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The effective board Chair

‘Using the right channels for engagement will enhance the quality of the engagement itself and therefore its effectiveness. In particular, judging the balance between formal and informal engagement … is a characteristic that many good Chairs instinctively get right. Whilst many Chairs may have their preferred channels of communication because of personality or their usual work patterns, diligent Chairs tend to be more intentional in choosing their methods for engaging with stakeholders.’

Alex Cameron and Chris Stamp

Good governance and market valuation

‘The research shows that good reporting does, perhaps as expected, improve capital market performance. It highlights the necessity to put in place internal controls at the executive level to guarantee that management and boards are verifying the accuracy of their reported information, and to re-establish trust in the corporation.’

Dr Luis Correia da Silva and Derek Yide Song

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FT BOARD DIRECTOR PROGRAMME

News

UK CG Code revision

The Financial Reporting Council (FRC) has taken its first steps to revising the UK Corporate Governance Code with the launch of a public consultation. The proposed revisions aim to enhance the Code's effectiveness in promoting good corporate governance and include:

- board responsibilities,
- audit committees and external audit,
- audit, risk and internal control,
- malus and clawback,
- resilience, and
- ESG and sustainability.

Board responsibilities
Companies will be required to list in their annual reports all significant director appointments and consider each director's commitments to other organisations and their ability to discharge their responsibilities effectively. The proposed revision would not only require setting out board positions of each director, but also their committee roles and the potential number of commitments each year. The revised Code emphasises that company Chairs should commission (rather than consider having) a regular externally-facilitated board performance review. Additional reporting requirements on the work of the nomination committee are proposed, to provide greater clarity on succession planning, board and senior management appointments and the effectiveness of the diversity and inclusion policy.

Audit committees and external audit
A new Standard for audit committees published on 22 May 2023 specifically covers the work of the audit committee in relation to external audit and the requirement for the audit committee to report on this. To avoid duplication, the new Code will refer to the Standard. Although only intended to apply to FTSE 350 companies, there will be some non-FTSE 350 companies that will be brought into the scope of the Standard because of this proposal. However, non-FTSE 350 companies can approach implementation of the Standard on a 'comply or explain' basis.

Audit, risk and internal control
It is proposed that boards should not only establish but also maintain an effective risk management and internal control framework, to enhance their accountability for the framework. The revised Code also proposes additional audit committee responsibilities and enhancement of annual reporting requirements by aligning them with the additional responsibilities. The proposed additional responsibilities include:

- developing, implementing and maintaining the audit and assurance policy (AAP);
- following the Audit Committees and the External Audit: Minimum Standard; and
- promoting effective competition during an external auditor tender, in order to support audit market diversity.

Malus and clawback
Companies will be required to provide additional information on malus and clawback provisions in the remuneration report. This includes a statement on whether the company has malus and clawback arrangements in place; whether the provisions have been used in the last reporting period; if provisions have been used, a clear explanation of the reason; the minimum circumstances in which they could be used; the minimum period for their application (along with an explanation of why this period is best-suited to the organisation); and any use of the provisions in the last five years.

Resilience
Compliance with the new reporting requirement for a Resilience Statement (expected to apply only to Public Interest Entities (PIEs) will also mean compliance with the relevant Code provisions. For companies not subject to the statutory Resilience Statement, the board should report in a similar and proportionate way to the statutory requirement or set out the basis for the assessment in the annual report. The viability statement provision has been amended to just call for an explanation of how the board has assessed the future prospects of the company, including its ability to meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary.

ESG and sustainability
Recognising that the Code should reflect the importance of ESG and sustainability matters, the following additions are proposed:

- environmental and social matters (including climate ambitions and transition plans) should be considered in assessing the basis on which the company generates and preserves value over the long-term;
- audit committees should monitor the integrity of narrative reporting and, in the annual report, disclose considered significant issues relating to narrative reporting, including sustainability matters, how they were addressed and, where commissioned by the board, the assurance of ESG metrics and other sustainability matters; and
- a requirement that consideration of whether remuneration outcomes are clearly aligned to successful delivery of the company's long-term strategy includes consideration of ESG objectives.

