collective engagement but later believes there is a material negative change and sells. The investor would also have to recuse herself from the engagement; the other collaborators could infer that she has sold, which could be deemed to be inside information. As a result of the ambiguity, many investors will not engage in any potentially collaborative communication without the involvement of lawyers. Given the cost of doing so, some investors simply choose not to collaborate – in turn reducing their engagement.
- Some are clear on the rules and believe that the UK rules are restrictive. An international comparison of hedge fund activism across different countries concludes<sup>36</sup>:

The regulatory environment in some jurisdictions is not conducive to such wolf packs because of disclosure, “market abuse” and mandatory bid rules. A comparison of the UK, the US and Germany illustrates this. In the UK, with relatively restrictive rules, if one hedge fund informed another hedge fund

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<sup>34</sup> Financial Services Authority. (August 19, 2009). ‘Shareholder engagement and the current regulatory regime’. Retrieved from [https://www.frc.org.uk/FRC/media/Documents/shareholder\\_engagement\\_FSA\\_letter.pdf](https://www.frc.org.uk/FRC/media/Documents/shareholder_engagement_FSA_letter.pdf)

<sup>35</sup> European Securities and Markets Authority. (June 20, 2014). ‘Information on shareholder cooperation and acting in concert under the Takeover Bids Directive – 1<sup>st</sup> update’. Retrieved from <https://www.esma.europa.eu/sites/default/files/library/2015/11/2014-677.pdf>

<sup>36</sup> Becht, M., Franks, J., Grant, J., Wagner, H. (2016). ‘The Returns to Hedge Fund Activism: An International Study’. *Review of Financial Studies*, forthcoming.

about its intention to increase its holdings, it would make the latter an insider and prevent it from trading in the target's shares. In the US, with less restrictive rules, in the same case the second fund would not generally be prevented from trading. In Germany, rules appear to be the weakest, considering that the market regulator found no market abuse in the Deutsche Börse case, although five of the 11 hedge funds in the pack were located in the same building in London and three shared an office.

- Some believe that the rules are clear and non-restrictive, and that the main barrier to change is cultural – e.g. lack of trust between institutional investors, or lack of belief in the benefits of collective engagement. If this is the case, policies are unlikely to change it.

One important step forward was the creation of the Investor Forum, which has developed a Collective Engagement Framework with the guidance of five law firms. This establishes a structure within which investors can collaborate without sharing inside information or breaching other rules; the Investor Forum Executive manages such collaborations to ensure compliance. The need for such a structure, and for legal advice to create the structure, highlights the complexity of the rules. Despite these important advances, perceptions of legal ambiguity may still deter collaboration. Some investors are not a member of the Investor Forum; collaboration outside such a group may be deemed sufficiently risky given legal ambiguities, particularly given the international dimensions. Moreover, the Investor Forum's main focus is intensive and wide-ranging engagements. There is no similar framework for routine or specific engagements. Hopefully, once the Collective Engagement Framework builds a track record of success for intensive and wide-ranging engagements, it can be applied and adapted to routine and specific engagements.

The first proposal (3a) is for the FCA to (further) clarify what type of collaborations are allowed and not allowed, and what information can and cannot be shared in such collaborations – similar to the Takeover Panel's Practice Statement 26. Even though regulators have already issued clarification statements, it seems that many investors are not aware of them, perhaps because collaborative engagement is not their focus. The second (3b) is to consider relaxing any restrictions that may deter collective engagement.

The Voting with Borrowed Stock policy (4) will allow investors to vote with borrowed stock only if they own (in their own right) a sufficiently 'large' stake to be likely to be informed and aligned with firm value. As discussed earlier, while percentage thresholds are commonly used, an investor with a small percentage stake may have significant incentives to intervene if her pound sterling stake is sufficiently large. We thus propose allowing an investor to vote with borrowed stock if she owns either at least 5% or £200 million of the firm's stock on the record date. In addition, it will impose a maximum period between the record date and the vote date, to reduce the ability of shareholders to acquire a 5% stake by the record date, borrow votes, and then secretly sell to a short position before the vote date. Note that, under this policy, all

investors can still borrow and lend stock, so liquidity should not be affected; the restriction is only on voting with borrowed stock.

The policy would also need to restrict investors from ‘synthetically’ borrowing stock. It is technically possible for an investor to buy stock, and then synthetically create a short position through trading derivatives and end up with a small or zero net economic exposure. The FCA would thus have to include such derivatives positions in its calculation of economic interest. If it is not possible to do so, the requirement for a 5% stake should still reduce investors’ ability to arbitrage around this policy. While borrowing large amounts of shares is possible, buying a 5% stake and then creating a synthetic short position of the same magnitude is likely to be difficult.

The Minority Shareholder Protection policy (5), for future discussion and research, aims to ensure that minority investors are not disadvantaged despite policies (1)-(4) which aim to incentivise blockholders. Existing research shows that blockholders improve firm value for the benefit of all shareholders, including minority shareholders, as well as stakeholders. However, there is some evidence that, particularly in emerging markets, blockholders can extract private benefits at the expense of minority shareholders, and we must ensure that the policies encourage blockholders to grow the pie rather than take a greater slice of the pie.

## Policy Rationale

Fragmented owners take advantage of corporate governance due to their small stakes. In contrast, blockholders have the incentives and ability to engage in governance, due to their large stakes<sup>37</sup>. There are two ways in which blockholders perform this function. The first is engagement/‘voice’ – direct intervention such as advising the manager on a restructuring, using their business contacts to benefit the firm or blocking pet projects. For example:

- The (former) Hermes Focus Fund engaged in private interventions with management; when these engagements were successful, they led to an average increase in firm value of 5%<sup>38</sup>. Note that ‘engagement rarely took a public form’, involving meetings and telephone calls with chairmen and senior executives rather than shareholder proposals or proxy filings. In part, this was due to the Fund contacting other institutional investors and soliciting support for its activities, thus having the threat of jointly calling an EGM if management were intransigent. This demonstrates the importance of (a) collaborating with other shareholders and (b) successful

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<sup>37</sup> Edmans, A. (2014). ‘Blockholders and Corporate Governance’. *Annual Review of Financial Economics*, (6), 23–50.

<sup>38</sup> Becht, M., Franks, J., Mayer, C. and Rossi, S. (2009). ‘Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund’. *Review of Financial Studies*, 22, 3093–3129.

engagement requiring ‘teeth’.

- Similar results were found for TIAA-CREF, a large US pension fund<sup>39</sup>. Again, activism primarily involved private letters to management, rather than open confrontation.
- Engagement can involve pursuing environmental, social, and governance (ESG) factors, rather than only shareholder value. However, consistent with the evidence in the [Interim Report](#), improving ESG factors also improves shareholder value. A study of a large anonymous institutional investor found that ESG engagements improved stock returns by 2.3% over the following year, and that ‘collaboration among activists is instrumental in increasing the success rate of environmental/social engagements.’<sup>40</sup>

The second governance mechanism is monitoring/‘exit’. If the manager underperforms or is delivering high short-term earnings at the expense of purpose and long-run value, blockholders can sell their shares, reducing the stock price and thus punishing the manager<sup>41</sup>. The threat of exit induces the manager to improve firm value. One concern with ‘exit’ is that, if an investor sells shares based on short-term earnings, this pressures managers to focus on earnings rather than long-term value. Nevertheless, earnings are public information and immediately incorporated into the stock price. There is little motive to sell a firm after it has delivered low earnings, as its price has already dropped. Instead, blockholders have the incentive to gather costly intangible information about a company rather than just relying on freely-available earnings – analyse its customer satisfaction, corporate culture, business strategy, and innovative capability<sup>42</sup>.

It is very important to note that, contrary to popular misperception, selling a stake is not short-termist. What matters is not whether an investor *trades* in the short term or long term, but whether she trades on short-term or long-term *information*. Blockholders, due to their large stakes, have incentives to gather long-term information. Indeed, there is evidence that blockholders trade on long-term information, and that their trading puts information into prices<sup>43</sup>. Consistent with both voice and exit mechanisms, blockholders are associated with

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<sup>39</sup> Carleton, W., Nelson, J. and Weisbach, M (1998). ‘The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF’. *Journal of Finance* 53, 1335– 1362.

<sup>40</sup> Dimson, E., Karakas, O., Li, X. (2015). ‘Active Ownership’. *Review of Financial Studies* 28, 3225-3268

<sup>41</sup> Admati, A. and Pfleiderer, P (2009). ‘The Wall Street Walk and Shareholder Activism: Exit as a Form of Voice’. *Review of Financial Studies* 22, 2645–2685.

<sup>42</sup> Edmans, A. (2009). ‘Blockholder Trading, Market Efficiency, and Managerial Myopia’. *Journal of Finance* 64, 2481–2513

<sup>43</sup> Parrino, R., Siais, R. and Starks, L. (2003). ‘Voting With Their Feet: Institutional Ownership Changes around Forced CEO Turnover’, *Journal of Financial Economics* 68, 3-46; Brockman, P. and Yan, X. (2009). ‘Block Ownership and Firm-Specific Information’, *Journal of Banking and Finance* 33, 308–316.; Yan, X and Zhang, Z. (2007). ‘Institutional Investors and Equity Returns: Are Short-term Institutions Better Informed?’. *Review of Financial Studies* 22, 893-924

higher R&D expenditure<sup>44</sup>, innovation<sup>45</sup> and firm performance<sup>46</sup>.

In the absence of significant blockholders, there are fewer shareholders in the UK who have the interest and resource to gather costly information about the companies in which they invest, and then help monitor and govern them, than in virtually any other major industrialised country. This is the rationale behind our individual policies.

The Disclosure Relaxation (1) aims to reduce the disincentives to investors forming a large block. There are several such disincentives. First, acquiring a large stake moves the price against them, particularly if they have to disclose their holding at interim stages before they have acquired their full block. For example, if an investor intends to acquire a 6% stake, in the UK she has to disclose her position after crossing 3%. This disclosure typically increases the stock price and makes it costly to acquire the remaining 3%. She may choose not to do so, and thus has half the incentives and half the power to engage. In the UK, directors are required to call a general meeting only if requested by the holders of 5% of shares; directors are required to call for a poll on a resolution only if requested by the holders of 10% of shares. These engagement thresholds are inconsistent with the 3% disclosure threshold: since the 3% disclosure requirement deters investors from acquiring stakes of more than 3%, in some firms, no single shareholder has the power to call for general meetings or poll votes.

Second, a large stake is illiquid. Selling a large stake will lower the price; moreover, the price fall is exacerbated by disclosure requirements. For instance, a 6% shareholder may wish to sell her entire block, either due to a liquidity shock or the firm neglecting long-term purpose. However, once she has sold 1%, she must disclose this sale, reducing the sale price for her remaining 5%. Expecting such illiquidity, she may not buy the block, to begin with. Third, a large stake is risky.

A major rationale for disclosure requirements is to address the **horizontal agency problem** between large and small shareholders – e.g. a majority shareholder channelling the firm's resources into another firm that she owns ('tunnelling'), or building a stake to benefit from a subsequent engagement without alerting small shareholders that she will be engaging. Nonetheless, the horizontal agency problem is unlikely to be severe in UK public firms. Tunnelling is rare given strong minority protection and the absence of majority shareholders. It is also not clear that the blockholder should alert small shareholders to the engagement (by disclosing her interim position) since she bears the full costs of it, and obtains only 6% of the benefits even after completing her 6% purchase. Moreover, both concerns are much smaller

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<sup>44</sup> Baysinger, B., Kosnik, R. and Turk, T. (1991). 'Effects of Board and Ownership Structure on Corporate R&D Strategy'. *Academy of Management Journal* 34, 205–214.

<sup>45</sup> Aghion, P., Van Reenen, J. and Zingales, L. (2013). 'Innovation and Institutional Ownership'. *American Economic Review* 103, 277–394; and Lee, P. (2005) 'A Comparison of Ownership Structures and Innovations of US and Japanese Firms'. *Managerial and Decision Economics* 26, 39–50.

<sup>46</sup> See, for example, Ekholm, A. and Maury, B. (2014). 'Portfolio Concentration and Firm Performance'. *Journal of Financial and Quantitative Analysis* 49, 903–931; and Bharath, S., Jayaraman, S. and Nagar, V. (2013). *Journal of Finance*, 68(6), 2515–2547

if the blockholder does not intend to engage in activism, hence the US's introduction of Schedule 13G filings. Note that even if the blockholder does not engage, she may still have substantial value through monitoring.

