BLACKROCK

21 February 2017

Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
3rd Floor Spur 1
1 Victoria Street
London
SW1H 0ET

Submitted via email to corporategovernance@beis.gov.uk

RE: BEIS – Green Paper on Corporate Governance Reform

Dear Sirs,

Please find attached BlackRock's[1] response to the Green Paper (Paper) on corporate governance reform published by the Department for Business, Energy & Industrial Strategy (BEIS).

Please contact Jennifer Law (jennifer.law@blackrock.com) if you would like to discuss any of the points we have raised.

Yours faithfully,

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[1] BlackRock is one of the world's leading asset management firms. We manage assets on behalf of institutional and individual clients worldwide, across equity, fixed income, liquidity, real estate, alternatives, and multi-asset strategies. Our client base includes pension plans, endowments, foundations, charities, official institutions, insurers and other financial institutions, as well as individuals around the world.

Executive summary

BlackRock supports a review of the state of play in UK corporate governance in light of recent high profile events and the commitments from the Prime Minister in this area. We agree with the UK Government that the country has a leading corporate governance framework. We see the UK as an attractive market for investors with strong and responsible businesses. We agree there is a need for business to take heed of evolving consumer, public and societal views which call on business to play a broader role in society. We would, however, caution against a too-blunt approach to reforming corporate governance. We recognise there have been some instances in recent years which have damaged the public's trust in business, and our approach is to focus on proposals that will serve to re-establish this trust.

BlackRock's mission is to create a better financial future for our clients. As a fiduciary, we focus on the long-term sustainability of the investments we make on behalf of our clients. In being a good steward of our clients' investments, we advocate corporate governance practices which we believe will maximise long-term value creation. Central to this is engagement with boards and management on the topics essential to delivering value for shareholders. We regularly ask CEOs to lay out for shareholders a multi-year strategic framework for long-term value creation. In our engagement with boards, we seek to understand how management is implementing this long-term strategy, and how it is approaching the range of factors, internal and external, that contribute to the company's sustainable growth.

Directors' competency and accountability at the roots of sound corporate governance

BlackRock believes the primary focus of any review of corporate governance should be on ensuring competent and effective board oversight and true director accountability.

BlackRock's approach to corporate governance is to focus on the board of directors as the agent of shareholders. We see the board as responsible for reviewing management's strategy and overseeing a framework of prudent and effective controls which enables risk to be assessed and managed. The board should provide direction and counsel to management, and oversee management's performance. Critical to this direction and leadership by the board is what BlackRock refers to as directors' competency. We see competency as a measure of quality and define it as the ability to make critical judgments. In our experience, this requires a combination of the requisite professional skills and experience as well as interpersonal capability encompassing strength of character, personality and behaviour. A high-quality and effective board will comprise competent directors able to ensure healthy and robust discussions during meetings.

We believe the board chair, in partnership with the nomination committee, is responsible for ensuring the board comprises the required mix of skills and experience to oversee the execution of the company's strategic objectives. In order to help shareholders better assess the overall strength of the board, the company should disclose detailed biographies of the directors and provide an explanation of how each director's experience and interpersonal capabilities are relevant to the long-term work of the board. Shareholders, then, must hold directors to account for their discharge of duty through engagement and voting on director re-elections where they have concerns. More explicitly, where shareholders believe directors have not provided effective or robust oversight of management, it is incumbent upon them to reflect these concerns to the board and to withhold support from the re-election of these directors if their concerns remain unaddressed.

The need to put accountability back in the hands of directors for decisions they have taken becomes clear with a review of the topics examined by the Paper. In this response to the questions raised in the Paper we put forward possible options for an improved oversight model; however, we stress the importance of remaining focused on addressing directors' competency and accountability as the cause of any corporate governance failings, rather than on simply masking the symptoms.

Executive pay

Highly talented and experienced executives are sought by many companies and deserve appropriate incentives, including substantial compensation. We recognise that companies in the UK market compete for talent globally hence any potential policy or regulation on executive remuneration should be considered in this context. BlackRock believes that the key purpose of remuneration is to attract, reward and retain high calibre directors, executives and other staff who are fundamental to the long-term sustainable growth of the company, with reward for executives contingent, at least in part, on controllable outcomes that add value. BlackRock considers pay from the perspective of performance. Executive pay should be closely linked to performance, by which we mean strong and sustainable returns over the long-term, as opposed to short-term hikes in share prices. This includes the critical assessment of pay outcomes and gauging performance based on metrics that are under the direct control of senior management. We believe it is the role of the board of directors and the remuneration committees to design and set pay aligned to these principles.

