Local Authority
Pension Fund
Forum

LAPFF Response to BEIS Corporate Governance Green Paper

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 72 local authority pension funds based in the UK with combined assets of approximately £175 billion. It exists to promote the investment interests of the funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

Summary

The Department for Business, Energy & Industrial Strategy has requested comments regarding its Green Paper on Corporate Governance Reform issued in November 2016. This request for comments focuses on ensuring that executive pay is properly aligned to long-term performance, giving greater voice to employees and consumers in the boardroom, and raising the bar for governance standards in the largest privately-held companies. LAPFF works extensively in the first two areas but does not, as a matter of course, engage with private companies. Therefore, this response addresses the first two areas of inquiry but not the third.

Although The Forum is concerned that the current executive remuneration system is fundamentally broken and needs to be overhauled, for the purposes of this Green Paper, a number of suggestions are offered regarding the existing framework. Binding upper thresholds for total annual pay and mandatory disclosure of fund manager voting records are recommended. Furthermore, increased stakeholder engagement on executive remuneration, including employee representation on remuneration committees and incorporating employee views into pay policy, are recommended.

In respect of stakeholder engagement, LAPFF would like to see more legal requirements to ensure that stakeholder voices of all types, not just those of employees and consumers, are used to build business resilience through appropriate consideration of non-traditional financial factors. While voluntary standards can be helpful to elucidate legal requirements in this area, it is noted that they can just as easily misrepresent or gloss over legal requirements, which puts companies at greater legal, operational, reputational, and ultimately, financial risk.

LAPFF also sets out two areas (Q1 and Q7) where there are major problems with the regulator of governance, accounts and financial reporting, the Financial Reporting Council ('FRC')

CONFIDENTIAL

© Local Authority Pension Fund Forum, 2017

To put this consultation response into context, we have provided a brief critique of the concerns with the legislative and regulatory context of corporate governance in the UK.

The legislative requirements that the FRC is getting wrong are not even complex, the only things that are complex are the excuses that the FRC constructs to avoid dealing with its mistakes.

On s172 ('enlighted director duties'), the FRC has used several techniques to give the impression it has done nothing wrong. First, the FRC has cited a lack of prescriptive reporting methods in the legislation as the means to deny the prescribed purpose of the legislation. The falsity of that argument is betrayed by the Green Paper itself, which sets out that the lack of prescriptive methods is deliberate to enable flexibility in delivering the prescribed purpose. Second, the FRC has cited supplementary prescriptive reporting requirements in the Regulations that are only applicable to quoted and large companies, as the means of satisfying the legislative requirements of s414C(1). That is a fallacious argument given that s414(1) applies to all applicable companies, and the other supplementary requirements do not.

It is one thing for a regulator to make basic errors, but to then deny the facts when the errors are pointed out is entirely unacceptable. On the issue of "true and fair view" and distributable profits the FRC has tried to sustain its position by stating that the government had agreed with it, but correspondence from a Freedom of Information request showed the government did not.

The governance of the FRC itself is deficient, instead of having objectives, structure, responsibilities and powers defined in statute, the FRC operates with a 'Memorandum of Understanding' signed by departmental officials, not even a Minister. Despite fulfilling public interest functions the FRC is not subject to Freedom of Information for relevant areas of its work (such as policing accounts or setting standards, under delegated powers). One reason why the FRC is failing is because it was never set up properly in the first place.

The Treasury Select Committee described the position of the FRC as "inexplicable as it is unacceptable". We agree and believe that Downing Street needs to take an active interest in the position of the FRC; it falls so far short of the standards expected in public life, it warrants intensive investigation. LAPFF believes serious consideration should be given to disbanding it, and recommends that an independent Companies Commission be set up.

Executive Remuneration

LAPFF recognises that this paper provides a window of opportunity to redefine the debate on executive remuneration. The Forum is concerned that the current remuneration system is broken.

There are two principal reasons, the first is the long-standing concern about 'rewards for failure', where executives are highly rewarded despite subsequent failures in continuing company performance. The second reason is the growing belief by many stakeholders that executive pay at UK companies might be too high in general.

A more fundamental question is whether performance-related pay – a significant proportion of total pay - is really effective in motivating directors in the first place, or aligning their interests with those of shareowners.