Instead, underinvestment in purpose is due to a **vertical agency problem** between management and shareholders in general. Managers may pursue short-term profits due to uninformed investors evaluating the firm based on profits, or pursue excessive pay or empire building due to a lack of active engagement. Vertical agency problems are likely more severe than horizontal agency problems in UK public firms, and so disclosure policy should be designed with the former primarily in mind.

The Structured Access policy (2) aims to clarify the distinction between confidential and inside information, thus making investors willing to receive the confidential information that is necessary for both engagement and monitoring. For example, providing advice on the company's future strategic direction requires a detailed understanding of the company's current position, and deciding not to sell shares after a low earnings announcement requires the investor to be able to analyse the firm's intangible assets.

As evidence on the potential benefits of structured access, we can study the effect of Regulation Fair Disclosure ('Reg FD') in the US, which moved in the opposite direction by preventing firms from making selective disclosure of material information and requiring broad, nonexclusionary disclosure of such information. Reg FD increased analysts' difficulty in forecasting earnings beyond the current quarter, and increased the quantity of voluntary disclosure by firms but only for current quarter earnings.<sup>47</sup> This highlights the potential unintended consequences of a level-playing field: only short-term, tangible information can feasibly be disclosed to all investors; long-term, intangible information (such as a company's strategic outlook) is difficult to disclose due to commercial sensitivity or intangibility. The results are consistent with concerns expressed prior to Reg FD: in the authors' words, '*Skeptics counter that, despite its good intentions, Reg FD will chill corporate disclosure and trigger an "information brownout." If the materiality standard is vague, companies will restrict discussions with analysts and institutional investors to avoid potential SEC legal action. Communication will be reduced to "sound bites," "boilerplate" disclosures, or large amounts of nonmaterial and raw information of little value to analysts and the public at large.*'

The Collective Engagement policy (3) aims to facilitate blockholder co-ordination. Many successful engagements involve collaboration between shareholders. This is because, even if an investor is a blockholder (owns 5% of the votes), she does not own the remaining 95%,

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<sup>47</sup> Bailey, W., Li, H., Mao, C. and Zhong, R. (2003). 'Regulation Fair Disclosure and Earnings Information: Market, Analyst, and Corporate Responses', *Journal of Finance* 58, 2487-2514.

and so her chances of success when engaging alone remain small.

An analogy is the SEC's relaxation of proxy rules in 1992, which allowed shareholders to make public statements of their voting intentions and/or voting rationale (including public speeches, press releases, newspaper adverts, and internet communications), thus facilitating coordination. This led to institutional ownership having an even more positive effect on firm innovation (measured by citation-weighted patents) than before the reform.<sup>48</sup>

The Voting with Borrowed Stock policy (4) aims to ensure that borrowed stock can only be voted by investors with the incentive to (i) make decisions in the interest of the firm as a whole, and (ii) conduct extensive analysis on the optimal way to vote. Blockholders satisfy both criteria. Their large stake ensures that they are aligned with the firm's purpose, and also gives them 'skin in the game' to become informed about the optimal decision.

This policy will address two issues. First, it will prevent votes being driven by small investors who are either uninformed and/or misaligned with firm value. Some merger decisions are swung by arbitrageurs with small stakes borrowing vote.<sup>49</sup> More generally, former SEC chairman Christopher Cox said that the practice of empty voting *'is almost certainly going to force further regulatory response to ensure that investors' interests are protected... This is already a serious issue and it is showing all signs of growing.'*

However, an outright ban on voting with borrowed stock may be unnecessarily restrictive. Evidence shows that stock lending can be a way of reallocating votes from uninformed investors to informed investors.<sup>50</sup> Small investors typically do not have sufficient 'skin in the game' to pay the cost of becoming informed about the vote, but large investors do. Indeed, analysis shows that stock lending creates value if the votes go to blockholders, but destroys value if they go to investors with a short position.<sup>51</sup> Thus, allowing stock lending to blockholders is a way of capturing the benefits of stock lending while minimising its costs.

Thus, the second rationale for policy (4) is to further encourage investors to become blockholders in the first place, and to engage once they have acquired a block. Note that policies (3) and (4) are related as they are both ways to increase the success probability of engagement. Policy (3) allows a blockholder to communicate with other large institutional shareholders, who typically vote their stock rather than lending it out, and persuade them to

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<sup>48</sup> Aghion, P., Van Reenen, J., Zingales, L., 2013, Innovation and Institutional Ownership. *American Economic Review* 103, 277-304.

<sup>49</sup> For example, in 2006, Henderson Land offered to buy the 25% minority interest in its publicly-traded affiliate Henderson Investment at a premium. A hedge fund borrowed Henderson Investment shares before the record date, short-sold those shares after the record date, then voted against the buyout and caused the stock price to fall by 17%. See Hu, H. and Black, B. (2007). 'Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership'. *Journal of Corporate Finance*, 13(2), 343-367

<sup>50</sup> Christoffersen, S., Geczy, C., Musto, D., Reed, A. (2007). 'Vote Trading and Information Aggregation'. *Journal of Finance*, 62(6), 2897-2929

<sup>51</sup> Brav, A., Mathews, R. (2011). 'Empty voting and the efficiency of corporate governance'. *Journal of Financial Economics*, 99(2), 289-307

vote the same way. Policy (4) allows a blockholder to borrow votes, for example from small retail shareholders who are unlikely to vote.

Note also that policy (4) is not intended to be a 'micromanaging' policy to allow blockholding, i.e. to create an unnecessary restriction and then to allow only blockholders to circumvent it. Instead, a restriction on voting with borrowed stock is desirable to promote purpose in and of itself. The exemption to blockholders is in recognition that blockholders are likely to vote with borrowed stock in an informed manner consistent with the company's long-term value. Policy (4) can also potentially be expanded to allow other likely informed investors to vote with borrowed stock, e.g. those categorised as Tier 1 by the FRC's Stewardship Code. Note that this would require further increasing the diligence of the FRC's given the additional benefits of being categorised as Tier 1.

## 5. Finance for Purpose

The proposal aims to create a greater flow of equity investment (and associated credit) dedicated to supporting purposeful companies. Our goal is to address the equity financing gap left by the retreat of increasingly fragmented and short-term UK institutional investors, provide a vehicle for better stewardship and growth of purposeful companies and secure more rooted long-term British ownership.

### The Case

The aim of increasing the flow of finance are to:

- Address the equity financing gap left by UK institutional investors such as Defined Benefit (DB) pension funds and insurance companies whose need to meet short-term liabilities deter them from investing in long-term risky equity assets on the necessary scale.
- Provide a vehicle that can act as a focus for better stewardship, developing and supporting companies' pursuit of purpose and engaging collaboratively with other investors to do so.
- Bolster the success of value-generating companies operating in the UK with clearly defined corporate purposes, and strong market positions at home and abroad.
- Balance the advantages of inward investment and foreign ownership against the loss of control over broader stakeholder interests in UK-based corporates.

#### ***Recommendation 5.1: Purposeful pension investment***

***BEIS and the Department for Work and Pensions (DWP) should offer DC pension fund members the choice of either joining newly created social pension funds or earmarking part of their portfolio for investment in purposeful companies. Moreover, such earmarking could be part of the default pension fund allocation, creating a pool of up to £100 billion for such investment by 2030. Funds would either be invested directly in purposeful companies or bonds issued by the Business Growth Fund (BGF) and British Business Bank (BBB) (see below).***

DC pension funds are projected to grow to £600 billion by 2030, a significant potential source

of new equity for purposeful companies. Unlike DB schemes, which guarantee that the final pension will be linked to the contributor's salary, DC schemes build a pension pot that can be used to buy an annuity or, under new legislation, used to be drawn down flexibly to support income in retirement. DC schemes are thus much better placed to accept investment risk to increase long-term returns because the fund does not have to achieve a given short-term return to meet a liability.

We propose that BEIS and the Department for Work and Pensions, after consultation, offer members of DC pension funds the choice of either joining newly created social pension funds, following the template recommended by the UK Advisory Board of the Social Impact Investment Taskforce, or to earmark part of their DC portfolio for investment in purposeful companies. Funds would either be invested directly in purposeful companies or bonds issued by the BGF and BBB. This proposal builds on existing trends in the market: for example, HSBC's £2.6 billion DC scheme is a global index fund with a climate change 'tilt'. Investing in purposeful companies would represent a similar 'tilt' which may be attractive to many DC pension fund members interested in devoting part of their portfolio to 'purposeful' investment, given that purposeful companies are proven to outperform non-purposed peers. In the next phase of The Purposeful Company, we will analyse ways to define companies as 'purposeful' and thus eligible for such investment. (One criterion could be that the firm follows the recommendations elsewhere in this report, e.g. incorporation around purpose, intangible asset reporting, and long-term executive remuneration.)

A further option would be to change the default pension allocation to apportion a given percentage towards purposeful companies or a purposeful company index. For example, if this apportionment is 20%, this could open up £100 billion of DC pension fund monies for investment in purposeful companies by 2030.

There is abundant evidence that the default option has a significant effect on choices. For example, organ donation<sup>52</sup> and pension plan<sup>53</sup> participation increase significantly when these are the default option. Moreover, many pension plans, while offering their members choice, include a default option given the complexity of the pension allocation decision; a significant proportion of members elect for the default option<sup>54</sup>. Simply offering purposeful investments as an option may not lead to significant uptake if members view them as unfamiliar and are unwilling to invest in them without significant analysis, which they may not have the capacity for. Including them within the default option does not restrict choice, since all members have the option to deviate from the default – in keeping with our enabling rather than prescriptive approach. Moreover, it should only enhance the return enjoyed by members who stick with

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<sup>52</sup> Rithalia, A., McDaid, C., Suekarran, S., Myers, L., (2009): 'Impact of Presumed Consent for Organ Donation on Donation Rates: A Systematic Review.' *British Medical Journal* 338, 284-287.

<sup>53</sup> Madrian, B., Shea, D., (2001): 'The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior.' *Quarterly Journal of Economics* 116, 1149-1525.

<sup>54</sup> Choi, J., Laibson, D., Madrian, B., Metrick, A. (2002): 'Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance' in Poterba, J., ed., 'Tax Policy and the Economy', MIT Press, Cambridge.

the default given the evidence that purposeful companies outperform in the long-run.

We note that many DC schemes have adopted passive investment strategies to keep costs within their 0.75% charge cap, raising questions about whether they could afford the stewardship costs of purposeful investment (engagement in and monitoring of investee companies) – although the introduction of innovations like the HSBC tilt suggest it is possible. Our view is that any such costs should be managed within the cap. If this is not possible, part of the annual positive duty on pension fund trustees should be to consider whether the fund has sufficient scale to engage in purposeful investing (our recommendation in Subsection 4.6). It also underlines the importance of structuring fees and commissions to reward desired behaviours.

***Recommendation 5.2: Purposeful collective investment***

***DWP, working with BEIS and the Department for Communities and Local Government (DCLG), should set guidelines for central and local government pension funds to invest in purposeful companies and promote engaged stewardship, following the example of the Japanese Government Pension Investment Fund (GPIF).***

An important source of equity earmarked for purposeful companies will come from the merger of Local Government Pension Scheme Funds. The formation of the London Collective Investment Vehicle (LCIV) in April 2016 was the first stage in this historic consolidation of Britain's local sub-scale public pension plans. The entire pension merger process will generate a pool of some £200 billion, creating one of Europe's largest pools of institutional assets. The government has already proposed that these investment pools could help fund improvements to Britain's infrastructure. Within the broader objective of securing returns with low volatility, it should still be possible for one or more of the subfunds in which the LCIV invests to be devoted to investing in purposeful companies – as for other consolidated local government pension schemes.

We also propose that all UK public pension funds should be required to demonstrate purposeful investment. It involves prioritising investment in purposeful companies, helping these companies to embed their purpose via active engagement and monitoring, and systematically publishing key performance indicators on how this investment strategy is being delivered. This requirement is modelled on the Japanese GPIF, whose \$1.3 trillion funds are required to support better corporate governance and stewardship. The GPIF has taken the lead in promoting long-term dialogue with companies and requires even managers of its passive funds to engage in good stewardship. It created the Japanese 'Stewardship Enhancement Group', established the 'Business and Asset Owner's Forum' and 'Global Asset Owners' Forum' to optimise the investment chain to pursue long-term investment returns for beneficiaries and has signed the UN Principles for Responsible Investment. It champions the Japanese stewardship code.