Next steps
The consultation closes on 13 September 2023 and comments should be sent by e-mail to codereview@frc.org.uk. The current expectation is that the revised Code will apply to accounting years commencing on or after 1 January 2025 to allow sufficient time for implementation.

For the full consultation paper go to: https://bit.ly/45Pa4lo

News

FTSE 350 Corporate Governance Review

The unforeseen events of the last three years have delivered an unwanted crash course in dealing with the unexpected, according to Grant Thornton's *FTSE 350 Corporate Governance Review 2022*. Companies have embraced elements of the UK Corporate Governance Code (the Code) as a blueprint in navigating crises, however there has been a dramatic drop in annual reports that fully complied with the Code over the last two years.

Compliance

Despite a fall in Code compliance, the quality of disclosures around non-compliance has risen, as has the number of companies providing a statement on Code application. The three most common areas of non-compliance were:

1. executive pension alignment;
2. Chair tenures; and
3. post-employment shareholding mechanisms.

However, there has been increased compliance around independence, with a significant drop in the percentage that have Chair tenures over nine years; a combined Chair and CEO role; and improved compliance around non-executive director independence.

Purpose and culture

Companies are talking about purpose and culture, but few are 'walking the walk'. Ninety-one per cent stated a purpose and 81% demonstrated how purpose aligns with company practice, but only 23% showed how they measure purpose against progress. Ninety-nine per cent of companies also stated they monitor culture, however only 18% were transparent about how culture is measured and monitored.

The good news is that the proportion of companies recognising the link between culture and purpose is rising. Only 15%, however, link culture to executive remuneration to demonstrate accountability and strategic importance.

Seventy-eight per cent of companies demonstrate how their business model informs strategic priorities. However, transparency about the future impact, opportunities and challenges remains weak, only 16% providing basic or generic reports.

Stakeholder engagement

There has been a steady increase in the number of companies discussing the application and impact of decision-making related to Companies Act 2006, s 172, although only 40% provide detailed disclosures.

There has been a significant increase in companies reporting on customer metrics. Engagement with employees has also been growing. Eighty-two per cent of companies engaged with the workforce through surveys and questionnaires and 62% through a designated non-executive director.

Stakeholders are becoming more engaged and boards are responding. Forty-five per cent of boards acted on stakeholder feedback. A further 54% said they collected feedback but did not disclose how they acted on it. Main reported themes included: director overboarding; re-election of directors in non-independent circumstances; failure to deliver board commitments; and director authority to approve pay increases outside of the remuneration committee.

ESG

ESG reporting indicated that boards perceive environmental risk as a higher priority than social and not something which is systemic to the whole business model. Despite 59% of companies identifying the environment and climate as risks, only 48% had related KPIs and just 45% connected it to executive pay. More than half of companies in every sector demonstrate a board-down approach to sustainability governance. Focus on the environment is overshadowing social action, with only 15% of companies stating a social KPI and 19% linking it to remuneration. Twenty-eight per cent of companies have a separate board-led ESG committee, down from 34% the previous year. In terms of ESG risks, 82% of companies identified employees as a principal risk, followed by environmental and climate (59%) and social (21%).

Risk

Most companies focused on risk, 93% outlining principal risks and 80% linking principal risks to strategy. However, 66% of companies do not outline mitigating actions for emerging and newer risks. Principal risks identified were: operational, financial, regulation and compliance and technology and cyber.

Increasingly, companies recognise that human capital may present more risk than financial capital. Eighty-two per cent of reports cited employees as a strategic risk area, however only 51% had associated KPIs and 24% tied it to remuneration. People-specific expertise was the least mentioned board skill in company reports.

Board effectiveness and development

Ninety-one per cent of companies shared the findings of their board effectiveness review and 81% provided good or detailed explanations of board evaluation. Whilst succession planning is the second highest area of focus for boards and directors, only 6% explained the relevance of directors' skills in the context of strategic risk, regulation changes and market shifts.

The top five areas for development were identified as:

1. strategic focus and future planning;
2. board succession planning;
3. senior management succession planning;
4. wider stakeholder engagement; and
5. employee related.