The Forum is of the view that simply 'tinkering at the edges' of pay will not achieve the fundamental change that is required. Adjusting performance periods, setting acceptable minimum and maximum thresholds, or requiring more and more disclosure, will not lead to a dramatic reduction in pay. Nor will it necessarily result in an appropriate realignment with financial performance and shareowner interests.

CONFIDENTIAL

However, for the purpose of this Green Paper, the Forum submits its views as follows:

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

The Forum believes that the Board should be held accountable to shareholders on matters relating to executive compensation. With this in mind, option (i) an annual binding vote on the remuneration report is considered the best principle. However, we acknowledge the implications this will have on executives' service contracts, and therefore believe this vote should focus on variable pay, which is the primary driving force of pay inequality.

LAPFF believes that this move would promote a more active interest in scrutinising the annual remuneration report, and by focusing on variable pay the Company can continue to pay a fixed salary until shareholders have approved the variable element of remuneration.

The Forum also highlights that only six companies in the FTSE All-Share had remuneration reports rejected. The annual binding vote would facilitate greater levels of engagement, as companies seek to ensure that the resolution is approved at the AGM, or be faced with having to hold an EGM.

In addition, the Forum believes as a measure of controlling overall quantum, and a move to increase overall transparency, option (iii) a binding upper threshold for total annual pay (from all elements of remuneration) should also be introduced as part of the remuneration policy vote.

We believe that adding a maximum threshold would aid transparency as variable pay is granted in shares, where the intrinsic value is linked to share price. When coupled with holding periods, the true value of awards is often lost. Therefore, if shareholders were given the opportunity to approve a maximum cap on total pay every three years, it would allow certain 'passive' investors to keep track of pay levels at companies, without having to spend excessive resources evaluating the remuneration report annually.

Further, we do not agree that adding a cap will reduce motivation in executives to perform any better, as money is not necessarily the best motivator to recruit and retain executives. The Forum believes that many people are motivated by factors other than money, including a desire for challenge, mastery and personal satisfaction. Money is a factor, but it is not the sole determinant of why executives are attracted to a position, nor of why they choose to stay with a firm. Pay practices must take into account other motivations and incentives that drive human behaviour. [LAPFF Report: 'People and Investment Value']

Further to this, is a basic problem that proper governance requires the right numbers. The orginal Cadbury Committee report was entitled "the Financial Aspects of Corporate Governance".

There are major problems with both the accounting standards and the FRC as the regulator responsible for this area. LAPFF now has two opinions from eminent counsel that show how the FRC has got the wrong position on the law regarding true and fair view, distributable profits, distributions and net asset solvency, as well as the basic requirments of IAS 1 not being what they have been purported to be. On that basis the FRC is presiding over the setting of accounting standards that fail their core required purpose. But, not following the law is not only a hazard to investment, it creates illegal outcomes.

In October 2016 LAPFF wrote to FTSE 350 companies advising them to disregard the position of the FRC. Further to that is possible to see from circulars issued, where there has been a problem, companies are citing law in a way that is consistent with the position of LAPFF and

© Local Authority Pension Fund Forum, 2017

CONFIDENTIAL

Mr Bompas (e.g. Dominos Pizza plc, Wm Morrison Supermarkets, Next plc) and not the way of the FRC.

However, in November 2016, the FRC continued to put out guidance that is wrong and misleading, even though law firms correctly follow a contrary position that is consistent with the positions of LAPFF.

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

The Forum welcomes the mandatory disclosure of fund managers' voting records (option i). In particular, the Forum welcomes the idea of strengthening existing guidelines to encourage institutional investors to publish more detail on the rationale for their voting decisions. Frequently fund managers will often side with management, and ignore all other factors if the company performs as expected financially.

As responsible investors we do not believe it is prudent to award executives for making decisions to increase profits if it means the company's ethical conduct or reputation will be severely damaged in the process. Such short-term thinking can be value-destroying, and is another form of 'reward for failure.' By holding fund managers more accountable for their voting patterns, it forces them to reinforce expectations regarding long-term, sustainable growth in line with company standards and ethics.