### ***Recommendation 5.3: Crowdfunding and digital platforms***

***The UK Municipal Bonds Agency should investigate building a crowdfunding platform Crowdfunding models and digital platforms, supported by the Municipal Bonds Agency, should be created to attract local equity investors for purposeful scale-ups and start-ups and scale-ups, initially working on pilots with a panel of Local Enterprise Partnerships.***

The UK should develop a variant of the local crowdfunding models created in the US to support municipal investment. For example, Neighbor.ly in the US pioneered civic crowd-funding and is currently building a platform to allow individuals and households to invest directly in their cities by buying bonds. Members of the community invest small amounts (e.g. £500-£5,000) and receive a certain interest rate (e.g. 6-7%) tax-free every year, plus their money back at maturity. This model is compelling because it has the potential to realise much bigger-scale projects. As a benchmark, most municipal bond issuances in the US are somewhere between one to ten million dollars, which is at the same scale as civic spending on transport infrastructure, water infrastructure, and other public improvements.

The UK could adapt this model, raising investment funds that, for example, Local Enterprise Partnerships might use to invest in purposed start-ups, scale-ups and spin-outs. The UK Municipal Bonds Agency was initially set up to reduce councils' capital long-term financing cost by selling bonds on the capital markets. Its mission should be expanded to build a crowdfunding platform to help UK citizens invest not only in their communities and infrastructure but also in locally based purposeful companies.

### ***Recommendation 5.4: Purposeful investment bonds***

***BEIS should investigate options to finance a scale-up of both the BGF and BBB. For example, both operations could be empowered to The BGF and BBB should be empowered to issue purposeful investment bonds, possibly supported by the government, to invest in new and growing purposeful companies – in particular purposeful SMEs and scale ups where the need for more investment and engagement is particularly acute.***

The BGF, owned by the clearing banks, was set up in the aftermath of the financial crisis to provide growth equity capital in the £5-£100 million range for SMEs with growth opportunities. With £2.5 billion of capital and a national network of eight offices (in Bristol, Reading, Milton Keynes, Birmingham, Manchester, Leeds, Edinburgh and Aberdeen), it has established a market niche with professional expertise, investing £500 million in some 100 SMEs with apparently a high success rate. The BBB could become the complementary pillar supplying credit. It does not lend to SMEs directly but instead works with other financial institutions to increase access to funding, such as by providing part-guarantees for loans.

Both organisations could be repurposed and substantially scaled to allow them to fund

purposeful small businesses where there is currently a substantial funding gap. Both could issue some billions of perpetual bonds whose proceeds could be deployed as equity and credit packages to support purposeful companies, unquoted, on AIM or the wider public markets. The buyers would be long-term pension funds and insurance companies having an opportunity to match long-term liabilities with long-term assets.

The focus should be on medium sized public companies and SMEs with a demonstrable capacity to scale where there is significant evidence that the UK falls short, and where both the Kay Review and the FRC have noted suffer from particularly poor levels of engagement, support and stewardship. If this is considered a major policy priority, the government should consider guaranteeing the value of at least the first round of bond issuance to get the financing off the ground.

The BGF could strengthen its eight regional operations by issuing tax-exempt bonds to local savers. The BBB would become the loan/credit arm supporting purposeful companies, scaling into a fully-fledged development bank with autonomous regional offices. For reference, the North-Rhine Westphalia Development Bank in Germany has total assets of €140 billion. There is no reason why over the next generation the two organisations could not grow to similar scale. CBI research finds that 46% of small and medium sized businesses are concerned that equity investment may mean loss of control. The scaling up of the BGF would raise the profile of the benefits of equity investment and so increase demand, while a willingness by both investors and entrepreneurs to experiment with the privileged shareholder model as a vehicle for equity investment (recommended in Subsection 4.4) would help allay concerns about loss of control.

This proposal aims to reproduce the success of the Industrial and Commercial Finance Corporation (ICFC) and the Finance Corporation for Industry (FCI). In 1945, the UK government created the ICFC, an organisation co-owned by the clearing banks and the Bank of England, to provide equity and loans to British small and medium sized enterprises. In the same year, the FCI was founded with its share capital subscribed by insurance companies, investment trusts and the Bank of England with a remit to provide larger amounts of capital (mainly loans) than the ICFC was tasked to provide. The twin objective for both was to lift investment and facilitate industrial rationalisation and restructuring after the war.

The 1970s saw the merger of the FCI and ICFC to form Finance for Industry (FFI), which was rebranded Investors in Industry in the 1990s and as 3i upon its flotation in 1994. It had a forty-year track record of success. However, since privatisation 3i has redefined its mandate to become a successful global private equity, debt management and infrastructure firm, focusing on investment in mid-market companies in Europe, North America and Asia. As a result, the gap in the market it was designed to close has re-opened. This gap is what the expansion of the BGF and BBB is intended to fill.

### ***Recommendation 5.5: UK investment fund***

***A UK Investment Fund, dedicated to investing in purposeful companies, should be considered. Financing and governance structures should be modelled with a view to creating a pilot fund.***

While all the above measures are feasible, they will build up only slowly, which opens up the question of whether the UK government should investigate the creation of a large UK Investment Fund. The concept of a UK sovereign wealth fund, or variant, has been attracting increasing cross-party, City and business support, even prompting a parliamentary debate in December 2016.

Nevertheless, there are substantial obstacles. Any UK Investment Fund would be different from a sovereign wealth fund in vital respects. UK saving is low, and the country runs a current account deficit. So its rationale would be because too little of an already low flow of saving is being invested in the creation of long-term purposeful UK companies, there needs to be a UK Investment Fund to make good the shortfall. The fund would therefore largely but not exclusively invest at home, unlike sovereign wealth funds who invest wholly overseas. The key issue is how it would be financed.

We propose a further round of investigation in the next phase of The Purposeful Company, along with further testing of government and City opinion. The general outlines are that any potential portfolio would consist of publicly quoted purposed companies, bonds issued by the BGF and the BBB and other special purpose vehicles created to support purposeful companies. The returns from its investments would be dedicated to servicing its own borrowing so that its directors and managers will need to be particularly skilled – and credible – in securing commercial returns over the long term. The portfolio could be diversified to include overseas purposed companies, and the Fund would be structured and governed so that it could take its decisions purely on objective commercial criteria independent from government or political interference. It could issue bonds to be bought by DC pension funds and ISA investors; in particular, in return for the ISA tax advantage, part of the ISA investment could be used to purchase such bonds. If the case were felt to be sufficiently compelling commanding sufficient support, a further source of funding would be government issuance of perpetual bonds at today's very low interest rates. We propose that work begins on creating a potential pilot fund.

## 6. Executive Remuneration

### Introduction

Critics of the status quo in executive remuneration voice three primary concerns:

- That executive pay encourages short-term behaviour that is to the detriment of the long- term growth and productive potential of the British economy;
- That executive pay has become disconnected from the pay of ordinary working people to an extent that is damaging social cohesion; and
- That shareholders do not have adequate control over executive pay practices, enabling companies to continue with practices against shareholder wishes.

Great companies need to attract great leaders, motivated to act with purpose. The commentary on executive pay is so relentlessly negative it is easy to forget this important fact. Good CEOs remain good value. Some of the commonly held views about executive pay are not borne out by the evidence. However, reform is required to ensure that incentives are aligned to long-term contribution, and that pay is better seen as deserved by all stakeholders.

First, pay structures need to be reformed to support purpose. CEOs should act purposefully because of and not in spite of their incentives. Executive pay needs to have less emphasis on performance-based incentive plans and more on high and long-term shareholding. Bonus targets need to be focused on dimensions of purpose, not short-term financial returns.

Second, companies need to take a much more active stance on pay fairness. The increase in pay ratios over the last thirty years is more capable of rational explanation than often assumed. Nevertheless, public trust in pay fairness has been severely eroded and must be rebuilt. Also, aspects of the CEO pay market and associated regulation make it inherently prone to inflation. There should be clear board accountability for ensuring pay fairness is considered and communicated, supported by appropriate transparency and employee engagement.

Third, despite significant advances over the last 15 years, executive pay disclosures still need improvement to ensure investors have the clear information they need to judge maximum pay opportunity and the link between pay and performance.

Fourth, the consequences may need to be strengthened for companies that lose remuneration votes or persistently achieve significant opposition. This will enable shareholders to take robust action against outliers, who can significantly influence the overall executive pay market.

In the rest of this chapter, we outline policies for reform of executive pay in the four areas set out above. More detailed discussion on data and policy options has been set out in our separate [Executive Remuneration Report](#) which may be found online. This chapter summarises the key conclusions of that work.

## Reform Pay Design

Since the mid-1990s UK pay for CEOs has become dominated by performance-based pay plans which pay-out according to performance targets operated over one to three years. Such plans typically make-up over three-quarters of the pay opportunity for a FTSE-100 CEO according to the Manifest 2016 Executive Remuneration Survey. These plans were introduced with the best of intentions to ensure that pay is strongly linked to performance. However, research has shown that, when used to the extent that is now typical, such plans have significant shortcomings:

- Executive behaviour (for example, in relation to R&D expenditure, capital expenditure, news releases, and other short-term controllable executive actions) can be distorted by upcoming incentive vesting events and by equity vesting patterns, with the effect being most extreme when performance conditions are close to being triggered<sup>55</sup>. This suggests that so-called 'long-term' incentives with performance-based vesting actually encourage short-term behaviour as vesting dates and triggers approach.
- Executives discount complex performance-based long-term incentive plans to an excessive degree, thereby limiting their effectiveness<sup>56</sup>.
- Short-term or poorly designed financial incentives can crowd out creativity and intrinsic motivation, and thereby act to inhibit purposeful behaviour, can be ineffective in incentivising performance in relation to complex multidimensional jobs and can lead to excessive risk-taking and even unethical behaviour<sup>57</sup>.

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<sup>55</sup> Edmans, A., Fang, V., and Lewellen, K. (2016), 'Equity Vesting and Investment', *Review of Financial Studies*, Forthcoming, SSRN: <http://ssrn.com/abstract=2270027>; Edmans, A., Goncalves-Pinto, L., Groen-Xu, M. and Wang, Y. (2016), 'Strategic News Releases in Equity Vesting Months', ECGI – Finance Working Paper no. 440/2014, SSRN: <http://ssrn.com/abstract=2489152>; Bennett, B., Bettis, C., Gopalan, R. and Milbourn, T. (2016), 'Compensation Goals and Firm Performance', *Journal of Financial Economics*, forthcoming <http://tinyurl.com/hvjhrbh>; Bizjak, J., Hayes, R. and Kalpathy, S. (2015), 'Performance-Contingent Executive Compensation and Managerial Behaviour', SSRN: <http://ssrn.com/abstract=2519246>; Laux, V. (2012), 'Stock Option Vesting Conditions, CEO Turnover, and Myopic Investment', *Journal of Financial Economics* 106, 513-526

<sup>56</sup> Pepper, A. (2015), 'The Economic Psychology of Incentives: New Design Principles for Executive Pay', Palgrave-MacMillan; PwC (2012), 'Making Executive Pay Work', PwC Research Paper

<sup>57</sup> Deci, E., Koestner, R. and Ryan, R. (1999), 'A Meta-analytic Review of Experiments Examining the Effects of Extrinsic Rewards on Intrinsic Motivation', *Psychological Bulletin* 125, 627-668; Ariely, D., Gneezy, U., Lowenstein,

- Research and experience show that CEOs can have significant influence over target setting and, partly as a result of information asymmetry, Remuneration Committees struggle to set consistently challenging targets as evidenced by the fact that incentive pay-outs are consistently biased towards 'above-target' levels<sup>58</sup>.

However, evidence also suggests that a high level of equity ownership, and longer term pay orientation, do lead to improved company returns, innovation, and CSR over the long-term<sup>59</sup>. At the same time, higher levels of debt-like pay (deferred compensation and unfunded pension plans for example) are associated with lower corporate bond yields, lower bankruptcy risk, lower stock return volatility, lower financial leverage, and higher asset liquidity<sup>60</sup>.

So the idea that incentives do not influence CEO behaviour is not borne out by the evidence. They do, just not always in the manner intended. Indeed, with CEOs now subject to such high-powered incentives, which can deliver life-changing sums of money in just a few years, it is of particular importance to ensure that packages are structured to support purposeful, long-term behaviour. It is precisely because incentives do work that they should be reformed, which is the focus of our first recommendation in this area.