For the full Review go to: https://bit.ly/3LsavJ6

International

Using transparency to build trust

At its core, corporate governance is putting in place the structures that will allow for effective decision-making so that stakeholders can trust the oversight process. Prescribed disclosures regarding a company's practices and procedures used to be sufficient to establish trust. However, according to a report from PricewaterhouseCoopers, that trust appears to be eroding at a time when the board's mandate is expanding and the quality of board oversight is receiving additional attention. The Report, *Using transparency to build trust*, looks at what investor voting and data can reveal about trust in the board and how boards can build and enhance trust with stakeholders.

Investor voting and trust
Investor votes 'For' and 'Against' directors are a key indicator of investor trust. In the past five years:

- overall support for Russell 3000 director elections has fallen;
- the percentage of directors receiving qualified support (below 95%) has increased from 22% to 30%; and
- the percentage of director nominees failing to receive majority support (or more 'Against' than 'For' votes, a plurality) has increased slightly.

The decline in support can be attributed, in part, to a combination of investor voting guidelines that have more reasons to withhold support from directors and an increase in the frequency of 'vote no' campaigns. Common reasons for voting against directors include: lack of board diversity, oversight failures, poor climate-risk management disclosure, failed engagement activities, executive compensation issues and overboarding.

Boards and trust
Directors believe they can increase stakeholder trust through enhanced transparency and accountability with shareholders. Seventy-one per cent of respondents say that engaging directly with shareholders would enhance stakeholder trust and 60% that their boards are already doing this. Seventy per cent say that enhancing shareholder communications, eg disclosures or reporting, can have a positive impact on stakeholder trust. Directors seem less convinced that boards can have an impact with other stakeholders.

Enhancing trust beyond investors
To build and maintain trust with stakeholders, boards must identify, understand, prioritise and address the interests of all its stakeholders, some of which will be interconnected. Fifty-seven per cent of executives think their boards do not understand the concerns of other key stakeholders. Director interactions with shareholders, employees, customers and other key stakeholders also provide opportunities to learn about stakeholder interests, aspirations and concerns, as well as to build trust.

A key part of building a different and better relationship with stakeholders is mapping out the qualitative and quantitative ways that stakeholder trust enhances a company's long-term value. Mapping out includes: defining values-driven priorities and assessing how aligning with stakeholder values can enhance long-term economic success; integrating values-driven priorities in the long-term strategy; building internal reporting structures to communicate and report on these priorities; and creating a strategic narrative that brings together these processes.

Companies should identify the issues that align with their purpose, values and business and consider the company and board roles in responding to, or commenting on, these issues. Only 39% of directors say their board has discussed the company's stance on social issues during the past 12 months and only 30% that they have discussed corporate political activity.

Opportunities to increase trust
Expectations regarding transparency and disclosure are increasing and multi-dimensional. Stakeholders are looking for new, additional and more nuanced information about boards and companies.

The proxy statement is now very much a communications tool and can be a one-stop trust-building document. It is a major opportunity to build trust with the company's stakeholders. In proxy statements, stakeholders are looking for enhanced disclosures including:

- board self-assessment processes and the resulting actions taken;
- more comprehensive and nuanced board composition data;
- expanded director biographies;
- board response to votes on shareholder proposals, say-on-pay, or nominees the prior year, and what it learned from investor engagements; and
- board commitment to transparency and disclosure.

The company's website can also be a powerful tool for timely and substantive communication with stakeholders.

Incorporating stakeholder focus
Stakeholders place their trust in companies that incorporate them into planning for the company's future. They see value in actions the board takes to do so, incorporating stakeholder considerations into decision-making and disclosing in the proxy statement how the board is doing that. Boards, when evaluating current company leadership and when selecting and developing future leaders, should look for individuals who understand and address employee and customer (as well as other stakeholder) trust expectations. They should incorporate stakeholder focus into leadership decisions and into company strategy.

For the full Report go to: https://pwc.to/3CdKARl

Global News

New disclosure requirements in Canada

The Canadian Securities Administrators (CSA) has proposed two new disclosure requirements for consultation: one related to board nominations and board renewal and the other related to diversity. The Proposals, which will apply to a large number of Canadian public companies, are intended to encourage meaningful disclosure about how non-venture issuers identify and evaluate new candidates for nomination to the board, how they address board renewal and how diversity is incorporated into those considerations.

