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Tomorrow's Global Business

Part Three: Governance & Regulation

All above board

Inside Companies face pressure to recruit more women directors and communicate better with shareholders

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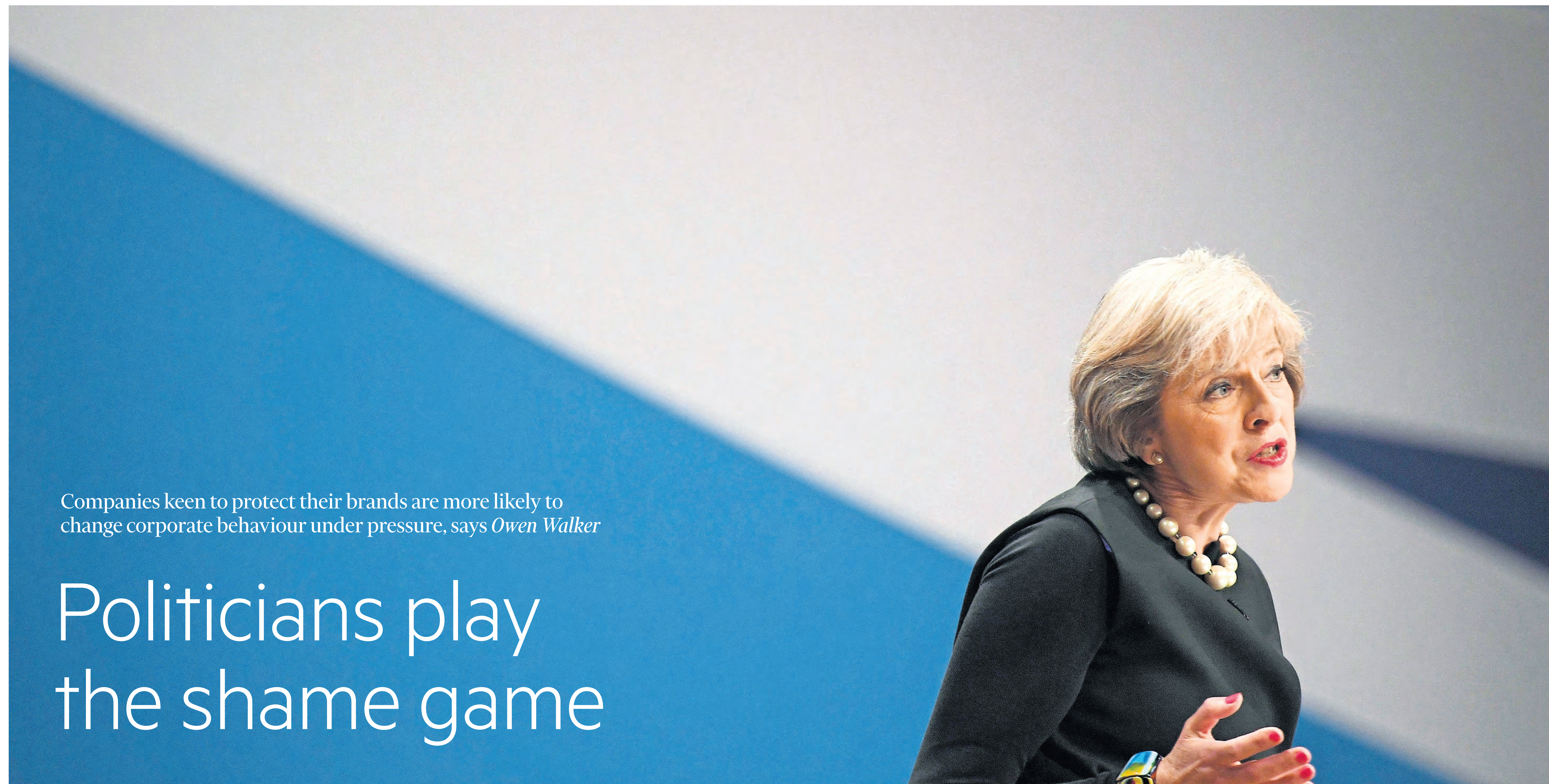


Politicians play the shame game

Companies keen to protect their brands are more likely to change corporate behaviour under pressure, says *Owen Walker*

The zeal to change corporate culture shown by the UK's prime minister, Theresa May, and her government has caught company bosses off guard. But the proposed policies that have caused most consternation are the ones playing on a raw human emotion to which British sensibilities are especially prone: embarrassment.

Naming and shaming has become a popular tool for regulators around the world. From clamping down on pay discrepancies to trying to make supply chains more ethical, policymakers have attempted to influence business practice by exploiting companies' obsession with protecting their brand.

Such policies are popular with politicians as they allow them to affect corporate behaviour without appearing too heavy-handed. In straitened times, they also limit the need to carry out costly enforcement.

When Mrs May launched her campaign to become UK prime minister in July, she said she wanted to bring in rules to make companies reveal how much their chief executive is paid compared to the average worker. The policy is based on one brought in last year by the US Securities and Exchange Commission, which regulates markets.

The idea behind the SEC's so-called pay-ratio rule is to expose companies where executives earn vastly more than average workers compared to their peers and to embarrass them into changing their pay policies.

Yet on both sides of the Atlantic, pay-ratio rules have been criticised by business groups for being too crude. "The good news is there's one figure everyone has to produce. The bad news is it's reductionist," says Ric Marshall, executive director of MSCI ESG Research, which analyses global governance trends.

Companies often react badly to state-sponsored naming and shaming rules. This was highlighted by business groups' response to UK home secretary Amber Rudd's proposed rule forcing companies to work out what proportion of their workforce is foreign and then share that information with the government. When announcing the policy at last month's Conservative party conference, Ms Rudd indicated companies would have to make their findings public — infuriating business leaders and lobby groups, in the UK and abroad.

Adam Marshall, acting director-general of the British Chambers of Commerce, responded that businesses "would be saddened if they felt that having a global workforce was somehow seen as a badge of shame".

Such was the outcry against the naming and shaming aspect of the policy that Conservative politicians were sent out to television studios to clarify that companies would not, in fact, be forced to publish their ratios of foreign workers. The data would be used only to help inform government policy, they insisted.

> 'It is more of a nudge from regulators. Why not let shareholders become the enforcers?'

UK experiments with using the threat of embarrassment to regulate companies have not always been so controversial.