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G., and Mazar, N. (2009), 'Large Stakes and Big Mistakes', *Review of Economic Studies*, 76, 451-469; Ordenez, L., Schweitzer, M., Galinsky, A. and Bazeman, M. (2009), 'Goals Gone Wild: The Systematic Side Effects of Over-Prescribing Goal Setting', *Academy of Management Perspectives* 23, 6-16.; Grant, A. and Singh, J. (2001), 'The Problem with Financial Incentives – and What to do About It', Knowledge@Wharton; Holmstrom, B. and Milgrom, P. (1991), 'Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design', *Journal of Law, Economics, and Organisation* 7, 24-52; Johnson, S., Ryan, Jr., H., and Tian, Y. (2009), 'Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter', *Review of Finance* 13: 115-145

<sup>58</sup> PwC (2015), 'Taking Stock – Review of 2015 AGM Season – FTSE-100', PwC Research Paper; Morse, A., Nanda, V., and Seru, A. (2011), 'Are Incentives Contracts Rigged by Powerful CEOs?', *Journal of Finance* 66, 1779-1821

<sup>59</sup> Flammer, C. and Bansal, P. (2016), 'Does Long-Term Orientation Create Value? Evidence from a Regression Discontinuity', *Strategic Management Journal*, Forthcoming SSRN: <http://ssrn.com/abstract=2511507>; Von Liliendorf-Toal, U. and Ruenzi, S. (2014), 'CEO Ownership, Stock Market Performance, and Managerial Discretion', *Journal of Finance* 69, 1013-1050

<sup>60</sup> Edmans, A. and Liu, Q. (2011), 'Inside Debt', *Review of Finance* 15, 75-102; Anantharaman, D. Fang, V. and Gong, G. (2014), 'Inside Debt and the Design of Corporate Debt Contracts', *Management Science* 60, 1260-1280; Wei, C. and Yermack, D. (2011), 'Investor Reactions to CEOs' Inside Debt Incentives', *Review of Financial Studies* 24, 3813-3840; Sundaram, R. and Yermack, D. (2007), 'Pay Me Later: Inside Debt and its Role in Managerial Compensation', *Journal of Finance* 62, 1551-1588; Cassell, C., Huang, S., Sanches, J. and Stuart M. (2012), 'Seeking Safety: The Relation between CEO Inside Debt Holdings and the Riskiness of Firm Investment and Financial Policies', *Journal of Financial Economics* 103, 588-610

### **Recommendation 6.1: Reform pay design**

**Shareholder guidelines and the UK Corporate Governance Code should enable and encourage companies to adopt simpler pay structures for CEOs based on long-term equity and debt holdings to encourage long-term behaviour and to avoid the unintended consequences of excessive focus on performance-based<sup>61</sup> incentives.**

- Packages should be structured so that exposure to the long-term value of the company out-weighs the potential gains from performance-based incentives vesting in any year. This means CEOs should rapidly (e.g. within two years of appointment) build up shareholdings of at least 2x the value of a year's performance-based incentives, with a target to increase this to 2x total compensation over time.
- This should be achieved through appropriate combination of reducing performance-based incentive plans in favour of long-term awards of equity; paying bonuses in shares; and making joining awards of equity to CEOs, vesting over long periods.
- Pay should be long-term, with shares released on a phased basis over periods of up to at least five to seven years depending on the industry with at least half of the shareholding requirement applying for at least two, and preferably three, years after leaving the company. Release of equity for sale should be phased and block-release should not be triggered on any defined event (e.g. retirement).
- Performance-based incentives should balance unleveraged financial measures of growth and return and should include non-financial and strategic measures based on fulfilment of the company's purpose, to ensure that targets are aligned with how companies will deliver value over the long-term in line with that purpose.
- Bonuses based on financial targets should be paid in shares, with board discretion to vary the bonus up or down based on holistic judgement.
- Particularly in highly leveraged or volatile companies, boards should consider paying CEOs in unsecured debt (e.g. via deferred compensation plans) as well as equity.

The evidence suggests that packages should be structured so that the primary incentive is to deliver long-term value through the share price, outweighing any incentives driven by

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<sup>61</sup> We use the term 'performance-based incentive' to refer to a cash or equity award with performance targets attached (typically over short-term periods of one to three years). This contrasts with simple equity awards, which while they are linked to performance by virtue of the share price, do not have performance targets attached and are not, for our purposes, included in the use of the term 'performance-based incentive'.

performance-based plans over the short to medium term<sup>62</sup>. Over the long run, there is no conflict between share price and purpose, with purposeful behaviour leading to higher shareholder returns<sup>63</sup>. De-emphasising annual bonuses and performance-based long-term incentives, making long-term stock awards, and requiring large shareholdings is, therefore, the most effective way to incentivise executives to truly long-term decision making and purposeful behaviour. Simpler packages, with less reliance on performance conditions, would also avoid the extreme difficulties that Remuneration Committees face in setting robust targets.

The logic behind the proposed level of shareholding is that the impact of a 25% change in the long-term share price should be more important than the amounts that could pay out from incentives in any year. A 25% change in share price is broadly equivalent to one quartile in the performance distribution over three to five years. Given the evidence that purposeful activity feeds into improved share price over the long term, this simple design principle ensures powerful incentive for companies to act with purpose. We note BlackRock's latest guidelines support the idea that shareholdings should be linked to the level of incentive opportunity<sup>31</sup>.

We would not encourage a 'one-size fits all' model. Pay packages should be tailored to individual company circumstances and strategies. There may be cases where traditional performance-based incentives may continue to be appropriate. This may particularly be the case in transformation or turnaround situations or distressed companies<sup>64</sup>. There are various ways of focussing packages on higher and longer-term shareholding:

- A rebalancing of packages away from performance-based incentives to stock awards;
- Initial stock awards or buy-in requirements for an executive on joining; or
- A phased approach so that performance-based incentives are increased in

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<sup>62</sup> Laux, V. (2012), 'Stock Option Vesting Conditions, CEO Turnover, and Myopic Investment', *Journal of Financial Economics* 106, 513-526; PwC (2012), 'Making Executive Pay Work', PwC Research Paper; Johnson, S., Ryan, Jr., H., and Tian, Y. (2009), 'Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter', *Review of Finance* 13: 115-145; Flammer, C. and Bansal, P. (2016), 'Does Long-Term Orientation Create Value? Evidence from a Regression Discontinuity', *Strategic Management Journal*, Forthcoming SSRN: <http://ssrn.com/abstract=2511507>; Edmans, A., Gabaix, X., Sadzik, T. and Sannikov, Y. (2012), 'Dynamic CEO Compensation', *Journal of Finance* 67, 1603-1647; Edmans, A. (2011), 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices', *Journal of Financial Economics* 101, 621-640; Edmans, A. (2012), 'The Link between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility', *Academy of Management Perspectives* 26, 1-19; Investment Association Executive Remuneration Working Group (2016), 'Final Report'; PwC (2013), 'Sense at Last', PwC Research Paper; Cronqvist, H., and Fahlenbrach, R. (2013), 'CEO Contract Design: How Do Strong Principals Do It?', *Journal of Financial Economics* 108, 659-674; Edmans, A. and Gabaix, X. (2015), 'Executive Compensation: A Modern Primer', *Journal of Economic Literature*, Forthcoming; Bebchuk, L. and Fried, J. (2010), 'Paying for Long-term Performance', *University of Pennsylvania Law Review*, 158, 1915-1959

<sup>63</sup> Edmans, A. (2011), 'Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices', *Journal of Financial Economics* 101, 621-640; Edmans, A. (2012), 'The Link between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility', *Academy of Management Perspectives* 26, 1-19

<sup>64</sup> Flammer, C. and Bansal, P. (2016), 'Does Long-Term Orientation Create Value? Evidence from a Regression Discontinuity', *Strategic Management Journal* Forthcoming, SSRN: <http://ssrn.com/abstract=2511507>

importance in the package over time as the shareholding builds up.

Package designs that meet the principles we suggest are likely to have features that go against many current corporate governance norms, for example:

- **Pro-rating for time:** reducing the value of long-term equity awards for good leavers simply means the timeframe of pay becomes shorter as CEOs approach retirement.
- **Making buy-outs in the form of performance-based awards:** in fact, making buy-outs in the form of shares provides the perfect opportunity to accelerate stock-holding as a balance to future performance-based incentives.
- **Heavy weighting to target based incentives:** packages should be rebalanced towards long-term stock awards to avoid short-term behaviour, which can be thought of as a rebalancing from variable to fixed pay, but with the fixed pay being delivered in shares.

However, we believe these norms should be set aside, as they militate against the development of packages that support long-term, purposeful behaviour. Examples of packages that would meet these criteria may be found in our [Executive Remuneration Report](#)<sup>65</sup>.

## Strengthen Board Accountability for Pay Fairness

Since the FTSE-100 index was launched in 1984, median CEO pay of companies in the index has increased around 7.5x in real terms. Over the same period, the declining share of wages in GDP means that wage growth has fallen behind economic growth by around 20%. In combination, these factors suggest that the ratio of FTSE-100 CEO pay to UK median earnings has increased from approximately 33x when the FTSE-100 Index was launched in 1984 to over 140x in 2015. This growth in CEO wages, and wage disparities has become a visible symptom of the perceived disconnect between ‘elites’ and ordinary people in the UK.

The reasons for the increase are hotly contested<sup>66</sup>. Factors that may reasonably be seen as justifying an increase in the pay ratio include the following:

- The constituents of the FTSE-100 have changed enormously since 1984. In particular,

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<sup>65</sup> Purposeful Company (2017), ‘Executive Remuneration Report’. pp 23-25

<sup>66</sup> Edmans, A. and Gabaix, X. (2015), ‘Executive Compensation: A Modern Primer’, Journal of Economic Literature, Forthcoming; PwC (2017), ‘Demystifying executive pay: Market or Racket?’, PwC research paper

the median value of a FTSE-100 company has grown 6.3x in real terms, whereas the economy has broadly doubled in size<sup>67</sup>. FTSE-100 companies have, therefore, become over 3x more valuable relative to the size of the economy over the last three decades. Research suggests we can expect a strong positive relationship between company size and pay levels, so a significant proportion of the increase in executive pay may be explicable in terms of increased size and complexity of the largest companies<sup>68</sup>.

- CEO pay has become more risky, through the decline of final salary pensions and the growth in performance-based pay. This has led to performance-based pay increasing from perhaps 25% of the package 30 years ago to more like 75% now. At the same time, contractual protection and CEO tenure have reduced, so part of the increase in pay can be explained by compensation for extra risk.
- Finally, there is evidence that CEO skills required to lead large companies have shifted from firm-specific skills to more general managerial and leadership skills<sup>69</sup>. This has opened up a more competitive market for executive talent with greater external and international hiring, leading to stronger market mechanisms in pay determination.

Given that increases in CEO pay reflect increases in pay across a wide range of occupations, where there is scarcity of skill (such as entertainment and media, sports, private medicine, private companies, finance, and professional services), the evidence suggests that a large portion of the increase in CEO pay can be explained by market factors<sup>70</sup>. Nonetheless, other factors may also have contributed to the increase:

- Executive pay disclosure rules may have led to a ratcheting effect in executive pay through chasing of benchmarks – while this may partly have led simply to the acceleration of trends already underway, there is evidence that this has had a causal impact<sup>71</sup>.
- Research and theory suggest that executive pay is subject to contagion effects<sup>72</sup>, where overpayment by a few companies or in a particular segment of the economy can result in an increase in levels of pay across the market. The financial services sector, where there was a well-documented pay bubble in the run up to the financial

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<sup>67</sup> Edmans, A. and Gabaix, X. (2015), 'Executive Compensation: A Modern Primer', Journal of Economic Literature, Forthcoming

<sup>68</sup> Gabaix, X. and Landier, A. (2008), 'Why has CEO Pay Increased So Much?', Quarterly Journal of Economics 123, 49-100

<sup>69</sup> PwC (2017), 'Demystifying executive pay: Market or Racket?' PwC research paper

<sup>70</sup> Kaplan, S. and Rauh, J. (2014), 'It's the Market: The Broad-Based Rise in the Return to Top Talent', Journal of Economic Perspectives 27, 3, 35-56

<sup>71</sup> Bereskin, F. and Cicero, D. (2013), 'CEO Compensation Contagion: Evidence from an Exogenous Shock', Journal of Financial Economics 107, 477-493

<sup>72</sup> Faulkender M. and Yang, J. (2010), 'Inside the Black Box: The Role and Composition of Peer Groups', Journal of Financial Economics, 96, 257-270

crisis, may have had a significant contagion effect in the UK and US.