Directors are best placed to determine pay given their access to management information, and their knowledge of the company's business model and future strategic plans. This information is not always public at an early stage, if at all. In determining the optimal pay structure, BlackRock recognises the value that remuneration advisers can add, for example in providing market data. We do, however, expect boards to make the final decision themselves. Any misalignment of pay with the delivery of the company's long-term strategic objectives is therefore indicative of a corporate governance framework which does not provide effective and sufficient oversight by the board over the design of pay.

Since the separate vote on pay was introduced, we have observed a shifting of responsibility for setting pay from the boardroom to, ultimately, the general meetings for shareholders (i.e., AGMs, EGMs). Shareholders, however, are not the best positioned to determine pay, not least because they do not and should not have access to the material non-public information discussed above, knowledge of which is required to create pay structures which truly align with execution of the company's stated strategy.

We believe the following proposals will rebalance this accountability and re-establish the right mechanisms for oversight on pay:

- Where a company's pay proposal does not receive 75 per cent support from shareholders voting for two consecutive years, remuneration committee members should offer their resignation from the board to the board chair; it is then incumbent upon the board chair and the remaining board members to determine whether they believe these directors have the required mix of professional skills, experience and interpersonal capability to remain on the board and/or remuneration committee; the board should submit a report to shareholders outlining the outcome of this review and any supporting rationale

- More generally, we expect a majority of remuneration committee members to have served on the board for a year or more before taking on their remuneration committee responsibilities
- Boards should consider ordered rotation or refreshment of the remuneration committee, for example after five years
- Boards should disclose services received from remuneration advisers and the chain of accountability, e.g., to the board or to management
- Boards should disclose envisaged pay outcomes, in normal business circumstances, under the pay policy

Stakeholder voice

BlackRock believes strong boards should ensure all relevant stakeholders, such as employees, suppliers, and customers, are being considered at board level, primarily through overseeing management on how well stakeholder input is being captured. We suggest the following proposals to ensure more intentional discussion at board level:

- Boards should report to shareholders in the annual report on how they have engaged with management throughout the year on stakeholder considerations
- Improve the current level of reporting on management's stakeholder engagement process, e.g., identification by management of relevant stakeholders and their interests, disclosure on the setting of objectives or action points, updates on achievements and progress
    - In this report, management should confirm how the board was made aware of its stakeholder engagement process and its objectives

Corporate governance in private companies

Under the Companies Act 2006, directors have a duty to promote the success of the company. This duty applies to all companies, including private ones. When considering this duty directors of private companies should have regard to the interests of the company's employees and the need to foster the company's business relationship with suppliers, customers and others. While there is no 'formal' corporate governance code for large, UK privately-held companies as a whole, some large private companies, particularly those in 'regulated sectors' (i.e. sectors whose regulators apply additional corporate governance requirements over and above the duties in the Companies Act), already operate under higher governance standards derived from the UK Corporate Governance Code and other sources of legislation. BlackRock suggests the following proposal as an option to strengthen the governance standards of large privately-held companies:

- The introduction of proportionate corporate governance standards could be applied, based on a size threshold of the privately-held company, to sectors that are not currently required to comply with additional corporate governance requirements in addition to the Companies Act. These additional standards should be focused on the competency of directors and fitness and propriety for directors and senior executives.

Detailed response

I. Executive pay

Highly talented and experienced executives are sought by many companies and deserve appropriate incentives, including substantial compensation. We recognise that companies in the UK market compete for talent globally hence any potential policy or regulation on executive remuneration should be considered in this context. BlackRock believes that the key purpose of remuneration is to attract, reward and retain high calibre directors, executives and other staff who are fundamental to the long-term sustainable growth of the company, with reward for executives contingent, at least in part, on controllable outcomes that add value. BlackRock considers pay from the perspective of performance. Executive pay should be closely linked to performance, by which we mean strong and sustainable returns over the long-term, as opposed to short-term hikes in share prices. This includes the critical assessment of pay outcomes and gauging performance based on metrics that are under the direct control of senior management. We believe it is the role of the board of directors and the remuneration committees to design and set pay aligned to these principles.