Earlier this year the government brought in rules that will require companies with more than 250 workers to publish by April 2018 the median and mean differences between what men and women earn. Women earn a median 19.2 per cent an hour less than men in the UK. Companies will also have to publish numbers of men and women in each salary quartile.

When it announced details of the plan in February, the government said it had not decided whether it would publish league tables to identify the worst offenders. Yet some employers are fearful that such disclosures will make them vulnerable

to class-action lawsuits from female workers.

The US is also in the process of introducing disclosure requirements on gender pay. But the Obama administration is trying to take it a step further by forcing companies to provide the same pay data for race and ethnicity. In announcing the proposal in January, President Barack Obama said: "What kind of example does paying women less set for our sons and daughters?"

Philip Ryan, a partner at law firm Shoosmiths who specialises in regulatory defence, says disclosure rules are often accompanied by financial penalties. He argues, however, that the threat of public embarrassment has so far proved more potent than fear of fines.

"The jury's still out on whether financial penalties really work. They send a message when they are considerable, but most companies are more concerned about the damage to their brand — no one wants to be the outlier in their industry," he says. "Most companies are trying to show they are good corporate citizens."

Mr Marshall of MSCI adds that disclosure rules are designed to put companies under pressure from three main groups. In the first instance it is the board of directors, who may have been unaware of certain practices within their companies. Then there is the media, which will highlight outliers and can influence consumers and politicians. The final group is investors, who have the power to vote against particular corporate policies and also against directors they feel are not tackling governance flaws.

"The aim here is not just to require companies to disclose this information but to bring the pressure of public opinion," says Mr Marshall of MSCI. "But it's via increased transparency and disclosure. It is more of a nudge from regulators to try to impact behaviour — which frankly makes sense. Why not let shareholders become the enforcers?"

Making an example: Theresa May speaking at the Conservative party conference
Toby Melville/Reuters

Ridding business of 'Victorian' practices

OPINION
Vince Cable

It may have been inspired judgment — or perhaps just a remarkable coincidence — that British prime minister Theresa May set out her commitment to reform "irresponsible behaviour in big business" only days before Mike Ashley and then Sir Philip Green had their reputations shredded by UK parliamentary committees. In Mr Ashley's case it was for the "Victorian" treatment of employees at his retailer, Sports Direct, while Sir Philip was accused of "systematic plunder" of BHS, the department store chain he once owned.

But what can realistically be done to bosses who sail close to the wind yet stay within the limits of the law? They can be named and shamed, though perhaps they don't care. They will say that the market is the best discipline — workers, investors and consumers can walk away from companies they dislike.

In reality, "irresponsible business" means different things. A company may behave with an admirable degree of responsibility to its customers but at the expense of its workforce. Alternatively, while another company may not be faulted for its treatment of customers and workers, it could take a cavalier approach to carbon emissions or paying tax to a host government.

In some areas there is less ambiguity. Corporate irresponsibility in banking led to systemic collapse affecting numerous other companies and millions of individuals. Yet few of those responsible for the 2008 crisis suffered any punishment beyond reputational damage. Prolonged inquiries provoked excoriating criticism, but little else.

The financial crisis has, however, led to two major regulatory changes with potentially wider application. Bankers can now be prosecuted in the UK for extreme recklessness even if there is no malign intent: the financial equivalent of manslaughter rather than murder. And UK traders now have to take their rewards in stock redeemable after several years, maintaining responsibility for past transactions. That principle of continuing responsibility, with clawbacks, could be a way of entrenching responsibility more generally in business, including among advisers.

Business irresponsibility is often found in activities that are already regulated but where oversight is weak. Companies are obliged to comply but they will claim that they have a duty to their shareholders not to over-comply.

But if the legitimacy of private enterprise is to be upheld, corporate responsibility must be more than staying just the right side of ineffective, under-resourced regulators. It must also comprise more than using deep pockets to browbeat the authorities with expensive litigation or ruthlessly exploiting legal and administrative ambiguity.

So what is to be done? One approach could be to strengthen the standards around directorships, as has happened already for bankers. The obligations on company directors under the UK's 2006 Companies Act are wide and encompass much of what we call responsible capitalism. But the bar for disqualification is high and even the most egregious behaviour is tolerated. Directorships could be treated as a profession with standards and ethics, and enforced by an oversight body.

A second approach would be to build on the advances already made in corporate governance. However, reliance on non-executive directors and long-term institutional investors to police company behaviour, along with more transparent and extensive reporting requirements, have had limited impact. When in government, I sought to strengthen corporate governance around executive

> 'Corporate responsibility must be more than staying just the right side of ineffective, under-resourced regulators'

pay, though highly paid financial intermediaries, remuneration consultants and non-execs had little appetite for slowing the gravy train. I would like to have gone further in involving staff. Mrs May has come to the same conclusion. The proposal will be debated further, but the fundamental point is that a wider definition of stewardship is needed.

Third, businesses should consider examples of good practice in different forms of corporate organisation. Private businesses often have longer-term time horizons than public companies. Retailers have the worker-owned John Lewis Partnership as a role model and comparator. The mutual financial sector offers alternative ways of conducting banking and insurance — in spite of the Co-operative Bank's failure. Social enterprise is growing rapidly in some industries, offering an alternative to shareholder capitalism: doing well and doing good. We need more.

The writer is a former UK business secretary and author of 'After the Storm'

All-powerful leaders are dying out

Dual positions

Splitting the chief executive and chairman roles can be good for returns, says *David Oakley*

The observation by 19th century historian Lord Acton that "power tends to corrupt and absolute power corrupts absolutely" seems appropriate when analysing one of the most significant trends in corporate governance — the steady demise of the "all-powerful" executive.

Over the past decade, the joint chief executive/chairman has become a dying breed. Globally, the number of new appointees holding the chief executive/chairman role has dropped to a record low as corporate governance best practice moves towards the idea that the two most senior roles at a listed company should be split, says Strategy&, a consulting arm of professional services group PwC.

The UK's corporate governance code advises against combining the two posts. Only one company in the FTSE 100 — Hikma Pharmaceuticals — has one person, Said Darwazah, sharing the chief executive and chairman roles, says research group MSCI.

The US is one of the few industrialised countries where a joint chief executive/chairman is still common at the biggest groups, although their numbers generally are falling. Half the companies listed on the S&P 500 have one person holding the combined role.