- The spread of target-driven performance pay, combined with the relatively low cost of CEOs relative to the value of companies they lead, may have contributed to a culture in which almost any payment can be justified: if upper quartile performance by a typical FTSE-100 company adds £10 billion over three years, then even £100 million can be articulated as a 'small price to pay' for that success. Equally, performance-based pay plans can inhibit understanding of the true value of remuneration being awarded to CEOs.

Overall, our view is that there are some very legitimate reasons that can justify a significant proportion of the increase in executive pay, without recourse to accusations of market failure or weak governance. However, at the very least, the CEO pay market has particular characteristics that make it prone to bursts of inflation, namely: the relatively low cost of CEOs relative to company value; the high degree of transparency around executive pay levels, which can cause contagion effects; and asymmetric incentives for boards, given the potential costs of losing or not hiring the right CEO compared with the value they can add.

The result of these characteristics is that the market is producing an answer that is ever less acceptable to the public. The evidence from moral philosophy and behavioural science is that fairness should be defined as a due reward, related to the contribution made. Accordingly, fairness should not be understood as simply being about equality of outcome. An individual's efforts and actions affect their due reward, and human beings strongly distinguish between deserved and undeserved gains, between luck that is genuine chance and good fortune that arises from the application of skill through hard work and contribution<sup>73</sup>.

Recent polling evidence consistently shows majority opinion that executive pay is undeserved, too high, or symptomatic of self-interested managerial elites. Studies across the world consistently show executive pay to be around a factor ten higher than the public thinks it should be<sup>74</sup>. Some views on executive pay are doubtless due to a misunderstanding of the scale, demands, and potential impact of the job, which has been transformed in large companies in the last few decades. Nevertheless, this chasm in expectations cannot be ignored, and much of the concern about executive pay in the public's mind is that rises are seen as disproportionate, undeserved, and therefore unfair.

At the same time, we also need to be realistic about the impact that reducing CEO pay would have on public opinion. Research shows that public concerns about inequality across countries are not correlated with actual levels of inequality in each country, but are strongly

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<sup>73</sup> Hutton, W. (2011), 'Hutton Review of Fair Pay in the Public Sector'

<sup>74</sup> Kiatpongsan, S. and Norton, M. (2014), 'How Much (More) Should CEOs Make? A Universal Desire for More Equal Pay', *Perspectives on Psychological Science*, vol. 9 no. 6, 587-593

correlated with concerns about employment prospects<sup>75</sup>. Indeed, concerns about executive pay were less in the decade preceding the financial crisis, when the pay ratio grew from around 50x to 140x than in the decade since, when it has reduced slightly in real terms. Some polling evidence suggests that people are less concerned about what the CEO is paid provided all employees are paid fairly. There is little direct evidence that reducing pay inequality improves company performance, and indeed the balance of evidence is to the contrary<sup>76</sup>. But trust in the process and outcomes of setting executive compensation must be rebuilt.

A purposeful company, strongly connected to the needs of stakeholders, must have a robust view on its relationship to the inequality question. In order to preserve the corporate social fabric, pay differentials should be regarded as proportionate. This can be the case even if those differentials are wide, but not if they are unjustified. Robust processes within companies to demonstrate fairness can make a contribution to a wider societal settlement on this issue.

All of this leads to five key conclusions:

- Public concern about executive pay and inequality cannot be addressed just through a focus on pay at the top, but also requires a focus on pay growth for ordinary workers.
- Given the characteristics of the modern executive pay markets, robust frameworks are required to control pay and prevent re-emergence of unjustified pay inflation.
- A focus by boards on pay fairness is essential to rebuilding trust in executive pay.
- Employee engagement is necessary to create accountability, build understanding, and restore confidence in pay processes within organisations.
- Pay transparency needs to be improved to provide better information on both the link between pay and performance and on the comparative movements in CEO and employee pay over time.

Under recommendations 6.3 and 6.4 we addressed the questions of improved pay-performance disclosure and enhanced shareholder voting powers. The current proposal seeks to address understanding of, and trust in, pay fairness through a three-pronged approach of enhanced board accountability, increased transparency, and employee engagement.

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<sup>75</sup> PwC (2016), 'Time to Listen', PwC Research Paper

<sup>76</sup> Kale, J., Reis, E., and Venkateswaran, A. (2009), 'Rank-Order Tournaments and Incentive Alignment: The Effect on Firm Performance', *Journal of Finance*, 64(30), 1479-1512; Mueller, H., Ouimet, P. and Simintzi, E. (2016), 'Within-Firm Pay Inequality', *Review of Financial Studies*, Forthcoming, SSRN: <http://ssrn.com/abstract=2716315>; Bevan, S. (2013), 'Compensation Culture: Is executive pay excessive? Does it matter?', The Work Foundation; Connelly, B., Haynes, K., Tihanyi, L., Gamache, D. and Devers, C. (2016), 'Minding the Gap: Antecedents and Consequences of Top Management-To-Worker Pay Dispersion', *Journal of Management*, 42(4), 862-885

**Recommendation 6.2: Strengthen board accountability for pay fairness**

***The UK Corporate Governance Code should be amended to broaden the role of the Remuneration Committee to oversee that business purpose is being translated into behaviour and decisions around reward, including in relation to pay fairness. The Remuneration Report should include a Fair Pay Report explaining the company's approach to pay fairness, and including specified metrics including relative movements in CEO and employee pay over time. The company should establish a meaningful process for engaging with employees on the Fair Pay Report.***

What is required is a change in attitudes, and greater rigour, within boards relating to pay fairness. We believe that this change in behaviour is best achieved through a combination of expanded oversight accountability for Remuneration Committees, disclosure requirements through a Fair Pay Report within the Remuneration Report, and meaningful engagement with employees.

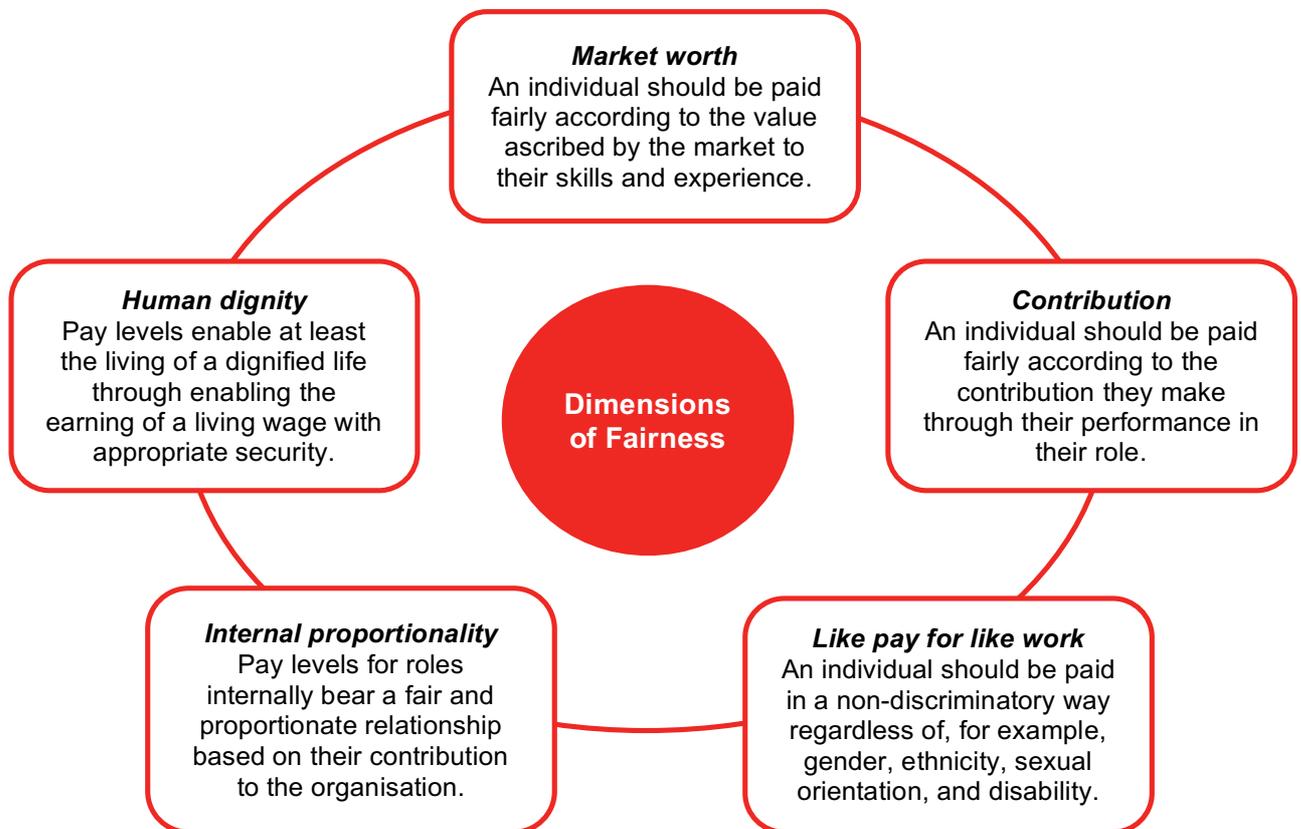
**Contents of the Fair Pay Report**

The current reporting regulations require a directors' remuneration report to include disclosure of: the percentage change in pay for the CEO compared with an appropriate employee group; an explanation of any differences in compensation policy between executive directors and the general employee population; a statement of how pay and conditions for employees were taken into account in setting director remuneration; a statement of whether and how employees were consulted when drawing up the policy; and a description of any comparative data used to inform decisions made. The resulting disclosures made by companies have generally been compliance-based and disappointing.

We, therefore, recommend that these requirements should be replaced by the requirement to publish, and engage with employees on, a Fair Pay Report, which would be the responsibility of the Remuneration Committee and would form part of the Remuneration Report.

In drawing up the Fair Pay Report, Remuneration Committees could usefully consider the different dimensions of fairness that may be relevant.

**Figure 4.6.1: Dimensions of pay fairness**



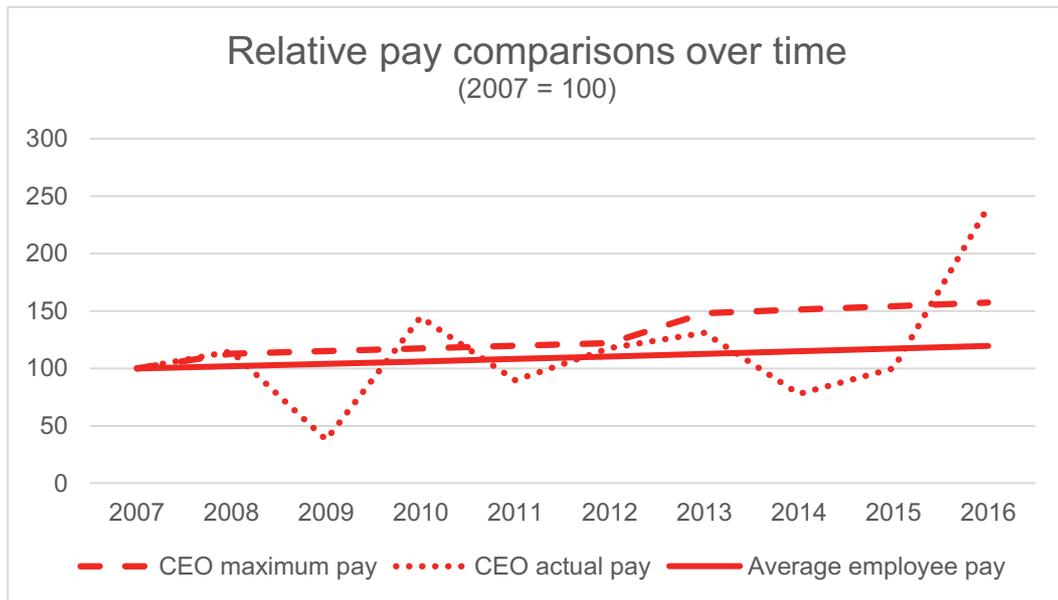
All dimensions of fairness are likely to have a role to play in most organisations. However, the emphasis may be different. For example, co-operative societies place a high value on internal proportionality. Technology companies, where wages are in any cases generally high, may operate a highly market-based approach while being consistent with their purpose. Global companies may be particularly concerned about ensuring human dignity is reflected in pay practices particularly in developing world operations and supply chains. What is most important is for the board, through the Remuneration Committee, to hold management accountable for developing a clear philosophy on fairness that supports the company's purpose and can be explained to stakeholders, particularly employees.