Board nominations and board renewal
The Proposals mandate disclosure regarding the board identification and evaluation process for nominating new candidates. Existing requirements regarding nominating committee disclosures are unchanged, however the requirement to describe nominating committee's responsibilities, powers and operations is removed.

A new requirement is added to disclose whether the board has a written policy regarding the nomination process and if not, the issuer would need to explain how the nomination process is conducted. New disclosures are also added regarding management of nomination process conflicts of interest, whether the board has a composition matrix and the skills, knowledge, experience, competencies and attributes of candidates considered during the evaluation process.

Regarding board renewal, existing requirements regarding adoption of term limits are unchanged. However, disclosure is now required on how other mechanisms, other than term limits, contribute to effective board renewal. Existing requirements to broaden the description of how board renewal is undertaken are also expanded.

Diversity
Diversity disclosure existing requirements will remain. It is proposed that data reporting on five 'designated groups: indigenous peoples, LGBTQ2SI+ persons, racialised persons, persons with disabilities or women' should be mandatory. Beyond data reporting, regarding the designated groups, issuers would also be required to have the following: written strategy and policies to maintain board member (but not executive officer) diversity; targets presented in a standardised tabular format; and measurable objectives of the issuer's written strategy, other than targets.

The number and proportion of current board members and executive officers, and those that filled vacant board seats during the prior year, who identify as being from designated groups (in addition to certain other required data) should be presented in a standardised tabular format. No mention is made of certain other demographical data, such as age or religion of board members and executive officers.

Dutch say-on-pay

A recent study amongst investors and non-execs looked at the current Dutch say-on-pay framework. The study, commissioned by Eumedion, found that the majority of investors (87%) and non-execs (83%) consider variable pay as an important part of the C-suite remuneration package. Both investors and non-execs agreed that incentivising good managers is one of the most important objectives of (variable) remuneration. However, investors stated that the most important objective is to drive business objectives and non-execs felt that remuneration should primarily be used to attract capable managers.

Engagement – Engagement and transparency are key issues. Investors reported issues regarding access to KPIs and, where access is granted, clarity is often an issue. There were divided views on whether the remuneration policy provides sufficient information regarding execution. Companies also reported issues with the level of shareholder interest in the company, as well as the lack of transparency on voting outcomes.

Policy – Investors were divided on whether the requirements regarding the content of remuneration policies instil sufficient confidence in shareholders on the ex-post execution of the policy. Investors, and to a lesser extent non-execs, believe that enhancement to (ex-ante) proposals for remuneration policies would alleviate the concerns of shareholders regarding (ex-post) policy execution.

Reporting – More than half of investors were unsatisfied with the current say-on-pay framework as it affects the remuneration report and only around half of investors believe the remuneration report provides enough information.

Most investors, and a small number of non-execs, believe that enhancements to (ex-post) remuneration report voting would alleviate shareholder concerns regarding the execution of remuneration policies. Whether a binding vote on the remuneration report would serve as an appropriate enhancement received mixed responses: investors were, by and large, in favour, whereas a small majority of non-execs believed that it was not the correct approach.

The majority of investors and non-execs believe that the consequences of a negative vote on the remuneration report should be borne by non-execs rather than executive directors. Where consequences are borne primarily by non-execs, the proposal to amend the remuneration policy emerged as the preferred action by non-execs and the second preferred action by investors. Investors' preferred option was that non-execs be obliged to research shareholders' concerns.

ESG processes and practices

Thirty-three per cent of companies have a specific ESG committee at board level, 27% have an ESG committee but not at board level and 40% do not have an ESG committee, according to a poll conducted by the Chartered Governance Institute, together with Core Partnership.

The poll looked at company ESG processes, perceptions of ESG ratings, prioritisation of ESG practices and decision-making structures.

Those companies polled were asked if quantitative ESG data models can be trusted to produce reliable, trustworthy and accurate ESG ratings or scores. No-one strongly agreed, 28% agreed, 38% neither agreed nor disagreed, 26% disagreed and 8% strongly disagreed. With increased regulation and reporting requirements emerging in this area, perceptions about the reliability of ESG ratings should improve.