"Having a separate chief executive and chairman is becoming a global standard for almost everyone," says Per-Ola Karlsson, a partner at Strategy&. "Governance codes around the world presume that it is best practice. But in the US, progress has been slow."

He attributes this to the different mindset of Americans. They are more inclined to believe that someone holding both roles can deliver greater efficiency and better performance, while not compromising the principles of good corporate governance, he says.

Jamie Dimon, chief executive, chairman and president of JPMorgan Chase, the US investment bank, is a prime example of a business leader who gives weight to the argument that one person in the joint role can deliver results.

The bank has consistently been one of the top performers among the world's financial groups since he took on the post of chairman in 2006, adding to his existing role of chief executive.

However, the bank has not avoided scandals. It suffered large losses after a series of derivatives transactions entered by a trader, nicknamed the London Whale, went wrong. This prompted several investigations into the group's internal controls.

Similar failures have prompted other companies and business leaders to emphasise the importance of having a separate chief executive and chairman.

Tom de Swaan, chairman of Zurich Insurance, argues that big financial groups should separate the roles because of their complexity. Although Mr de Swaan took up the joint role at Zurich temporarily last year after the departure — and subsequent suicide — of chief executive Martin Senn, he insists that it is healthier to split the positions.

"One of the most important roles in being a chairman is to have the right management in place," he adds. "The second thing is to make sure the company strategy is being executed effectively. It is hard to carry out these roles properly if you are the chief executive as well."

Some big investment groups, such as UK asset managers Schroders, Legal & General Investment Management and Aberdeen Asset Management, strongly support separate roles.

Jessica Ground, global head of stewardship at Schroders, puts it simply: "The chief executive is there to run the company, the chairman is there to run the board. These are two different activities."

Clare Payn, head of corporate governance in North America at LGIM, adds: "Having one person do both suggests the chief executive can mark their own homework. The big listed companies are often very complicated institutions. The CEO does not have time to act as chairman as well."

Findings are mixed over whether a company performs better with separate or joint roles. One factor that complicates this analysis is that companies with poor results often bring in a joint chief executive/chairman to turn round performance. Between 2011 and 2015, the lowest performing companies globally appointed 50 per cent more joint chief executive/chairmen than the highest performing companies, according to Strategy&.

Other research by MSCI shows that companies where the roles are combined tend to lag behind in the long term.

Over 10 years, average total shareholder returns were 225.8 per cent at the groups where the roles were combined and 361.9 per cent at the companies where they were separated. These figures were calculated as of December 31 2015.

The most recent data, published in August by Credit Suisse, also show that separating the roles may benefit performance. Of the 400 non-family-owned companies on the S&P 500, those with separate chief executives and chairmen delivered an average of 7.4 per cent annually over the 10 years to January 2016 compared with 5.3 per cent for companies with the same chief executive and chairman.

> 'The chief executive is there to run the company, the chairman is there to run the board. These are two different activities'

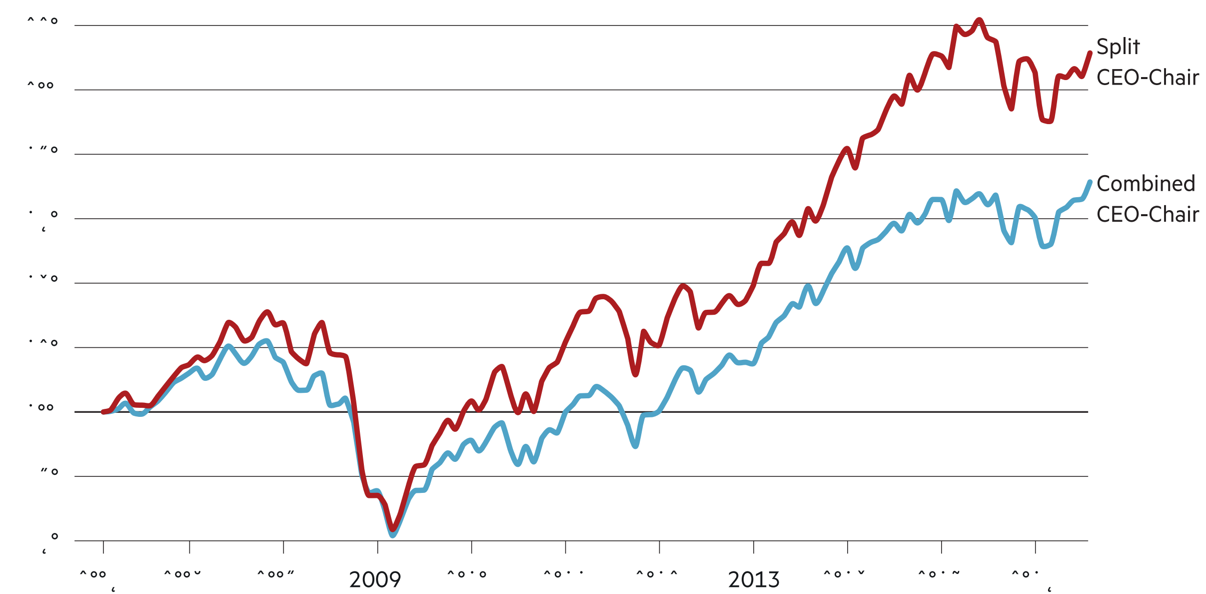
However, there are no hard data to indicate which groups fare best when it comes to preventing scandals and improving corporate governance, says Mr Karlsson of Strategy&. "I would say that a separate, independent chairman would give a company a better chance of avoiding a major scandal. But I have found no strong evidence to quantify this."

Until there are firmer data backing the separation of the posts, the joint role is unlikely to become completely extinct. Some investors, particularly in the US, will happily back an "all-powerful" holder of both roles — as long as they are delivering strong results and returns.