BlackRock believes that each company should structure their remuneration policies and practices in a manner that suits the needs of that particular company given the broader context and environment that it operates in. BlackRock assesses a company's approach to pay in the context of its business operations and strategic direction.

The board is responsible for determining the right amount to pay for key executive roles. This amount should be based on a calculated assessment of what needs to be paid to get the job done, rather than the amount a particular individual demands. BlackRock does not believe this amount should always be ‘the most’.

BlackRock has been an active participant in the debate on corporate governance, including executive pay, in the UK for a number of years. We acknowledge the Government’s aim to address pay at market level. While we believe there are a number of issues which are widespread and can indeed be addressed at market level, it is important to recognise that shareholders review pay, first and foremost, in the context of the individual business (i.e., alignment of structure to the execution of strategy). As stated above, we have observed a shifting of responsibility for setting pay from the boardroom to shareholders, since the separate vote on pay was introduced. Shareholders, however, are not the best positioned to determine pay, not least because they do not and should not have access to the material non-public information (including guidance on operational and commercial considerations, and other issues internal and/or unique to the company) necessary to create pay structures which truly align with execution of the company’s stated strategy. Our proposals below seek to rebalance this accountability, putting it decisively back in the hands of the board.

Shareholder voting powers

When examining options to strengthen shareholders’ voting powers on executive pay, it is imperative to first determine whether their existing powers are insufficient. Where shareholders believe directors have not demonstrated competency in designing and implementing pay policies, they should withhold support from the re-election of the remuneration committee members. These are the directors most responsible for setting pay. Table 1 below identifies the UK companies which received a significant minority[2] of shareholder opposition to their pay proposals in both 2015 and 2016 and the

[2] Defined for illustrative purposes as 25% of shares voted, or greater.

corresponding level of support on the re-election of the remuneration committee chair. As the table shows, shareholders in UK companies have historically been very reticent to withhold support from directors' re-elections, even when they were disappointed with the design of executive pay policies. Voting against a director's re-election has always been seen as a last resort as it would disrupt the board. BlackRock believes the separate vote on pay has become a proxy for shareholder dissatisfaction with the quality of directors' decisions on executive pay. Directors, in turn, have become shielded from true accountability for their decisions. Rather than focusing on additional voting powers on pay policies and outcomes, BlackRock believes instead that shareholders should more consistently withhold support from the re-election of directors where they have concerns with these directors' fulfilment of duties in relation to pay. In line with this, we have clarified our approach this year, as outlined in our revised remuneration guidelines for Europe, the Middle East and Africa.[3]

Table 1: Comparison between vote on pay and vote on the re-election of remuneration committee chairs in some UK companies

Company	**Year**	**Vote on pay**		**Reelection of the Chairman of the Remuneration Committee**
		Type	**Results** (% for)	**Results** (% for)
Ladbrokes plc	2016	Remuneration report (advisory)	58%	99%
	2015		70%	100%
Man Group plc	2016	Remuneration report (advisory)	60%	100%
	2015		65%	99%
	2015	Remuneration policy (binding)	57%	99%
SVG Capital plc	2016	Remuneration report (advisory)	62%	100%
	2015		62%	100%
	2015	Remuneration policy (binding)	60%	100%

Source: Proxy Insight, Proxy Monthly (volume 3, issue 9) September 2016, p. 4, plus company websites

Proposal: One way to reinforce board accountability through the voting process is to develop an escalation process. Where a company's pay proposal has received less than 75 per cent of votes in favour for two consecutive years, remuneration committee members should offer their resignation from the board to the board chair. It is then incumbent upon the board chair and the remaining board members to reflect on whether these directors have the required mix of professional skills, experience and interpersonal capabilities to remain on the board and/or remuneration committee. The board should submit a report to shareholders outlining the outcome of this review and any supporting rationale.