When asked about the extent to which companies would prioritise positive ESG practices if they hampered short-term company profits, 8% of respondents strongly agreed that their company would prioritise ESG practices; 39% agreed, 28% neither agreed nor disagreed, 20% disagreed and 5% strongly disagreed. This is an area where there may be movement over the coming years as organisations increasingly frame their purpose in broader terms than profit-making.

There was an encouraging response when participants were asked if they felt that there was diverse representation at senior level participating in company decision-making processes. Fifteen per cent strongly agreed that there was diverse representation, over half (52%) agreed, 15% neither agreed nor disagreed, 16% disagreed and 2% strongly disagreed.

Finally, respondents were asked if their company includes positive ESG performance as part of variable incentive plans for the board and senior management team. Participants were asked to select all relevant answers and the responses showed that 23% include it as part of the annual bonus, 8% include it as part of long-term incentive plans and 15% do include it but in other ways. Eighteen per cent did not know and 36% do not include it.

Hong Kong Listing Rules update

The Hong Kong Stock Exchange (SEHK) has updated its Listing Rules to include listings of Specialist Technology Companies. The revised Rules came into effect from 31 March 2023.

The new Rules permit listings by companies primarily engaged in the research, development and commercialisation of products and services that apply science and technology within specified industry sectors. These sectors are: next-generation information technology; advanced hardware and software; advanced materials; new energy and environmental protection; and new food and agriculture technologies, referred to as 'Specialist Technology Products'.

Applicants must demonstrate that they meet the definition of a Specialist Technology Company and are both eligible and suitable for listing as either a commercial company or a pre-commercial company, defined as follows:

- commercial companies – at least HK$250m in revenue arising from their specialist technology business for the most recent audited financial year;
- pre-commercial companies – products not yet brought to commercialisation and/or do not meet the minimum revenue requirement.

Both must have been in operation in their current line of business for at least three financial years prior to listing and under substantially the same management.

At the time of listing a commercial company must have an initial market capitalisation of at least HK$6bn: for a pre-commercial company, they must have an initial market capitalisation of at least HK$10bn. Applicants must also have received meaningful investment from Sophisticated Independent Investors.

The minimum free float upon listing must be at least HK$600m. Pre-commercial companies must be able to demonstrate a credible path to achieving the threshold of having a revenue of at least HK$250m. The post-IPO lock-up periods for controlling shareholders are 12 months for commercial companies and 24 months for pre-commercial companies.

The minimum research and development expenditure ratio has to be met on a yearly basis for at least two of the three financial years prior to listing and on an aggregate 18 April 2023 basis over all three financial years prior to listing. The minimum research and development expenditure ratio threshold for a commercial company is at least 15% of its total operating expenditure and for pre-commercial companies with revenue more than HK$150m but less than HK$250m the threshold is at least 30% of its total operating expenditure.

Pre-commercial companies listed must include in their interim (half yearly) and annual reports details of their research and development and commercialisation activities during the period under review.

Feature

The effective board Chair

Alex Cameron and **Chris Stamp** look at what makes an effective Chair based on lessons learned from carrying out board effectiveness reviews.

The role of the Chair is a critical but frequently underrated element of value-creating boards. This means that the effectiveness of the Chair is often a critical area of focus in board effectiveness reviews. During a recent webinar run in conjunction with *Governance*, members of *The Board Effectiveness Guild* used insights gained from their work in facilitating board reviews to identify some of the traits that can make Chairs stand out in leading their boards. The webinar focused on four key questions:

1. **Chairing boards and committees** – how does the Chair effectively create the right culture and manage the dynamics so that the board can be truly value-creating?
2. **Managing the principal stakeholder relationships** – what does the effective Chair need to do to outside of board meetings to ensure the board works well? And how is communication best managed with often competing stakeholder groups?
3. **Key board relationships** – the Chair must build and maintain a number of relationships inside and outside the boardroom – for example, with the CEO, SID, non-execs, executives as well as other colleagues. How is this best managed?
4. **Succession planning** – what is the Chair's role in one of the board's most important tasks: succession planning? How does the Chair recruit for a truly diverse board while ensuring the right skills and best dynamics are maintained?