Combined role: global trend has turned

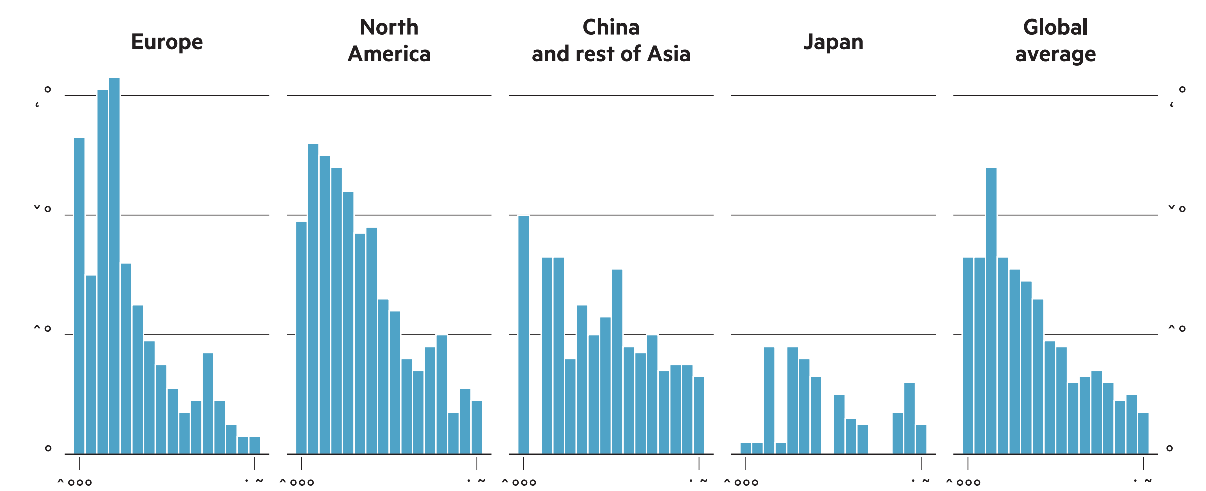
Companies with separate chief executives and chairs have outperformed those that combine the roles over the past decade ...

Share price performance of companies with split vs combined CEO and chair positions at non-family owned S&P companies (rebased)



... and the proportion of companies with combined chief executive-chairs is declining all around the world, though Europe has had the fastest pace of change

Incoming CEOs who hold the joint title of CEO and chairman (%)



FT graphic Sources: MSCI ESG; Bloomberg; Credit Suisse research; Strategy& CEO Success Study

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Business grandees: Mary Barra, Jamie Dimon and Jeff Immelt discussed improving shareholder relations — Getty Images/Bloomberg

Boards learn to listen to investors

Directors Energised shareholders are putting pressure on companies to engage, writes *Stephen Foley*

During a series of secret discussions over the past year, a small number of US business grandees tried to hash out some of the longstanding areas of tension between companies and their biggest shareholders.

They included some of the most important chief executives in US business: Jeff Immelt of General Electric and Mary Barra of General Motors from corporate America, plus investment management leaders Larry Fink of BlackRock and Vanguard's Bill McNabb.

They were joined by two executives straddling both camps: Jamie Dimon, who convened the meetings and runs JPMorgan Chase, a bank that includes one of the world's largest asset managers, and the investment guru Warren Buffett, whose Berkshire Hathaway is both the largest US conglomerate and a significant investor in the likes of Coca-Cola and Wells Fargo.

Having long been accused of being asleep at the wheel, institutional investors around the world are taking more interest in the way their portfolio companies are run.

In the past half-decade, the UK has experienced two so-called shareholder springs, where investors have voted against executive pay deals at WPP, the advertising group, and BP, the oil major. In Germany, the Volkswagen emissions scandal has had shareholders demanding governance reforms. Meanwhile, in the US, activist hedge funds have found it easier to gain support from other investors for demands that companies institute capital allocation plans that are more shareholder-friendly .

The restlessness is not surprising. Investors used to be able to do "the Wall Street walk", to sell their shares and walk away if they did not like a company's strategy or trust its board to look after their interests. But the rise of passive investing has made this approach less effective.

About a third of the money in the US equity market is now in funds that own all the companies in an index. Vanguard, which runs the largest equity fund, and BlackRock, owner of the iShares range of exchange traded funds, together typically hold stakes of more than 10 per cent in the biggest US companies, whether they like them or not. They believe they have a duty to their funds' investors to engage with companies and keep them focused on doing right by shareholders.

Forward-looking global companies are embracing, rather than resisting, more communication with shareholders. After all, no one wants to receive public criticism at a shareholder meeting or, worse, be defeated when an activist tries to storm the boardroom.

It is fast becoming best practice for directors to engage with significant shareholders rather than relying on investor relations teams, says Douglas Chia, a former corporate secretary at Johnson & Johnson who now runs the Conference Board Governance Centre, a research association.

> 'Boards have always been the most important aspect of governance'

"The requirement for annual say-on-pay votes was the catalyst, and forced directors to understand this is a new paradigm," says Mr Chia. "Directors still make the 'floodgates' argument, that if they talk to some shareholders they need to talk to them all, but typically companies start with the top 10 largest."

In the US, shareholders are gaining tools for holding boards to account — a growing number of companies are allowing long-term shareholders who have a minimum 3 per cent stake to nominate directors for election — but both sides hope that these measures should only be used as a last resort and will be unnecessary if both sides understand each other.

Forging good relations with shareholders can take a variety of forms, however, and different constituencies of investors require different things. Passive shareholders are prioritising discussions about the quality and the processes of the board, who are their main representatives and responsible for holding management to account.

"Boards have always been the most important aspect of governance," says Glenn Booraem, head of corporate governance at Vanguard. He says much of what Vanguard has worked for historically has been based on the rules that govern the election and replacement of directors. "Now we have got all the rules in place, we have got to look at the boards we are getting," he adds. "The rules govern how we can get rid of bad directors, but we would just as soon not have bad directors in the first place."

General Electric, which won the category for large companies at this year's IR Magazine awards for best investor relations, has given increasing space in its annual reports to the skills it requires of its board of directors, and what each individual member brings to the boardroom. The director recruitment process is joining the design of executive compensation as a staple of discussions between companies and their shareholders.

The private meetings arranged by Mr Dimon had a public outcome. The group released a statement of "commonsense principles of corporate governance", which stated "robust communication of a board's thinking to the company's shareholders is important", that "asset managers should raise critical issues to companies as early as possible" and that shareholders had a right to expect that directors understand their main concerns. Investor relations — which used to be primarily about talking to shareholders — are now about listening to them, too.

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Women still struggle to join boards where targets are absent

Gender Despite government initiatives, the number of female executive directors has increased only slightly, finds *Emily Cadman*

RM Vishakha, an insurance industry veteran with more than 25 years' experience, was appointed last year to head Legal & General's Indian joint venture, IndiaFirst. She nearly did not make it.