The Report should cover, supported by data where appropriate:

- The company's philosophy and principles on pay fairness across the population (including how fairness is defined), the approach taken to internal and external comparisons, covering the structure and level of pay, and the approach adopted to linking pay with performance, including the principal characteristics of incentive plans used.

- Explanation of how the policy on pay for the wider UK workforce differs from that for the CEO and other executives in terms of the elements of pay offered, the quantum of opportunity under those pay elements, and the target positioning of pay against the market together with justification for such differences.
- Explanation of the extent to which it is the company's policy and practice to pay living wages in the territories in which it operates and how these are established, statutory disclosures on gender pay, and broader approach to equal pay issues.
- Explanation of the approach by which the company engages with employees on the Fair Pay Report and a summary of any themes emerging from the feedback on the prior-year's Report.
- Tabular disclosure over the last five years (building to ten over time) of the maximum annual pay opportunity for the CEO; the actual amount paid (on a statutory single figure basis) and average pay for all other employees, or an appropriate subset representative of at least the general UK workforce.
- Graphical representation of the above tabular disclosures formed by rebasing each pay element to 100 at the start of the period, and a narrative explanation of the comparative trend over time (see Figure 4.6.2).

**Figure 4.6.2: Example tabular and graphical disclosure**



£000s	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Maximum CEO pay	3325	3749	3823	3900	3978	4057	4927	5025	5126	5229
Actual CEO pay	3263	3749	1237	4719	2927	3842	4272	2539	3266	7843
Median employee pay	40	40.8	41.6	42.4	43.3	44.2	45	45.9	46.9	47.8

The Fair Pay Report, therefore, combines defined quantitative disclosures and meaningful narrative disclosures to require companies to give a full account of their approach to pay fairness. Note that the link between pay and performance for the CEO is already covered in the Remuneration Report and would not be duplicated in the Fair Pay Report, although companies may wish to cross reference in the explanatory narrative.

The focus of the quantitative pay disclosures in the Fair Pay Report is on relative pay trends over time. This would identify whether the Remuneration Committee is structurally increasing the CEO’s pay opportunity relative to employees, as well as showing any divergence in pay-outs that would need to be justified by performance. This disclosure meets the intent of increasing scrutiny on pay inflation, but also on pay fairness, and would provide an effective trigger for board discussions and external challenge. We believe this is a more efficient implementation of the policy intent than annual spot pay ratios. The latter would place focus on potentially highly misleading comparisons between companies as opposed to within a company over time (see full [Executive Remuneration Report](#) for details). Moreover, the implication that lower ratios are always better is not supported by the best recent evidence from the UK and the US which suggests that, on average, higher ratios are in fact associated with higher performance, consistent with the idea that paying more to secure higher quality management can

be beneficial<sup>77</sup>. The Fair Pay Report would give anyone wishing to calculate a pay ratio easy access to the relevant information. However, we believe the statutory disclosure should focus on relative trends as above.

### **Enhancing engagement**

The Remuneration Committee should be required to report that it is satisfied that there has been effective engagement with employees on pay arrangements at all levels. The Remuneration Committee is responsible for only a sub-set of pay decisions so the executive team should undertake employee engagement in the same way that the board should expect customer insight to be conducted via market research led by management. The exception to this is that there should be an opportunity for representative employees to meet with the chair of the committee to hear an explanation of decision making relating to Executive Director pay.

Engagement would have two benefits. First, increased understanding of the company's approach to pay fairness can help increase employee engagement. But also, the accountability created by engagement would itself influence the nature of debate and decision making in the board, and ensure fairness considerations were given appropriate weight.

We do not recommend that the mechanisms for employee engagement should be legislated. It suggests that partnering with employees on such an important issue of well-being is bad for firm value, so we need to pass a law to achieve it. This is not true, many companies already voluntarily engage directly with their employees and employee representatives on issues impacting well-being. Robust evidence also shows that focusing on employee wellbeing (which involves consultation) improves firm value by 2.3-3.8% pa<sup>78</sup>.

At the same time, models for employee engagement will vary by the circumstances of each company, including its geographic reach and the nature of its workforce. There would be the possibility of extending the role of consultation and information requirements, which have been used to address a range of aspects of employee engagement, including on crucial organisational changes, health and safety and so on.

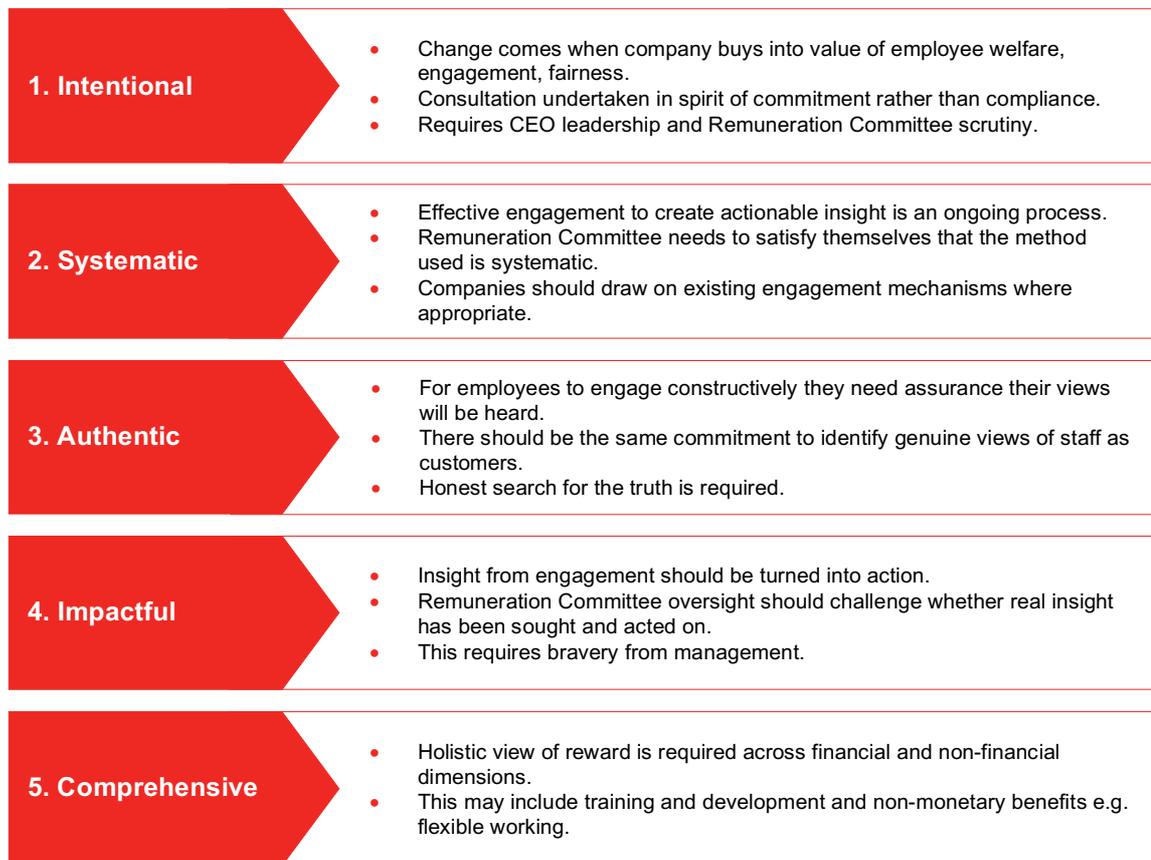
To satisfy themselves that employee consultation around pay practices has been done effectively, Remuneration Committees should look to assure themselves that the consultation undertaken by the executive team passes the five tests of effective engagement.

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<sup>77</sup> Kale, J., Reis, E., and Venkateswaran, A. (2009), 'Rank-Order Tournaments and Incentive Alignment: The Effect on Firm Performance', *Journal of Finance*, 64(30), 1479-1512; Mueller, H., Ouimet, P. and Simintzi, E. (2016), 'Within-Firm Pay Inequality', *Review of Financial Studies*, Forthcoming, SSRN: <http://ssrn.com/abstract=2716315>; Bevan, S. (2013), 'Compensation Culture: Is executive pay excessive? Does it matter?', The Work Foundation; Connelly, B., Haynes, K., Tihanyi, L., Gamache, D. and Devers, C. (2016), 'Minding the Gap: Antecedents and Consequences of Top Management-To-Worker Pay Dispersion', *Journal of Management*, 42(4), 862-885

<sup>78</sup> Edmans, A. (2012), 'The Link between Job Satisfaction and Firm Value, With Implications for Corporate Social Responsibility', *Academy of Management Perspectives* 26, 1-19

**Figure 4.6.3: Tests for effective engagement**



Where there is existing machinery for staff insight, either via management teams, the use of external research capability or with trade unions, then this can be used. In recent years there has been a steady increase in the systematic consultation of employees in response to statutory rights for employees to be informed and consulted in an increasing range of areas, which has led to the development of consultation mechanisms. As part of the government's wider review into enhancing stakeholder's voice, we are likely to see board sustainability committees taking a greater role in ensuring mechanisms exist for taking on board stakeholder views. These mechanisms could be used for consultation on the Fair Pay Report.

This process may not be easy for the executive team - particularly if there are trade-offs to be made. Employees may, for instance, have an interest in protecting their rights or preserving the status quo regardless of customers' needs, or maximising their compensation as possible, against the interests of shareholders. But, as with listening and acting on customer feedback, the value that can be created is significant. Moreover, in order to rebuild trust in pay, to the benefit of all UK business, decisive action is required. Despite the undoubted practical difficulties of engaging on the Fair Pay Report, we believe such engagement would strongly reinforce remuneration committee accountability in this area. Therefore, there should be a determination to overcome these difficulties..

## **Improve Transparency of Executive Pay and Performance**

The revised reporting requirements for Directors' Remuneration introduced in 2013 significantly improved transparency of the structure and outcomes for executive pay. However, experience over the last three years suggests three areas for improvement.

### **Clarifying the maximum in the policy**

The flexibility in the regulations about how the maximum for each pay element should be defined in the policy has led to different elements having a maximum defined in various ways, and at times no maximum applied at all. For instance, final salary pensions are often described just in terms of the benefit, rather than the maximum value. As a result, there have been cases of pension benefits amounting to many millions of pounds being reported when a director receives a substantial increase in pensionable pay for example. We believe that all elements of pay should be subjected to a clear monetary maximum. Where the value of a benefit is unpredictable, the company will be forced to provide a realistic assessment of the maximum amount, and would then be required to obtain shareholder approval for any excess payment over that amount.

The exception would be awards based on shares. It would be counterproductive to impose a limit on the value that arises purely from share price growth, as this is directly aligned with shareholder returns. Therefore, the maximum value of share awards would, as now, be defined by reference to their face value at the date of grant.

### **Separately showing the impact of share price growth on the single figure**

Although the maximum pay-out from share-based plans should be based on the face value at grant, we believe that it would be helpful for shareholders and other observers to understand the component of the single figure of pay that arose from share price growth as opposed to fixed pay or achievement against performance conditions. Therefore, we suggest the addition of two columns to the single-figure table to show:

- i. The single figure with share awards valued based on the share price at the date of grant of those awards.
- ii. The additional amount within the actual single figure disclosure that arises because of share price growth.

The amounts under (i) and (ii) above would by definition add up to the total single figure. This would help readers of the report to understand any cases where the single figure has exceeded the maximum in the scenario chart at the time the policy was approved. This disclosure is already included on a voluntary basis by some companies and can help reduce misunderstandings about the drivers of pay and how it compares with the policy limits.

## Improving disclosure of pay versus performance

The current 'single figure' disclosure of executive pay looks at pay elements crystallising based on performance in the reporting year. As such, it ignores the impact on the CEO of changes in value of previously granted equity. This is like analysing investment returns based on dividends but disregarding capital gains. High quality academic research always looks at the combined sensitivity of pay and wealth to performance, including previously granted equity. Given that the median FTSE-100 CEO has an after tax equity exposure of around £6.5 million, a 20% share price fall is equivalent to a pre-tax pay cut of around £2.3 million. This cannot be ignored.