[3] BlackRock, *Our Approach to Executive Remuneration in Europe, Middle East and Africa*, January 2017, https://www.blackrock.com/corporate/en-gb/literature/market-commentary/blk-approach-to-executive-remuneration-in-emea-jan2017.pdf, p. 3.

To further strengthen director accountability, when a pay proposal does not receive 75 per cent of votes in favour in one year, the board should seek to understand shareholders' concerns. In the annual report the following year the board should clearly and explicitly articulate what these concerns were and how they have been addressed. This should result in an improvement to the current levels of disclosure we see from companies with a significant vote against, which are boilerplate at best.

BlackRock believes this approach will provide the necessary rebalancing of accountability to the board. While we believe the entire board is accountable for decisions on pay, as mentioned previously we believe remuneration committee members are the directors most responsible for setting pay.

Other options discussed: BlackRock has reservations over the effectiveness of creating additional shareholder votes on pay and additional binding votes on pay, as explored by the Paper in options i-iv. These proposed mechanisms continue to remove responsibility for setting pay from directors. As stated above, directors are responsible for determining the optimal pay structure for the company, based on their access to management information, and their knowledge of the company's business model and future strategic plans. This information is not always public at an early stage, if at all. Shareholders should not have access to this information due to its material and non-public nature. The role of shareholders is not to design pay but instead to hold directors to account for their decisions on pay. Shareholders should withhold support from the re-election of directors where they have concerns with the effectiveness or robustness of director oversight in relation to pay decisions.

Option v suggests reviewing how companies engage with their shareholders on pay. In BlackRock's experience, the level of dialogue between UK boards and their shareholders is comprehensive and thorough. Discussions on setting executive pay provide illuminating insights into boardroom culture and the robustness of oversight. However, pay cannot be looked at in isolation, and it is important that shareholders continue to have the opportunity to discuss issues critical to the long-term success of the business, such as board composition, director competency, strategic direction, or identification of long-term risks and opportunities.

The role of shareholders

Shareholders' transparency on their voting actions offers a good tool to examine whether they have held directors to account for design of executive pay. There are already a number of transparency standards which are applicable to institutional shareholders around the world, as relevant, including through the FRC's UK Stewardship Code,[4] or the US Investment Company Act of 1940.[5] BlackRock believes the disclosure requirements for asset owners and asset managers under the revised Shareholder Rights Directive, to be implemented by EU Member States in 2019, offer a comprehensive level of transparency[6].

Other options discussed: BlackRock has the following concerns with the establishment of a senior shareholder committee, as discussed under option ii:

[4] UK Financial Reporting Council, *UK Stewardship Code*, 2012, Principle 7, p. 9.
[5] US Securities and Exchange Commission: *Investment Company Act of 1940*, Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, https://www.sec.gov/rules/final/33-8188.htm.
[6] '*EU Shareholder Rights Directive*', Proposal for a Directive of the European Parliament and of the Council on amending Directive 2007/36/EC and Directive 2013/34/EU, Article 3f(b) p. 36, http://data.consilium.europa.eu/doc/document/ST-15248-2016-INIT/en/pdf.

- It reinforces the current perception that shareholders are responsible for designing executive pay policies. Boards and remuneration committees are responsible for determining executive pay policies. Shareholders are responsible for holding directors to account for their decisions on pay.
- It could expose shareholders on this committee to material non-public information, e.g., corporate strategy and operational goals, thus making them insiders and constraining their ability to meet their fiduciary duty to clients
    - This is even more the case where the Paper suggests this committee could also be called upon to scrutinise other key corporate issues such as long-term strategy or directors' appointments
- It requires a level of micromanagement of the company that most shareholders are not well-placed to perform
- A small group of shareholders cannot and should not be presumed to represent the views of all shareholders

Remuneration committee competency and accountability

BlackRock does not believe there is a need to amend the role of the remuneration committee. However, as stated above, greater consideration needs to be given to the competency of directors appointed to this committee, and to boards as a whole. Additionally, BlackRock sees merit in exploring options for refreshing the diversity of thought on remuneration committees to ensure continued critical judgment.

Equally, as a matter of accountability, the board should provide more transparent reporting on the remuneration committee's use of remuneration advisers. Our proposals below provide some suggested guidance which could be useful for companies and investors.