After being on the longlist, Ms Vishakha was left off the initial shortlist, and reinstated only after executives from L&G's London headquarters complained about the lack of female candidates. Ms Vishakha was then given the opportunity to wow the appointment board during her interview.

It is a story that "illustrates the whole ethos around our move to change our hiring practices", says Lesley Martin, L&G's head of diversity and inclusion. As part of its aim to increase the number of senior women from 35 per cent to 40 per cent by the end of 2017 and to parity by 2020, the investment and insurance group insists there is a woman on every senior appointment shortlist.

"It's not about positive discrimination, it is about the getting the widest possible talent pool and a different perspective," Ms Martin says.

Policies like these are still needed more than 45 years after the UK's Equal Pay Act came in, which was designed to ensure equality in the workplace and prevent discrimination, particularly on pay. Despite a surfeit of charters, targets and reports, female executives are still an uncommon sight in boardrooms.

Fewer than 10 per cent of executive director roles at the UK's 100 biggest public companies are held by women, according to Cranfield School of Management. The number of women in executive director roles has increased only modestly in the past five years, even while the overall proportion of female directors has risen from 15 per cent of board seats in 2012 to 26 per cent today.

Improving representation in the executive layer — both in the boardroom and among other senior leadership roles — is now the main focus of the government-backed Women on Boards commission.

The new head of the commission, Sir Philip Hampton, told the Financial Times this year that he was determined to "kick-start" the initiative after data suggested progress had stalled.

But for every company that is already going beyond national targets, there are others where it is clear — even if they are not prepared to say so publicly — that they are not yet convinced of the argument that diverse leadership teams bring business benefits.

When the UK's Equality and Human Rights Commission surveyed top corporations anonymously this year, it found that while three-quarters had board diversity policies, around two-thirds of these did not have any targets or objectives. One anonymous FTSE 250 company, which has no women on its board, told the EHRC: "The company's policy is to make appointments on merit and for this reason the setting of specific, measurable targets is not considered to be appropriate."

This belief that targets and merit-based hiring are incompatible is a source of exasperation for many campaigners. Simon Collins, chairman of professional services group KPMG, which along with the government sponsors the annual Female FTSE Board Report, said at the launch of this year's study that the push for more diverse senior teams "isn't a moral crusade".

All aboard: RM Vishakha (left), and Lesley Martin (below)
Richard Boll/Getty Images

"I have no doubt that including a more diverse mix of experience and opinion within our leadership team and throughout our organisation will make us a more profitable, as well as a more responsible, business," he said.

That is the attitude of retail group Kingfisher, parent company of home improvements retailer B&Q. It has one of the most gender-balanced senior leadership teams in the FTSE 100, with women holding four board seats out of the nine in total, and half of the positions on the group executive committee.

Its chief financial officer, Karen Witts, stresses that finding the best person for the job regardless of gender is always the priority. But the company also recognised that women account for around half of its customers and make about three-quarters of home improvement decisions. As such it is vital for the company to "develop a management team and a pipeline of talent that reflects the way our customers live and shop," she says.

Kingfisher operates a formal leadership programme aimed at men and women. It also runs an informal women's network, which offers support for female managers, with the help of exec and non-exec directors.

Ms Witts says the company has done "pretty well" in ensuring a more balanced executive team, but adds: "We know there is more that we can do to bring more women through all the way from the shop floor to the most senior roles."

While the likes of KPMG, Kingfisher and L&G are making progress, those British companies that have no interest in change have seen one potential threat removed after the UK's vote to leave the EU. The possibility of formal gender quotas has been much discussed in recent years in Brussels. But Brexit would mean any action would now be unlikely to affect British companies.

> 'A more diverse mix of experience will make us a more profitable business'

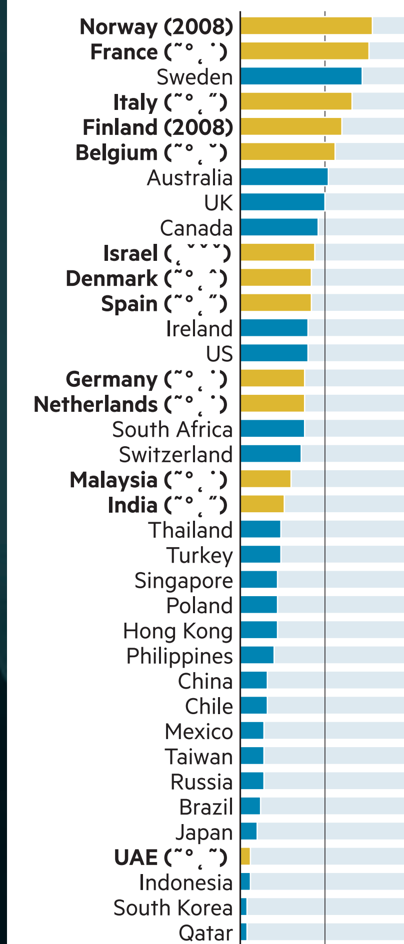
Domestically, the Conservative government has been clear it has no appetite for introducing legislative targets. In a letter to the FT in August, Greg Clark, the new UK business secretary, wrote that while the "whole government" was behind efforts to increase female representation, "government alone cannot force a change in corporate culture; this must be business-led". It would therefore be no surprise if the gap between the most and least gender-balanced companies were to widen further.

Tomorrow's Global Business Governance & Regulation

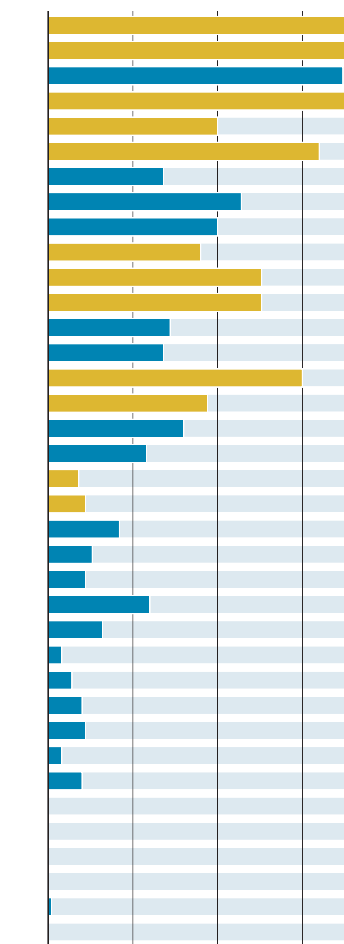
Women at the top: the quota effect

Condoleezza Rice, member of the board of directors at Dropbox since
Photo: Rob Kim/Getty Images