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

As shareholders with an active interest in the companies we own, we believe companies should make their best efforts to consult with investors on their pay policies and practices. Only through meaningful dialogue with large and small shareholders in open forum, can the remuneration committee ensure that pay is both appropriate, and in line with shareholder expectations. We would particularly encourage outreach to investors that may take a critical view of remuneration, and for transcripts of the discussion to be made available to all shareholders

In addition, the issue of executive pay is not solely the purview of the remuneration committee. Decisions made about pay at senior levels affect the rest of the organisation; both in terms of influencing the availability of capital to be distributed elsewhere (dividends, reinvestment, employee pay and bonuses), and the motivation and productivity of middle-management and junior employees.

The Forum therefore believes that incorporating the views of employees is critical when setting executive pay. We strongly encourage companies to consider having employee representation on the remuneration committee, or formally canvassing employee views through surveys or separate advisory committees. In all cases we would encourage the company to implement a formal process to feed these views back into the deliberation of the remuneration committee, and to report back to shareholders on how the committee considered those views.

As a result LAPFF is supportive of option (i), the requirement of the remuneration committee to consult shareholders and the wider company workforce in advance of preparing its policy.

© Local Authority Pension Fund Forum, 2017

CONFIDENTIAL

When this can be done with executive director contracts it can reduce mitigating costs that may arise through legal action with regard to excessive terms and conditions.

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

The Forum believes there is a false market for executives, due to the small and homogenous pool of candidates whose current pay packages (as a group) are inflated to begin with. Peer group benchmarking serves to simply justify current levels of pay based on this false market. In addition, high rewards at one company can inflate pay within the peer group, regardless of each company's fundamental performance.

With this in mind, the Forum welcomes the possibility of having mandatory pay ratio reporting, specifically LAPFF would like to see annual publication of the ratio between average employee pay and average executive pay, as well as the ratio of pay between the top and bottom 10% and the provision of a graph charting the pay ratio trends for the current year and the preceding five years.

The Forum wants companies to create a shared vision of growth and success in collaboration with employees at all levels. However, we are concerned that the growing gap between pay at the top and everyone else can undermine morale and motivation in the workforce. We do not advocate that companies set an upward limit on the ratio of executive pay to average employee pay, but we believe the publication of these ratios on a yearly basis will make the remuneration committee more accountable for making appropriate pay distributions.

To counteract the 'misleading interpretation' of the ratio, companies are encouraged to explain the methodology for calculating the ratio, giving reference to sector pay averages and ratios as part of their rationale.

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

The Forum welcomes the idea of making retrospective disclosure of all bonus targets within a specified timeframe a reporting requirement. As these targets are based on past company performance, it is not clear why they would be deemed as materially sensitive.

However, increased disclosure of targets does not necessarily mean a greater control over the quantum of executive pay, and therefore when the Company deems the actual target to be commercially sensitive, a replacement placeholder scaling (e.g. a percent of target) should be provided to help shareholders evaluate the level of attainment and gain a greater understanding of final payout percentages.

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

The Forum fails to see the value of long-term incentive plans in motivating people to oversee complex business strategies spanning many years. Few executives would admit that if they

© Local Authority Pension Fund Forum, 2017

CONFIDENTIAL

were paid more, they would perform better, and few would succeed in explaining exactly how their LTIP motivates them to achieve company goals.

We regret that LTIPs have been used as a tool to complicate executive pay. As such we advocate a return to a simpler model of profit pools that use a straight-forward formula for calculating bonuses based on base salary and seniority.

That being said, if we want to encourage out-performance over the lifecycle of a company, the current performance periods of long-term incentive schemes are not long enough. For pension funds that often have 20 to 50 year time horizons it is difficult to understand how long-term has been defined as three to five years. We welcome the move to increase the minimum holding period of awards to five years, with a preference for ten years.

In addition, decisions taken by executives today may have repercussions for the company many years into the future. We want to be assured that executives have "skin in the game" and share in both the costs and benefits of their decisions over the long-term. As such, we recommend executives invest their own money and use their annual bonus scheme to achieve the minimum requirement within five years of their appointment. We do not believe unvested shares or unexercised options should be used to achieve the requirement. Setting a high share ownership requirement is one tool we feel will better align executive decision-making to the interests of their long-term shareholders.