Proposal: In general, we expect a majority of remuneration committee members to have served on the board for a year or more before taking on their remuneration committee responsibilities. This will ensure that directors appointed to this committee have the opportunity to gain a better understanding of the company, its business model and any other considerations unique to the company before determining a pay structure to support the execution of strategy.

Proposal: Boards should consider providing an orderly rotation or refreshment of remuneration committee members, for example after five years. This will ensure fresh views while maintaining the understanding of the company as detailed above.

Proposal: Boards should disclose services received from remuneration advisers, and the chain of accountability, e.g., to the board or to management.

Separately, while BlackRock's view is the UK market already provides one of the highest levels of disclosure on pay elements (based on our experience in assessing pay across different markets within Europe and globally), disclosure of the additional data points would enable a more accurate and relevant assessment of executive pay and, thus, the directors' discharge of duty.

Proposal: Boards should disclose envisaged total pay outcomes under the pay policy, in normal business circumstances, at threshold, target and maximum levels of performance. Boards should also disclose the envisaged pay (in normal business circumstances) at these levels of performance when proposing a new pay policy. Such an approach provides an understanding of the remuneration committee's intended outcomes based on various performance scenarios and enables shareholders to judge the appropriateness and rigour of the performance measures and hurdles.

II. Stakeholder voice

As laid out in the Companies Act, Section 172, directors should have regard to the interests of and impact to all of the company's stakeholders, including employees, suppliers, customers, the environment and the community.

Options for stakeholder input

BlackRock believes direct input from stakeholders is most appropriately picked up through management's stakeholder engagement process. However, we support a more explicit expectation of boards to ensure intentional discussion of the impact of the company's business to these stakeholders at board level.

Proposal: The board should report to shareholders on how they have engaged with management throughout the year on stakeholder considerations. The board should retain flexibility over how this oversight is designed. In BlackRock's view this is best captured in discussions with management on strategy, as how the business's operations impact its shareholders should be core a core consideration. This will give the board an opportunity to assess how well management is capturing and considering stakeholder input. This approach also aligns with the board's existing responsibility to oversee management processes.

Other options discussed: BlackRock agrees with the Paper not to propose mandating the direct appointment of employees or other interested parties to company boards. In our response to the BEIS Select Committee Inquiry on Corporate Governance last October we laid out a number of concerns and considerations that this approach would warrant.[7] BlackRock believes that all directors appointed to the board should act in the long-term interests of all shareholders and represent their views and concerns, rather than only those of a particular subset of stakeholders. The unintended consequence of mandating stakeholder representation on boards is the creation of separate classes of directors, thereby creating special interest groups. In extreme circumstances the danger is the board, which is supposed to act in the best interests of the company as a whole, will be paralysed by conflicting interests of stakeholders, e.g., in the case of a restructuring which will result in significant job loss.

BlackRock's main concern with the proposals put forward by options i (designation of a non-executive director to be responsible for reflecting the views of stakeholders) and ii (creation of a stakeholder advisory panel) in the Paper is as follows:

- These fall outside management's stakeholder engagement process as:
    - This adds complexity through additional and, possibly, conflicting feedback mechanisms
    - These mechanisms could become siloed over time and therefore ineffective

Furthermore, option ii (stakeholder advisory panels) raise concerns and considerations similar to those presented by stakeholder representation on boards (option iii):

- How will the relevant stakeholder groups be identified and agreed upon; will there be one panel for all stakeholders, or different panels for each set of stakeholders

[7] BlackRock, *Response to the BEIS Committee Inquiry on Corporate Governance*, October 2016, https://www.blackrock.com/corporate/en-gb/literature/publication/corporate-governance-inquiry-beis-committee-102616.pdf, p. 4-5.

– if the former, how will the panel prioritise concerns; if the latter, how will multiple panels be managed?

- How will the representative(s) be chosen; what would be the skills and competencies required of a stakeholder representative?
- How representative of the broader stakeholder group will these individuals be, e.g., if representing employees, will the individual represent senior management, the union, full-time or part-time staff, etc.?