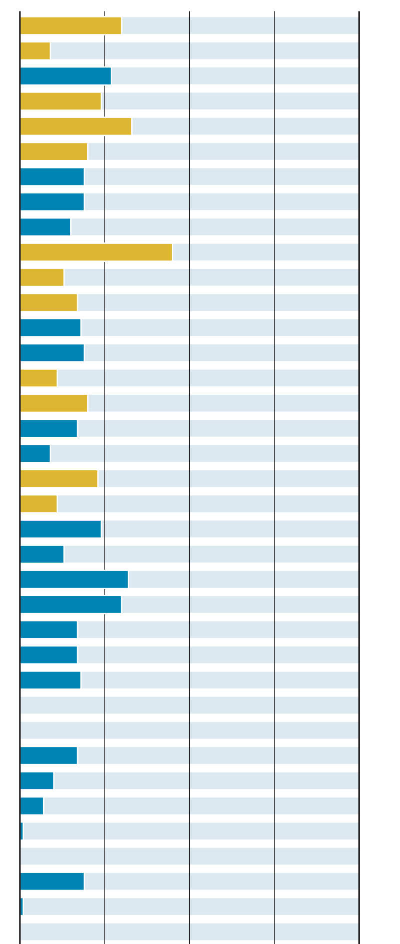
Countries with gender quotas are among the countries with highest ratios of **women on boards** in the world ...
Per cent



... they also have high numbers of **companies with at least three women on boards** ...
Per cent



... and early adopters have a growing number of **companies where the CEO, CFO or chair is a woman**
Per cent



FT graphic Source: MSCI ESG Research as of September

Some French equities are more equal than others

Dual-class shares

The government has benefited from its drive to bring in double-voting rights. By *Adam Thomson*

The French government received a gift from its 13.4 per cent stake in telecoms group Orange in April: overnight, the voting rights attached to the holding increased to more than 20 per cent.

The seemingly magical increase, which also affected holdings in the group by other state entities, happened courtesy of France's so-called Florange law, which made double-voting rights automatic for long-term investors in listed companies unless shareholders specifically voted to opt out.

Yet more than two years on from the controversial bill's approval, and as long-term shareholders start to reap the rewards of their holdings this year, broad opposition remains.

The law — which took its name from the dispute between France's Socialist government and ArcelorMittal after the Luxembourg-based steelmaker tried to shut a mill in the north-east commune of Florange — was supposedly designed to reward and encourage long-term shareholders. The hope was that this would give greater stability to boards to set company strategy and governance.

Last year, a throng of France's largest listed companies voted on the issue at their annual shareholder meetings. Double-voting rights were adopted at companies such as Renault, Engie and Vivendi but shot down at other groups such as BNP Paribas and L'Oréal.

Overall, however, the number of companies with double-voting rights changed only slightly because such provisions have long been commonplace in French business. Before the law, 22 members of the CAC 40 had double-voting rights, compared with 26 after the law came into force.

Loïc Dessaint, chief executive of Proxinvest, which advises investors on votes and corporate governance, argues that the relatively small change was the result of relentless communication from his company to investors over what he considered to be the negative effects of double-voting rights.

"We spent a lot of time explaining things in France and abroad, and everyone realised that they would be diluted," he says. "It was clear in the minds of most investors that it was a terrible move."

Mr Dessaint and other critics of the law argue that double-voting rights favour big investors over small. He adds that they often lead to minority shareholders eventually controlling companies with relatively small stakes.

"The large shareholders end up controlling the main bulk of the voting rights," he says. "It does not promote long-term investment but instead promotes big owners who, most of the time, are French."

Vincent Bolloré: double-voting rights at Vivendi

One of the biggest beneficiaries of the law was French industrialist and billionaire Vincent Bolloré, who managed to have double-voting rights passed at his media and content group, Vivendi.

More than half of Vivendi's shareholders voted to strike down double-voting rights at last year's annual general meeting, but that was still below the two-thirds majority that the Florange law requires to block its implementation.

As a result, Mr Bolloré, who has ramped up his Vivendi stake over the past two years and is by far the group's biggest shareholder, will have 29 per cent of voting rights by next April, according to his Bolloré Group. But that should rise significantly in the coming years even if he keeps his equity stake the same since more of his equity holding qualifies for double-voting rights.

Shareholders in several large French groups voted against the introduction of double-voting rights. As well as L'Oréal, the cosmetics company and one of the country's biggest businesses, property developer Unibail-Rodamco and construction group Vinci were among them.

But Veolia, the water and waste management group, Engie, the energy company, and Orange were among a handful of businesses that opted to take up double-voting rights.

So did Renault, the French carmaker, in which the government controversially bought an additional 5 per cent stake to boost its holding to about 20 per cent. It did this in the run-up to the company's annual meeting to try to guarantee that double-voting rights were implemented.

Some 60 per cent of the company's shareholders voted against the Florange law — a clear majority but still shy of the 66 per cent required to stop double-voting rights being implemented.

Catherine Salmon, a Paris-based executive director at proxy voting adviser Institutional Shareholder Services, argues that the fact the government was a significant shareholder in each case is far from coincidental.

"The French state is a big beneficiary of the law because it allows it to reduce its holding in the companies while keeping its voting rights," she says.

The French government is under pressure from Brussels to reduce its fiscal deficit to bring it in line with EU rules. It is also committed to participating in planned capital raisings at majority state-owned utility EDF and energy company Areva.

As a result, the French government is looking for additional sources of income.

The French government has yet to sell its stakes in its portfolio of 77 companies, which was worth more than €77bn last April, according to APE, the holding company for the state's investments. But it has already hinted that it may do so in future.

The changes may benefit the French government in the form of providing greater flexibility to reduce its shareholdings, but Mr Dessaint has no doubt that it is a bad move in the long run.

"It's a terrible sign for investors because it looks very protective," he says. "When you have double-voting rights in place, it is a sign that you don't want to play by market rules."