In order to address this, as well as disclosing the single figure of pay, the company should show the wealth impact: the pre-tax change in value over the reporting year of previously granted vested and unvested<sup>79</sup> equity awards. The absolute £ value of that total shareholder return over the year should also be disclosed. These items should be published for the last ten years alongside the current requirement to disclose the single figure and vesting history.

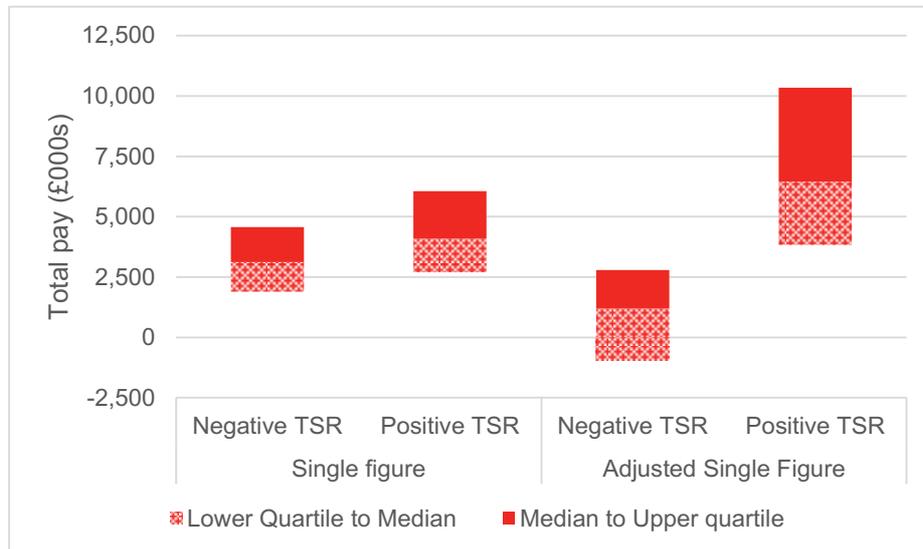
The chart below demonstrates the importance of this additional disclosure. It compares the single figure of pay for CEOs in the FTSE-100 for their most recent reporting year. This comprises base salary and benefits, bonus for the year, and long-term incentive pay-outs. The companies are split between those that delivered a positive Total Shareholder Return (TSR) over the year and those where TSR was negative (just over 1/3<sup>rd</sup> of the companies). The left-hand bars show the reported single pay figure. The right-hand bars show the reported single figure plus or minus the pre-tax change in value of previously granted equity (vested shares still held by the executive and unvested deferred awards).

Companies delivering positive TSR over the year had a slightly higher median single figure of pay - £4.1 million as opposed to just over £3 million for those companies that delivered negative TSR. This is a difference of one-third at the median; however, there is significant overlap between the quartiles of pay for the positive and negative TSR companies. While this analysis has not been subject to detailed controls, note that the median market capitalisation for both the negative and positive TSR groups was almost identical, so there is no obvious size affect distorting the results.

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<sup>79</sup> Note that changes in the value of unvested awards would only be included once those awards had counted towards the single figure in a prior year – for example a deferred bonus. This ensures no double counting of the share price impact on award values over time.

**Figure 4.6.4: FTSE-100 CEO pay for positive and negative TSR companies, before and after adjustment for previously granted equity**



The right-hand set of bars adds the change in value of previously granted equity. The impact of declining share price on the negative TSR companies reduced the pay of the CEOs of these companies by nearly one-half at the median, or about £1.5 million. Indeed, for nearly one-third of the companies delivering negative TSR, the fall in the value of shares more than offset the single figure of pay received in the year, meaning that those CEOs in effect received negative pay.

Using the adjusted figures, the difference between the pay of the negative and positive TSR companies increases to nearly a factor five, and there is no overlap in the quartiles. This analysis not only demonstrates the importance of ensuring CEOs are significant shareholders in their business but also shows the relevance of developing a pay disclosure that includes changes in the value of previously granted equity.

The time series disclosure would enable a user of the Fair Pay Report to aggregate and analyse the wealth impact over any period. Summing the single figure and wealth impact over every year of a CEO's career would yield the total change in wealth they had experienced as a result of being CEO. This could then be compared easily to the aggregate value created.

More detailed analysis shows that including the wealth affect significantly increases the observed correlation between pay and performance in the FTSE-100. This analysis indicates that the measured correlation between pay and performance increases from broadly zero

when no adjustments are made to nearly 80% when appropriate adjustments are made for size and previously granted equity<sup>80</sup>.

**Figure 4.6.5: Correlation between pay and performance with and without adjustment for previously granted equity**

Pay definition	R-Squared*
Single figure	19%
Single figure adjusted for size	48%
Single figure adjusted for size and previously granted equity	77%

\*Correlation between pay rank and three-year TSR rank

***Recommendation 6.3: Improve transparency of executive pay and performance***

***The Directors' Remuneration Reporting regulations should be updated to enable greater stakeholder understanding of a company's maximum pay and relationship between pay and performance.***

- The single figure table should disclose how much of the single figure arises from growth in share price on share incentives between the date of grant and measurement of performance and should show a separate total single figure excluding this amount.
- The single figure table should include the wealth impact on CEOs of the pre-tax change in value of previously granted equity over the year. This item should also be shown in the ten-year history together with the absolute total shareholder return achieved by the company over each year.
- Disclosure of share interests should include a weighted mean period to release for each of shares beneficially held, shares subject to service, and shares subject to performance.
- Within the remuneration policy, a clear monetary maximum should be stated and justified for each element of compensation other than those linked to the value of shares, in which case the limit should be based on the initial value of shares awarded.

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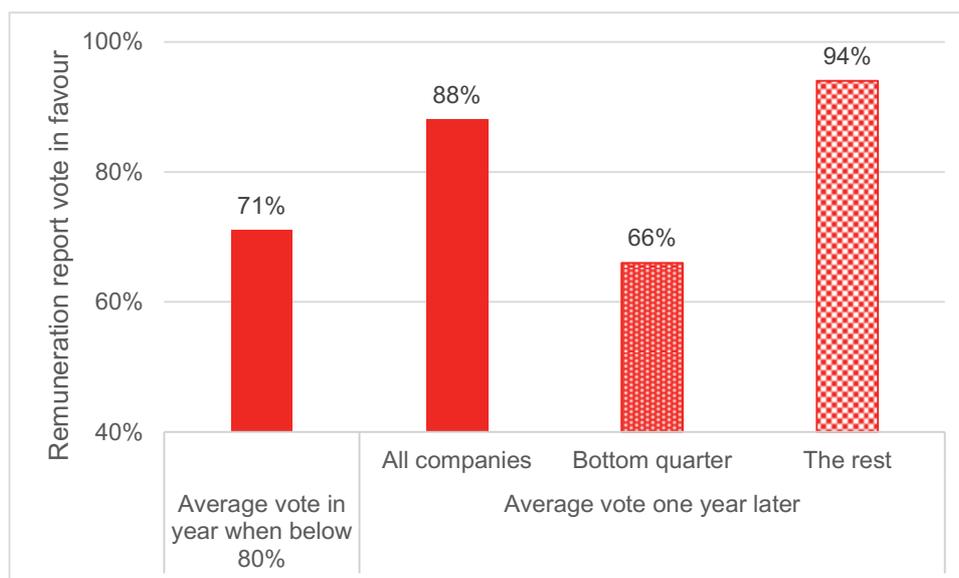
<sup>80</sup> PwC (2017), 'Demystifying Executive Pay: Paying for Performance', PwC Research Paper

## Strengthen the Binding Vote Regime

Evidence shows that the current UK voting regime, combining triennial binding policy vote and annual advisory vote on implementation of policy, has been effective<sup>81</sup>. It has enabled shareholders to bring about significant limitations on sign-on packages and lengthening of shareholding periods, has facilitated the suppression of pay inflation, and has resulted in improved disclosure of bonus targets. This is consistent with international evidence which shows that say on pay regimes are effective at improving the performance-alignment of pay plans and reducing pay inflation<sup>82</sup>.

Although the annual regime is advisory, companies do generally respond to low advisory votes. On average, a FTSE-350 company receiving less than 80% support for its remuneration report increases its vote by 17% points a year later. Three quarters of companies receiving more than 20% votes against improve their vote to an average of 94% a year later (see Figure 4.6.6).

**Figure 4.6.6: Shareholder votes for companies receiving 'low' levels of support**



Source: Proxy Insight Database, PwC analysis

However, a quarter of companies in this category also receive a vote below 80% the following year and, indeed, see their vote fall. This means that overall a small proportion of companies

<sup>81</sup> Ferri, F. and Maber, D. (2013), 'Say on Pay Votes and CEO Compensation: Evidence from the UK', *Review of Finance*, 17, 527-563

<sup>82</sup> Correa, R. and Lel, U. (2014), 'Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation around the World', *Journal of Financial Economics*, Forthcoming, SSRN: <http://ssrn.com/abstract=2328678>.

(c. 2%-3%) either lose the advisory vote or repeatedly receive significant levels of opposition (20% of votes or more against) on the advisory vote. These cases can undermine public trust in the voting system if it appears that there is no binding sanction. In fact, shareholders do have significant escalation powers, including voting against Directors in the case of companies that are persistent offenders. Nonetheless, shareholders' historic reluctance to use these powers undermines the effectiveness of the deterrent. There are signs of this changing, with Legal & General, BlackRock, the Pensions and Lifetime Savings Association, and Institutional Shareholder Services (ISS) amongst others issuing guidance that voting against the re-election of remuneration committee chairs will form a more formal part of their escalation process.

Given that we are only now coming to the second round of policy votes under the new system, there is a strong case for giving the current system more time to work. However, there is at the same time a clear political imperative to give the public confidence that shareholders are being given all necessary powers. Moreover, there is both theoretical and empirical evidence that a relatively small number of companies adopting outlier practices can have a surprisingly large impact on the whole market through a contagion effect<sup>83</sup>. Given the political context for executive pay, this creates a further rationale for enhancing the voting regime in order to ensure that shareholders have appropriate control mechanisms in such cases.

In our [Executive Remuneration Report](#), we compare different possible voting regimes. In summary, we conclude that introducing a binding vote for all companies every year is a disproportionate response to this problem, and would be likely to have many negative unintended consequences, as well as imposing unnecessary burdens on the 97% of listed companies, and their shareholders, where consistently high shareholder support is maintained. Having shareholders approve particular pay outcomes each year also fundamentally changes the nature of the relationship between shareholders and boards and represents a level of micromanagement of pay by shareholders that we do not see as appropriate or practical.

Therefore, it would be better to design an escalation approach such that only those companies showing an inability to sustain high levels of shareholder support would trigger a binding regime. Our proposal is that the escalation regime should be triggered if either:

- A company loses the advisory remuneration vote; or
- A company receives 25% or more votes against two years in a row.

Both GC-100 guidance and Legal & General have proposed 20% as representing a significant

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<sup>83</sup> Connelly, B., Haynes, K., Tihanyi, L., Gamache, D. and Devers, C. (2016), 'Minding the Gap: Antecedents and Consequences of Top Management-To-Worker Pay Dispersion', *Journal of Management* , 42(4), 862-885; PwC (2017), 'Demystifying Executive Pay: Paying for Performance', PwC Research Paper

vote against. We have chosen 25% vote against as our threshold for two reasons. First, this represents roughly a lower decile level of support in a given year, and second, we cannot see a rationale for triggering an enhanced voting regime at a level of support higher than that required to pass a special resolution.

There are several options for the consequences of entering the escalation regime:

- The company has to enter a binding vote regime on salary, bonus, and incentive outcomes for a period of time;
- The company has to bring back their policy for approval the next year with a supermajority of, say, 75%;
- The company has to bring a vote of confidence in the work of the remuneration committee which, if lost, would require a change in remuneration committee chair and a company statement of how shareholder concerns will be addressed.

Each has merits, and the pros and cons of each are discussed in our [Executive Remuneration Report](#). On balance we favour the second option above for two reasons. First, by requiring a new vote on the whole policy, it enables shareholders to focus attention on whatever aspect of the policy it was that caused concern. For example, if the concern relates to the treatment of leavers, then it may not be helpful if the sanction is a binding vote on bonus outcomes. Second, the supermajority threshold requires companies to adopt a relatively conservative policy to secure the necessary level of support. This provides a disincentive against companies either having their report voted down or consistently get opposition above 25%, and a sanction if they do.