This article considers the role of the Chair in managing stakeholder and board relationships, which was discussed in the second and third sections of the webinar.

Managing the principal stakeholder relationships

One of the characteristics of an effective Chair is clarity in understanding the boundaries of their role. And the evidence of board effectiveness reviews certainly suggests that this is the case when it comes to stakeholder relationships. Many boards are now focusing more on their collective engagement with key stakeholders as a result of increased regulatory focus on directors' duties under the Companies Act, and the boards that do this well are the ones where there is clarity about who should lead the engagement. Many of the key stakeholder relationships, for example with customers and suppliers, are naturally led by the executive team – particularly the CEO. Nevertheless, the Chair should certainly play a role in some of these relationships. Effective Chairs generally have a good feel for the relationships they should prioritise and how they should be involved either as the lead or supporting other board colleagues.

As a rule of thumb, Chairs tend to be most closely involved in the following relationships: key players in the boardroom; the owners of the business (shareholders, trustees etc); key people internally (senior executives, employee representatives); and those relationships associated with the organisation's licence to operate (regulators, community leaders). Some of these relationships may be more ambassadorial rather than operational. Whilst many relationships may be led by the executives, particularly the CEO and CFO, the Chair has an important role to play in reinforcing the organisational links by providing another point of reference or contact which can be valuable if there are problems with primary contact relationship at executive level.

Stakeholder relationships generally function in different ways and board review experience suggests that good Chairs have a good feel for the appropriate ways to conduct the different relationships that they need to be involved in. In some of the more ambassadorial roles, the main form of contact may be social, *personal* but infrequent – providing the basis for building a rapport with the relevant counterparty so that either side can 'pick up the phone' if they need to. Other relationships may be more *periodic* with regular but occasional information sharing and some relationships will be more *professional*, working relationships which may focus on planning, projects or problems.

The balance between these different approaches will vary from organisation to organisation. For example, in a company which is steady in meeting investor expectations, the Chair's role with shareholders may be personal and very occasional (for example a coffee or lunch every couple of years); whereas in a company where there is a lot of activity but generally has a good rapport with shareholders, the Chair's role may be a more periodic one (eg attending results meetings once a year). Where there is a controlling shareholder the Chair's role may be more of a professional one with regular working meetings and discussions about key board decisions on capex and the like. Using the right channels for engagement will enhance the quality of the engagement itself and therefore its effectiveness. In particular, judging the balance between formal and informal engagement and between face-to-face and electronic meetings is a characteristic that many good Chairs instinctively get right. Whilst many Chairs may have their preferred channels of communication because of personality or their usual work patterns, diligent Chairs tend to be more intentional in choosing their methods for engaging with stakeholders.

Managing key boardroom relationships

The Chair's sphere of greatest influence is perhaps in the boardroom where he or she is the leader. In most cases the Chair is a non-exec role, and the authority of the role has natural boundaries. The execution of this limited authority is built on the quality of relationships that the Chair has with key

Feature

‘For some the company secretary is little more than a minute taker and administrator, but this is to miss the rich contribution that they can make to the board and the Chair.’

members of the board. An effective Chair understands the importance of investing in these relationships to build trust, to communicate and to listen to feedback from board members. An effective Chair also knows that these relationships are ‘hard won and easily destroyed’, so they manage each interaction with care.

The Chair and the other non-execs

Executives spend considerable time working together as a team, leading the business. The non-execs spend little time together to align their views and discuss the concerns that face the business. The Chair has an important role to engage with and listen to this group. Some Chairs are reticent to bring non-execs together in non-exec-only sessions, but these can be very valuable. Before the board meeting to review the agenda ahead, or at the end of the meeting to reflect on the performance of the board – and the executives.

The Chair and the company secretary

The extent of the company secretary role varies widely from board to board. For some the company secretary is little more than a minute taker and administrator, but this is to miss the rich contribution that they can make to the board and the Chair.