Private business The BHS collapse highlights the need for stricter scrutiny. By *Kate Burgess*

Unlisted companies play by their own rules

Nearly 70 years ago RE Thompson, a small British family business in Whitchurch, Hampshire, started making vacuum and leak test equipment. In 1968, it began to focus solely on manufacturing aerospace and industrial components. Today the business is still owned and managed by the Thompson family, but it produces the boxes that house the power management system of the F35 joint strike fighter, one of the UK's biggest military procurement projects.

In the past five years it has invested £7m in equipment, doubled turnover and is on track to double revenues again. "The plant is already running 24 hours a day, seven days a week," says Michael Thompson, managing director and a third-generation family member involved in the business.

RE Thompson is still a small business, turning over less than £20m a year with about 50 employees. But it is growing fast and to many observers it looks like a well-run company, balancing the long-term interests of staff, owners, customers and regulators.

Its governance, though, is very different from that prescribed in the UK's corporate governance code for big, publicly quoted companies with their extensive boards of executive and non-executive directors. Mr Thompson and his wife are RE Thompson's only directors.

In this regard, RE Thompson is like many UK companies that are not listed on tradable equity markets. They range from the John Lewis Partnership — employing thousands of staff — to private-equity owned ventures, family businesses and sole traders.

Many bigger private businesses do have multiple directors. John Lewis aims to comply with the rules that apply to listed businesses. It has 15 directors, two of whom are non-executives.

That is well beyond what is legally required. Section 154 of the Companies Act states only that private companies must have one director and that public companies must have two.

However, Susan Ralphs, managing director of the Ethical Property Company, says she could not do without her board of six directors, the other five of whom are non-executive. "The non-executives give us another level of expertise," she says. "They are not immersed in the day-to-day but are still wedded to our success. They hold us [executives] to account and they represent our shareholders."

The Ethical Property Company has ambitions ultimately to list on Aim, the London Stock Exchange's junior market. It makes about £400,000 a year in pre-tax profits from renting property to voluntary organisations and developing eco-friendly buildings. In recent years it has raised about £14m from 1,400 shareholders in five issues and may well raise more, says Ms Ralphs. The company is part of the LSE's Elite programme, which aims to promote better governance and help companies grow.

Even businesses that are not trying to raise capital will benefit from having external directors on boards, says the UK's Institute of Directors. The effect on companies "should not be underestimated", it says.

Oliver Parry, the IOD's head of governance, argues directors with wide experience help managers spot problems, lessen wastage and prevent assets from being misappropriated. In essence, governance guards against rising agency costs, minimises risk and enhances the reputation and confidence in a group.

Effective governance frameworks define the roles and responsibilities and distribute power between shareholders, boards, managers and other stakeholders. "Especially in smaller companies, it is important to recognise that the company is not an extension of the personal property of the owner," the IOD says.

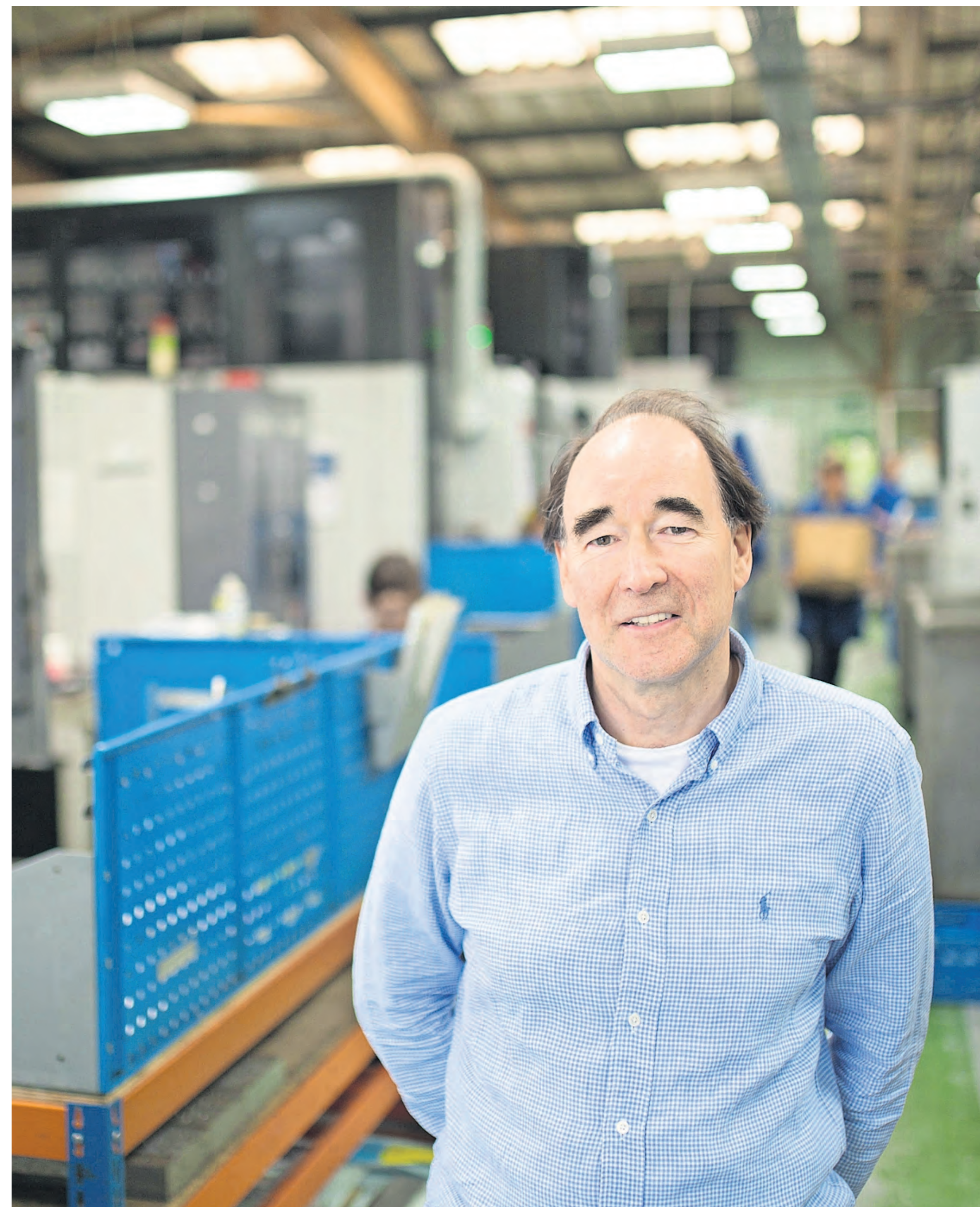
The IOD set out a governance code for unlisted companies about six years ago. Now, in the wake of the scandal over the collapse of BHS, which has put jobs and pensions of thousands of workers in jeopardy, Mr Parry is working with Deloitte, the consultants, to beef it up.