The main disadvantage of this approach is that it may be considered disproportionate ever to require a supermajority on a binding remuneration matter, given that much larger decisions relating to corporate activity, for example, can be taken on a simple majority. There is also a risk of giving undue influence to activist investors or proxy voting agencies.

To guard against this, the requirements could be implemented on a 'comply or explain' basis through the UK Corporate Governance Code. If a company declined to bring forward a special resolution when a majority of shareholders wished them to do so, then shareholders could vote against the re-election of directors. Alternatively, if the proposal is implemented through legislation, then at the same AGM, at which the policy is brought for re-approval, a parallel resolution could be tabled authorising the requirement of a supermajority. If this resolution were defeated, then a simple majority would apply to the policy vote. Therefore, if there were reasons to believe that the vote could be subject to unintended consequences due to, for example, a large activist shareholder, it would be possible for a majority of shareholders to avoid being 'held to ransom' by a minority investor. This adds complexity but is a necessary safeguard in extreme cases.

Any approach that involves ‘special measures’ being triggered by a 25% threshold could be argued to give undue influence to proxy voting agencies: for example, a ‘vote against’ recommendation from ISS is typically associated with a vote against of c. 30% in the UK. We believe this fear may be overstated. Proxy voting agency recommendations commonly reflect concerns of major shareholders, with whom they regularly consult on their voting guidelines. Proxy agencies can be a helpful agent for marshalling coherence in investor views on crucial issues, and for enabling stewardship activities to be carried out at a reasonable cost. They can also arguably act as agents in support of collective engagement. Moreover, it could be argued that any concerns about the use of proxy agency recommendations should be laid at the door of shareholders rather than the agencies themselves: proxy agencies only advise, investors decide. It is important that this separation of responsibilities is kept clear.

Nevertheless, we do think that it would be good practice for proxy agencies to give clear feedback in engagement on company-specific issues, especially where they issue recommendations based on benchmark rather than tailored policies. There is evidence from the US that ISS recommendations do have a material impact on investor voting decisions<sup>84</sup>. In particular, we believe it would be good practice for proxy agencies to:

- Be open to engagement with companies and in particular to provide clear guidance, when proposals are likely to attract a negative recommendation;
- Take into account the views of a company’s major shareholders when making voting recommendations, particularly, for example, when those shareholders are supportive of an unconventional approach taken by the firm in the context of its strategy.

Equally, shareholders themselves should review whether, in their use of proxy voting agencies, they are taking their stewardship responsibilities sufficiently seriously, as covered in Subsection 4.4 on Repurposing the Investment Industry.

#### ***Recommendation 4: Enhance the binding vote regime***

***A binding vote regime should be triggered when companies lose, or repeatedly fail to achieve a threshold level of support on, the advisory remuneration vote.***

This could be implemented through legislation or changes to the UK Corporate Governance Code. If a company loses the advisory remuneration vote in any year or receives 25% or more votes against the advisory vote two years in a row, then:

- The company should bring forward its remuneration policy for approval at the next

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<sup>84</sup> Malenko, N. and Shen, Y. (2016), ‘The Role of Proxy Advisory Firms: Evidence from a Regression Discontinuity Design’, *The Review of Financial Studies*, 29, 3394-3427.

AGM of the company as a Special Resolution requiring a 75% majority to pass.

- At the same AGM, a motion would be brought forward enabling shareholders to dis-apply, by simple majority, the requirement to pass the remuneration policy by a super-majority.

Where issuing recommendations based on benchmark policies, proxy voting agencies should:

Give clear guidance during engagement with companies if proposals are likely to attract a negative voting recommendation and take into account the views, if made public, of major shareholders in a company when making voting recommendations on proposals where strategic fit is a strong element of the rationale.

## Section 5 – What’s Next?

The policies contained in this report point the way to re-thinking and re-orientating the fundamentals of a modern company, laying the foundation for a new wave of investment and innovation in the UK. The issue could not be more timely and of more national importance, with the Governance and Industrial Strategy Green papers initiating a much needed public debate about how the UK can thrive and grow, in a way that benefits all stakeholders – investors, employees, customers, suppliers, and society– across all regions.

This is a vital discussion. Unless radical action is taken, the UK’s stubbornly low productivity and wage growth, and high current account deficit and income inequality, will persist in the future, given continued weak investment. Our Task Force is stepping up to this challenge. We are very grateful to all the companies, investors, policymakers, academics, and stakeholders representatives who are participating via The Purposeful Company Task Force and also the broader collaborative endeavour created through the convening power of the Big Innovation Centre. All have shaped thinking and pushed ambition.

This leadership has created a potentially transformative programme for change where each policy proposal is powerful in its own right. The real opportunity for impact, however, comes from taking the programme of policies as a whole. The UK’s problems are systemic. Change cannot be piecemeal but must be system-wide, involving long-term thinking not only by executives, but also the directors who evaluate them, and the investors who appoint the directors. It includes not only changes in individual firms but an overhauling of accounting principles and potentially company law.

### **Purposeful Company Task Force - Phase 1**

The Purposeful Company Task Force anticipated this need for change. Since 2015, the focus of the Task Force has been on how UK governance and the capital markets environment can better support the development of great UK companies that think long term and act with purpose. The world’s best evidence around the impact of purposeful companies summarised in our [Interim Report](#) provided the platform for the recommendations in this Policy Report, and the next phase has to be about making change happen. Our policy proposals are a significant contribution to this debate, and we invite you to engage actively with them with urgency. We need to move beyond diagnosing the problem to bold, inspired, and committed implementation of solutions. The recommendations in this report give us a clear roadmap for this change and, as the table below illustrates, consist of change which can happen quickly, reform that will happen in the medium term, and open innovation and consultation which needs to be kicked off.

**Figure 5.1. Promoting purpose at an early stage, in the medium- and in the long term.**

	Early wins	Medium-term wins	Long-term wins /Further consultation
<b>Purposeful Companies</b>	<p><b>Recommendation 1.1:</b> Directors to Report on how they fulfil their Section 172 duties and satisfy the Fair Pay Report</p> <p><b>Recommendation 1.2:</b> Incorporation by declaring purpose statement in articles of association</p>	<p><b>Recommendation 1.3:</b> Adopt incorporation templates of public benefit, stakeholder participation and privileged shareholder models</p> <p><b>Recommendation 1.4:</b> Certification process created to assess companies' delivery of purpose</p>	<p><b>Recommendation 1.5:</b> Review and reform system to ensure neutrality between incorporation and governance choices</p>
<b>Purposeful Reporting</b>		<p><b>Recommendation 2.1:</b> Overhaul company reporting to ensure proper valuation of long term value and Intangible assets</p> <p><b>Recommendation 2.2:</b> Improvement of national measures and national valuation mechanisms of intangibles</p>	
	<p><b>Recommendation 3.1:</b> Investment Management companies to declare and report on purpose</p> <p><b>Recommendation 3.2:</b> Improved framework for describing purpose at fund and mandate level through clear investment objectives and reporting measures:</p>	<p><b>Recommendation 3.3:</b> Tougher stewardship rules, strengthen stewardship quality assessment and promote engagement activity</p>	
<b>Purposeful Capital</b>	<p><b>Recommendation 4.1:</b> Relax disclosure requirements for block formation</p> <p><b>Recommendation 4.3:</b> Clarify types of information that can be shared between companies and investors</p>	<p><b>Recommendation 4.2:</b> By developing protocols for structured access, work towards 'safe harbours' for confidential information sharing</p> <p><b>Recommendation 4.4:</b> Only blockholders to vote with borrowed stock</p>	
	<p><b>Recommendation 5.2:</b> Newly formed collective investment vehicles to lead on stewardship</p> <p><b>Recommendation 5.3:</b> Creation of local crowd funding models</p> <p><b>Recommendation 5.4:</b> Expand mandate of Business Growth Fund and British Business Bank</p>	<p><b>Recommendation 5.1:</b> DC pension funds to adopt default allocation of a percentage of assets for UK purposeful investment, creating potential pool of £100bn by 2030</p> <p><b>Recommendation 5.4:</b> Develop purposeful investment bonds for issuance by Business Growth Fund and British Business Bank</p>	<p><b>Recommendation 5.5:</b> Consult on possible creation of UK Investment Fund</p>
<b>Purposeful Pay</b>	<p><b>Recommendation 6.2:</b> Strengthen pay accountability through remuneration committee accountability for overseeing pay fairness, publication of a fair pay report, and establishment of employee engagement mechanisms</p> <p><b>Recommendation 6.3:</b> Greater transparency and simpler exposition of executive pay and performance</p>	<p><b>Recommendation 6.1:</b> Companies to adopt simpler pay structures for CEOs based on long-term (5-7 year) equity and debt holdings</p> <p><b>Recommendation 6.4:</b> Enhanced binding vote regime based on an escalation mechanism to focus on repeat offenders</p>	

## Purposeful Company Task Force - Phase 2

We are committed to going far beyond simply publishing reports to promoting engaged, intentional discussion on how to embed purpose so that it flows throughout an organisation and its ecosystem. Our priority is to identify and disseminate the strongest examples of progress around the policy proposals identified in this report and to showcase solutions that have developed and companies and investors who are implementing programmes that benefit both business and society. The Task Force will, therefore, publish an annual **Acceleration Report** each year over the next three years to highlight that business can deliver greater productivity, competitiveness and success without sacrificing sustainability or the public good. We will do all we can to champion these programs wherever we find them.

Phase 2 will also be about delivering **Change Accelerators** with action in three areas:

1. **Pilots** will be kicked off around the policy recommendations on pay, accounting for purpose and investment funds to demonstrate what is possible and encourage take-up. The Task Force, the Big Innovation Centre and change catalysts will prioritise where action is needed and then create the conditions for successful pilots along with resulting best practice blueprints and advice to policy makers, so we build urgency to act with companies and investors.
2. **Detailed work and consultation** will also commence in those areas requiring more development - particularly around Blockholding, Repurposing the Investment Industry, Finance for Purpose and valuing IP. Here we see the role of the Task Force and our broader partner network being about enabling and catalysing action. This means creating the conditions for change (e.g. in influencing government leaders to enable open innovation around value reporting), using our convening power to bring key players together to complete policy development or undertaking policy delivery design and providing thought leadership.
3. **Further evidence** will also be pulled together showing links between purposeful companies, trust and industrial strategy.

## Time for advocacy - Join The Purposeful Company Task Force

Given the opportunities provided by the Green Papers on Governance and Industrial Strategy, we want to ensure vigorous public debate. As we re-architect our country post-Brexit it is a time for policy solutions and mind-set change which are well rooted in evidence, so we positively impact our ability to deliver growth and wellbeing.

Business and investment leaders have a particular responsibility to implement change. Doing so will create sustainable wealth that can be shared with all stakeholders:

- **Investors will benefit** from better insight, dialogue and long term returns from those

they invest in.

- **Business will reap the rewards** of more sustainable returns and improved trust and credibility with their stakeholders.
- **Customers and the public** will be able to make more informed choices as to who to trade with and who to invest in dependent on the stated purpose and reported outcomes or companies that do business in the UK.
- **Government policy makers and regulators** will be able to set a minimum standard for those businesses who want to trade in the UK, ensure that we are investing in national infrastructure that will enable the emerging digital economy and effect a fairer distribution of the resulting wealth.

The next meeting of the Task Force to kick off this new phase of The Purposeful Company will be on the 27th April 2017. We invite you to join us to become part of this powerful movement transforming how the UK can thrive and grow. Contact us on [info@biginnovationcentre.com](mailto:info@biginnovationcentre.com) with comments and suggestions on the Report or to explore joining The Purposeful Company Task Force.

## Big Innovation Centre

This Policy Report is a publication from the Big Innovation Centre. The content of this paper reflects the opinions of its authors and not necessarily the views of the Big Innovation Centre or its supporters. The Big Innovation Centre is supported by the following companies, public bodies, universities and private trusts.



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Launched in September 2011, Big Innovation Centre is a hub of innovative companies and organisations, thought leaders, universities and 'what works' open innovators. Together we test and realise our commercial and public-purpose ideas to promote company and national innovative capabilities in a non-competitive and neutral environment. We act as catalysts in co-shaping innovation and business model strategies that are both practical and intellectually grounded. Our vision is to help make the UK a Global Open Innovation and Investment Hub by 2025, and to build similar initiatives internationally. For further details, please visit [www.biginnovationcentre.com](http://www.biginnovationcentre.com)

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