Other Issues

Fixed vs Variable Pay

We see variable pay as added reward for exceptional performance, not as an expected supplement to the annual salary. Variable payouts that are in excess of the negotiated rate for the job serve to increase pay volatility and create cost uncertainties for shareholders. Placing greater emphasis on the fixed component of pay, in our opinion, will reduce complexity and lead to more straightforward and understandable remuneration schemes, both for shareholders and for the executives themselves.

Directors' Service Contracts

The Forum believes that companies should fully disclose directors' service contracts and supports current best practice that all contracts should include a notice period of no longer than one year. The most common notice period for directors' contracts of one year has reduced substantially over the past decade due to investor pressure. Rolling contracts of longer than one year can, and have led, to excessive compensation payments.

Even a one year contract could be considered too long, especially when it can be a vehicle for rewarding executives for failure. For example at Tesco where there was insufficient evidence to establish gross misconduct resulting in Tesco having to contractually pay 12 months of salary, or face legal action. LAPFF therefore considers that the calls by some investors, such as Old Mutual, for UK companies to reduce the service contracts to a notice period substantially below 12 months, for example to a three-month maximum, have merit, and is closely looking at this issue in reviewing its approach to executive remuneration and pay policies in 2017.

In UK common law, there is an obligation on the employee to seek work (to 'mitigate' their loss) and, if he/she secures work before the end of the notice period, he/she should cease claiming remuneration from the original employer. Companies have the right to enforce this duty of mitigation by negotiating the level of compensation payable. Yet most companies do not state that they will seek to apply mitigation during settlements and those that often do not do so in practice. Companies should apply the principle of mitigation rigorously.

© Local Authority Pension Fund Forum, 2017 Private & Confidential

CONFIDENTIAL

Liquidated damage provisions, or pre-determined compensation clauses, are useful for clarifying the situation for both company and employer, and can be a simple alternative to mitigation by guaranteeing payment that poses less cost to the company. For instance, if a contract provides for one year's notice but only six months' liquidated damages, the company has capped its liability at the lower amount. However, the liquidated damages set out in contracts are usually equivalent to, or sometimes more than, that payable under a normal notice period. Any liquidated damage provisions should be clearly set at a level that is lower than the payment due under a notice period.

Stakeholder Engagement

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

There are problems with the way that the requirments of s172 CA 2006 ('enlighted director duties') have been implemented as a result of the FRC's guidance on the Strategic Report (see later in more detail).

As well as a need to apply the existing law properly in this area, there are other areas where existing law needs to be applied properly. Also, more law and enforcement is needed to ensure that companies account for stakeholder interests, especially given there are inadequate checks and balances on businesses and their role in society. This governance gap is being recognised through the promulgation of legislation such as the Corporate Manslaughter and Corporate Homicide Act of 2007, the Bribery Act of 2010, and the Modern Slavery Act of 2015, among others. Infractions of all of the above would be prevented or mitigated by greater consideration of stakeholder interests.

In this context, Option (i): create stakeholder advisory panels is too weak a proposal. We have seen through LAPFF's work on IFRS, through corporate co-opting of human rights law through codes of conduct for suppliers, and through the TCFD's inaccurate framing of corporate and environmental law requirements in suggesting a voluntary disclosure standard on climate change that reliance exclusively on voluntary measures is an insufficient driver for businesses to adopt appropriate and meaningful responsible business practices. As a result, options (ii) – (iv) – designating existing non-executive directors to ensure that the voices of key interested groups, especially that of employees, is being heard at board level; appointing individual stakeholder representatives to company boards; and strengthening reporting requirements related to stakeholder engagement – are all necessary.

Strengthening the UK Corporate Governance Code position on appropriate succession planning, to include the consideration of stakeholder perspectives in assessing prospective directors' skills and backgrounds would be helpful. This would be a good requirement for senior independent directors (SIDs), who should be recruited in part based on evidence of their ability to work effectively with stakeholders.

We are not sure that a board-level committee to ensure that executive decision-making takes appropriate account of employee, supplier or consumer issues is enough in itself. Most large UK companies already have CSR committees (or some equivalent) that undertake this function, and they are largely siloed or inconsequential. Rather than mirroring the audit and risk committee structure, there must be a way to integrate the work of the stakeholder committee into the audit and risk committees' work so that the two areas function in a joined up manner and as a strategy and business model consideration.