"This is all about reputation — maintaining it and enhancing it," says Mr Parry. The rate of high-profile insolvencies is, he says, feeding "a perception that companies are not being run very well and that something is systemically wrong with governance".

Mr Parry acknowledges that the costs of implementing the full code could be punitive for small businesses. The IOD proposes a two-tier regime, he says, but the principles of good governance are the same for all companies, big and small.

However, not all private businesses are convinced of the need to have non-executive directors, as Mr Thompson points out.

"It may be a good thing to have a sounding board but it can be difficult and creates conflicts. I'd find an outsider [on the board] a hindrance," says Mr Thompson.



Family affair: Michael Thompson is the third generation family member involved in his business
David Parry

'It may be a good thing to have a sounding board but it can be difficult and creates conflicts'

Rise of voluntary compliance in US

Many so-called "Sox-lite" private US businesses have voluntarily adopted Sarbanes-Oxley, the regulatory regime introduced for public companies after the Enron and WorldCom accounting scandals to boost corporate accountability. These Sox-lite groups do so as a way of boosting investor confidence. A US study by PwC found that by 2012 four-fifths of unlisted companies had voluntarily adopted certain governance practices. When companies did not bring in directors from outside to provide independent voices, they still encouraged their executives to broaden their experience by joining boards of public companies, the study showed. **KB**

Tomorrow's Global Business Governance & Regulation

Code gives Abe a rare reason to be cheerful

Japan

Governance and stewardship reforms have been successful, reports *Leo Lewis*

When Japan's corporate governance code was being drafted in early 2015, one of its authors, Scott Callon, said out loud what everyone else was thinking: conservative, opaque and intransigent corporate Japan would never accept such a radical document.

His observation was met with deafening silence.

Both the June 1 launch date and the code itself were orders from the very top. This was a critical strut of prime minister Shinzo Abe's "Abenomics" campaign to revitalise the Japanese economy, Mr Callon was told by one of the senior members of the committee, and a non-negotiable piece of the reform agenda. If Japan Inc did not like it, tough.

The governance code, and the associated stewardship code that defined the new responsibility of shareholders, remains for many observers one of the most unambiguous successes of Abenomics. The codes were introduced as part of the wider Abenomics effort to boost the performance of the Japanese stock market, encourage companies to increase capital expenditure and tempt citizens to shift part of their bank savings into riskier assets.

Progress on compliance has not been as fast as the original proposers of the code had hoped, and more broadly political momentum is flagging, but it is nevertheless highly visible. Some 80 per cent of large and midsize Tokyo-listed companies now have two or more independent directors — a tenet of the governance reforms — up 21 percentage points from the year before the code was introduced.

The number of listed companies that have established nomination committees to determine top executive positions has expanded more than eightfold since 2014 to 475. Companies that had never publicly uttered the phrase "return on equity" now feel under pressure to highlight that metric in their annual reports. Share buybacks have surged since the code came into force, and by the end of July had already surpassed the total for the whole of 2015.

Levels of shareholder engagement are also rising. According to Mitsubishi UFJ Morgan Stanley Securities, a financial services company, shareholders objected to the re-election of management in 26 cases this year, three times as many as the year before.

Perhaps the two codes' greatest impact, said analysts at Nomura in a report published in August, has been to create "evolutionary shareholder activism" — not the adversarial style of activism that generated such a bitter corporate backlash in the 2000s, but the emerging expectation that companies and investors will "build amicable relationships marked by constructive tension".

Nicholas Benes, head of the Board Director Training Institute of Japan, was the original proposer of a corporate governance code to the Abe government. He says that what the stewardship and corporate governance codes have done — and where some of the more tangible evidence of change is emerging — is in giving investors an accepted "language" with which to talk to companies and to express concerns or raise governance issues.

"In the past, investors that did this [feared] they might be labelled 'activists' and companies could avoid meetings and shut down information access," he says. "The corporate governance code means they can't easily do that any more — if the investor wants to ask those questions, he just uses the language of the code to ask how compliant they really are, or what alternative practices they employ."

For some, the success of the governance code is an anomaly in an Abenomics programme now largely on the ropes. More than 18 months since the code came into effect, the broader environment in Japan has changed — in many ways for the worse. Mr Abe's administration, though buoyed by a July victory in Upper House elections, seems less bulletproof than it did when the code was brought in.

The global economy is not providing the following wind it once did, and structural reforms are taking longer than the government hoped to crystallise into real change. Meanwhile, the Bank of Japan's decision in January to introduce negative interest rates to the world's third-biggest economy looked desperate to analysts and investors.

Despite the strength of the Tokyo stock market — up 60 per cent since Mr Abe came to power — it has become fashionable among Japan-watchers to highlight the many metrics by which Abenomics and the accompanying monetary easing policies of the BoJ are stuttering. The failure to free Japan from deflation permanently is foremost among those.

There is also scepticism on the true success of the corporate governance code. While many companies have signed up to the code, and even introduced their own guidance statements to signal their compliance with its spirit, Japanese companies have a long history of disguising opposition to reforms with superficial consent.

But the governance code may have produced sufficient environmental change to offset that, says Mr Benes, who adds that companies that just pay lip service to the code and produce only a few short sentences to describe how they comply with the code are "walking into a trap".

"They are opening themselves up to potential criticism from shareholders, analysts and the media that they need to have real substance and policies to show before they brag about 'full compliance'. That is how codes work," he says.

Companies will be expected to satisfy the spirit of the code, Mr Benes adds. "In this suddenly transparent market, these firms may be publicly singled out as bad examples, for saying they comply when they are not really compliant," he says. "This is where the shame aspect of Japanese society is very helpful."

The right direction: Japanese prime minister Shinzo Abe's corporate governance reforms have been well received
Tomohiro Ohsumi/Bloomberg

'These firms may be publicly singled out as bad examples. This is where the shame aspect of Japanese society is very helpful'

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