BlackRock is supportive of strengthening reporting requirements related to stakeholder engagement, as suggested under option iv. Through our dialogue with companies, BlackRock is able to gain an understanding of management's stakeholder engagement process. We believe that some companies are managing this process well but when we reviewed their annual reports, we struggled to find adequate disclosure of the good work they are doing. Given its strategic importance, BlackRock believes the annual report is the appropriate place for disclosure on stakeholder management. Our proposal below provides some suggested guidance which could be useful for both companies and investors.

Proposal: Management's reporting on its stakeholder engagement process could be improved to provide consistent and complete reporting on the following:

- How the company's relevant stakeholders were determined
- How their interests, feedback and views were identified and captured
- Whether any milestones or action points were set to address these
- How achievement towards these milestones or action points was measured over the year, and what lessons were learned
- How the board was made aware of management's stakeholder engagement process and objectives

This improved level of disclosure would enable shareholders to make a more well-informed assessment on how well the board is overseeing management's engagement with stakeholders.

III. Corporate governance in large, privately-held businesses

BlackRock believes it is important to understand the cause of the poor corporate governance behaviour that has been observed in some privately-held businesses, and the specifics of these cases. However, we caution against unintended consequences such as added costs and complexity being brought to bear on all privately-held companies, resulting from the corporate governance failures of a few.

Owners of private businesses should ensure that governance structures are adequate. We believe that, by nature of the investment model, investors in private companies are, in general, much more 'hands on' than those in public companies (e.g., private equity where investors take significant, if not controlling, stakes in companies; partnership structures where employees are the providers of capital).

BlackRock further believes recognition should be given to the strength of the current approach adopted in the UK. UK company law and corporate governance stand up well against international comparison, particularly in 'regulated sectors' (i.e. sectors whose regulators apply additional corporate governance requirements over and above the duties in the Companies Act). Indeed, many large private companies, especially those in 'regulated sectors' such as the financial services sector, already apply many aspects of the UK Corporate Governance Code. For the financial services sector in particular, this has evolved given the regulatory scrutiny, expectations and requirements which have developed under the Financial Conduct Authority's (FCA) Senior Management Arrangements, Systems and Controls (SYSC) rules and the EU's Capital Requirements Directive IV. The forthcoming FCA's Senior Managers and Certification Regime (SMCR) will further extend accountability and ownership for boards and senior managers.

There may be a case for exploring whether large private companies, once they cross a significant size threshold, should be subject to higher standards of governance than might otherwise apply.

Proposal: Introduce higher corporate governance standards, based on the size of the company, for sectors that do not already have to comply with additional corporate governance requirements. These additional possible standards should revolve around the competency of directors and fitness and propriety for directors and senior executives. This will ensure the board has the appropriate mix of competencies, skills and experience to oversee management.

Other considerations

While BlackRock believes there are opportunities, as laid out above, to improve the strength of UK corporate governance, we equally believe the broader market and societal context needs to be considered. UK corporate governance alone will not be able to address the broader considerations which have prompted this scrutiny. More than ever, the UK Government, the industry and society as a whole must address longevity and the current retirement savings gap. While we are living longer, our longer-term financial needs are also increasing.

BlackRock's annual Investor Pulse survey shows that less than half of Britons feel confident that they are making the right savings and investment decisions, and yet saving money and enjoying a comfortable retirement are their greatest financial goals.[8] One of the most pressing consequences is giving people the support they need to make adequate provisions for their own retirement.

Government and regulators can further improve financial capability in a number of ways, such as with a well-defined guidance framework that supports people to take the first steps towards investing for their futures. The UK has witnessed a continual wave of pension reforms in the last decade, yet a harmonious and sustainable pensions system still seems to be out of reach. HM Treasury, the Department for Work and Pensions and BEIS could work together on developing the well-defined guidance framework. Equally, industry must develop simple, relevant products and invest in technology to ensure that people find it as easy to save as it is to get into debt. Companies have also their role to play in helping their employees understand how to prepare for retirement, by building financial literacy of their workforce, for example.

[8] About Investor Pulse: BlackRock's survey was conducted on 4,000 adults aged between 25 and 75 in the UK. The fieldwork was conducted during August and September 2015. A summary of the findings is available at: https://www.blackrock.com/uk/individual/literature/brochure/global-investor-pulse-uk.pdf.