© Local Authority Pension Fund Forum, 2017

CONFIDENTIAL

CONFIDENTIAL

© Local Authority Pension Fund Forum, 2017

Having the SID sit on all three main committees – audit, remuneration and nominations – might help to ensure that there is a joined up approach to integrating stakeholder considerations. The SID could then write a segment or segments for the annual report outlining how the relevant committees account for stakeholder perspectives in their decision-making. This could include objective-setting and reporting on how objectives have been achieved or not achieved, as the case may be. Such an approach would fit with the integrated reporting framework suggested by the IIRC.

On the subject of stakeholder reporting we are concerned that the position set out in the legislation (the Strategic Report Regulations s414C and s172 Companies Act 2006 'enlightened director duties') and set out in this Green Paper, has been undermined by the Financial Reporting Council (FRC) giving conflicting guidance.

First, the FRC issued guidance after the Regulations were published that bears more relation to the OFR (Operating and Financial Review) that failed to get legislative backing in 2005. Indeed, a review of responses to the FRC's draft guidance is clear that others had spotted that the FRC was not following the purpose of the Strategic Report set out in the legislation but something else. Second, in November 2016 the CEO of the FRC told Parliament that in order to have regulatory powers over s172, there needed to be a reporting requirement on s172 as a first step. Clearly there is a reporting requirement, as the Green Paper sets out, s414C(1). The FRC has stated that there is not a requirement to report on S172. The Green Paper is clear that there is a prescribed requirement to report, what is not in the legislation is a prescriptive method for doing it. That is not the same as no requirement.

Any method of reporting to stakeholders is acceptable. The 2011 UN Guiding Principles on Business and Human Rights (GPs) states, for example, that 'Communication by business enterprises on how they address their human rights impacts can range from informal engagement with affected stakeholders to formal public reporting.' (GP3) It is important to note that internal communication should also be a consideration, 'Internal communication of the statement and of related policies and procedures should make clear what the lines and systems of accountability will be, and should be supported by any necessary training for personnel in relevant business functions.' (GP 16) The SID could again be responsible for this internal communication.

While companies' means of communication with stakeholders should be flexible, GP 21 provides guidance on adequate communication:

In all instances, communications should:

a. Be of a form and frequency that reflect an enterprise's human rights impacts and that are accessible to its intended audiences;
b. Provide information that is sufficient to evaluate the adequacy of an enterprise's response to the particular human right impact involved;
c. In turn not pose risks to affected stakeholders, personnel or to legitimate requirements of commercial confidentiality.

These guidelines could apply to stakeholder engagement more broadly, not just in relation to human rights risks.

As regards constraints of director duties, it is important to emphasise that they are not mutually exclusive from stakeholder interests in most cases. In fact, often if they are framed as such, there is a lack of understanding of the role stakeholder perspectives can play in strengthening

© Local Authority Pension Fund Forum, 2017

the company. This is a sign that there needs to be a reassessment of board members' skills, knowledge and background.

If a SID appropriately assesses and frames stakeholder interests to the board, it is far more likely that other board members will take a more, rather than less, active interest in issues affecting employees and other key interest groups.

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

All types of companies regardless of size can benefit from strengthening the stakeholder voice. The UNGPs, for example, make clear that the Guiding Principles apply to businesses of all types and all sizes. The Guiding Principles also stress the risk assessment benefits of stakeholder consultation (more broadly than just employees) for all businesses (GP 18, 21). We note that investors are considered relevant stakeholders (GP 21).

What must vary from a practical perspective is not the type or size of a business required to strengthen consideration of the stakeholder voice, but the way in which businesses must consider stakeholder input. Typically, larger businesses have more resources with which to undertake stakeholder engagement than smaller businesses do. Therefore, smaller businesses might have less formal processes of engaging with stakeholders, including workers, than larger businesses. However, businesses of all sizes should be able to understand the value of stakeholder engagement and show how they are engaging effectively with stakeholders (the Guiding Principles refer to this as 'knowing and showing').

To this end, Option iii: Appointing individual stakeholder representatives to company boards is a good possibility to improve stakeholder engagement. Stakeholder representatives on boards can provide a new perspective and important check and balance to board discussions and decision-making, adding both a longer-term perspective and a link to the social context in which the business is operating. This will help to provide businesses with a social license to operate.

In relation to the stated concerns with this approach presented in the Green Paper, in the Forum's view we do not find them particularly compelling. Greater conflict in board discussion and delayed decision-making can already occur on boards that choose the wrong people for directorships. If there is an appropriate nominations process for a director with the requisite set of skills and knowledge who also represents the interest of relevant stakeholders, the more likely outcome is better developed and more sustainable policy positions emanating from the board.

Furthermore, the idea that real decision-making will shift away from the boardroom and into less formal channels ascribes far more power to stakeholders than they usually have. Additionally, the decision-making still takes place through the board and its role and powers set down in the company's Memorandum and Articles, so it is unclear how these representatives would be able to wield undue influence or power without full board approval.

This is demonstrated by the contradictory note in the next point made, which states that a single employee director could have limited impact in practice. This is more likely to be the case, but especially given that there are fewer and fewer checks and balances in public governance, even limited stakeholder input could help to ensure that companies are considering stakeholder perspectives in their operations, thereby ensuring their license to operate and an adequate assessment of business risks.

Choosing a stakeholder representative would not necessarily be more challenging than choosing any other board director. Nominations committees should try to select directors with a wide range of experience and expertise relevant to the business. In reality, they should

CONFIDENTIAL

already be taking stakeholder engagement and perspectives into consideration in choosing representatives, and arguably, those companies not doing so already are putting their business interests at risk. What will probably be more challenging is ensuring that boards keep open minds to stakeholder representative input; this does not mean that stakeholder representatives should not be on company boards.

In relation to constraints on directors through common directors' duties to promote the success of the company, we really need to get past this idea that stakeholder interests and company interests are mutually exclusive. Yes, there are situations where they can be mutually exclusive, but as we learn more about the importance of non-traditional financial factors, such as governance, social and environmental considerations and behavioural economic impacts, and their impact on business performance, it is increasingly clear that failure to consider these issues does more damage to companies than considering them.

The confidentiality concern is also non-sequitor. There would of course need to be clear guidance and transparency from companies, preferably including negotiation with stakeholders to the extent allowed by law, regarding how communication with stakeholders would take place and what information would remain confidential. Again, this is not to say there would be no conflicts arising from such processes, but to suggest it should be a reason to prevent stakeholder representatives from participating on boards misses the bigger and more important picture.

Finally, the fact that the proposed models will not work for every company should not be a problem. We already have an extensive set of laws and regulations that apply to all companies in some form or another, and the companies are all structured differently within this legal and regulatory framework. The same would be the case with stakeholder representatives.

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

The Forum believes that a combination of all three approaches will be needed to drive change. A strong legislative base is necessary so that business interests do not entirely dictate the process, as has happened with IFRS reporting guidance promulgated by the accounting industry and as with the enforcement of codes of conduct on human rights at suppliers, which is dominated by business interests. The net effect of this imbalance is that businesses suffer in the medium to long-term because they have either used the wrong (ie, non-legal) metrics or have defined the legal metrics in a way that suits them rather than the way the legislation, the courts or treaty bodies have interpreted the legal standards. This leads to a disconnect between a public interest standard and a corporate standard of conduct. As a result, we have situations where companies fail to identify accounting deficiencies because they are using the wrong standards, and/or are using the right standards incorrectly, and then they go insolvent or maintain illegal accounts (for more see the Addendum below). Additionally, they fail to identify significant social and environmental impacts that substantially affect their business strategies, models or operations and cause them to lose money. Sports Direct is a clear recent example of these deficiencies.

However, laws, and even regulations, are often quite general and lack clarity on how to apply appropriate standards. In this respect, codes and voluntary approaches can be extremely helpful. In fact, the UK Corporate Governance Code is extremely well-regarded and often has the effect of law in terms of the level of compliance expected by companies. The problem arises when these codes and voluntary initiatives are unduly influenced by corporate (or any single stakeholder) interest and veer off course in reflecting and reinforcing legal standards.

CONFIDENTIAL

Therefore, any promulgation of code-based or voluntary guidance to facilitate stronger stakeholder input should reflect accurately and completely the legal standard on this issue.

LAPFF Contact: Alan MacDougall (alanm@pirc.co.uk)

CONFIDENTIAL