The most effective Chairs recognise the added-value of this role and build a close working relationship. A close relationship can assist the Chair with agenda building, the improvement of information provided to the board, and governance developments. In addition, a company secretary who is trusted by the Chair can help with time and agenda management at board meetings.

The Chair sharing authority with the CEO

Many examples of governance failures can be traced back to problems with either a weak Chair subservient to an over-bearing CEO, or a weak CEO allowing a non-exec Chair to operate in a quasi-executive manner exerting too much control. It is important that there is a formal schedule of meetings between the Chair and CEO to supplement ad hoc communication. This ensures that this relationship provides sufficient opportunity for appropriate challenge and support from the Chair.

Good governance suggests that the Chair and CEO should document the separation of accountabilities between these two critical roles. The discussion to create this document is often the most important step to flush out frustrations and to find ways to improve this important relationship. This is not a one-time activity. An annual review of the separation of accountabilities is good practice for the Chair and the CEO to maintain a strong, open relationship.

The counterpoint of the SID

The Senior Independent Director (SID) role was introduced by the Higgs Review of corporate governance. It offers an ‘insurance policy’ for the board if the non-execs are unhappy with the performance of the Chair. The SID also carries out the annual review of the Chair and this requires a productive Chair/SID relationship. It matters that the SID has credibility and experience to give confidence to non-execs and stakeholders that they can provide clear, useful feedback to the Chair – and that the Chair will listen to the advice from the SID. In some cases, the SID is appointed as a successor to the Chair. This expectation can influence the level of candour in this relationship and should be avoided where possible, as set out in the Higgs Review. From the Chair’s perspective, if the relationship is good, the SID can be a great asset to the effective operation of the board and a productive confidant to the Chair.

The Chair is in a leadership position in a complex collaborative group, the board. As such the best Chairs require a high emotional intelligence with great communication skills, but they also require a degree of comfort with the authority of the role. Together these abilities help build relationships both in the boardroom and with the wider stakeholder community. This enables the operation and profile of the board, enhancing its ability to influence and have impact.

The details of how the Chair manages the complex dynamics in the boardroom and the succession needs of the board will be covered in the next article.

Alex Cameron is a board evaluator and leadership consultant. He has over 30 years’ experience working with senior executives and boards to enable their individual and collective performance. As a founding director of Socia Ltd in 2002, Alex has built a strong reputation enabling boards to collaborate effectively, build strong reputations with their stakeholders and meet the demands of an increasingly complex governance environment.

Chris Stamp is a governance professional, board evaluator and business adviser with a strong understanding of corporate governance in UK listed companies built up over more than 30 years. In 2002, he set-up Prism Cosec, a leading company secretarial practice which was acquired by Equiniti Group in 2012. He now provides governance advice and board evaluation services to listed companies.

They are both founder members of The Board Effectiveness Guild, a group of experienced and independent board evaluators who have come together to enhance the value of board effectiveness reviews by sharing best practice with each other and contributing to the wider debate on excellence in corporate governance.
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Feature

Good governance and market valuation

Dr Luis Correia da Silva and **Derek Yide Song** discuss the advantages of implementing EU reforms to enhance corporate reporting, and how they can have a significant impact beyond what is initially perceived.

Capital markets are a crucial factor in resource allocation in western economies. They operate as hubs that amalgamate transactions, causing resources to shift towards the most promising investments that ultimately produce improved outcomes for consumers. However, the proper functioning of capital markets requires reliable and high-quality information to be made available to investors. In 2022, the European Commission's DG FISMA initiated a consultation among member states to improve the quality of this information.

DG FISMA states that corporate reporting is 'the bedrock of capital markets' since it provides investors with the financial information required to make informed investment decisions, and that '[h]igh-quality and reliable corporate reporting by listed companies is of key importance for the efficiency of EU financial markets'[1]. The consultation by the European Commission deals with three pillars of corporate reporting: corporate governance, statutory audit, and the supervision of statutory auditors and audit firms. This article focuses on the first pillar.

Corporate governance plays a crucial role in situations where management and ownership are separate, especially in listed companies. It is essential to safeguard investors' funds against mismanagement. Without proper investor protections, rational investors will pay less for such investments, resulting in inefficiencies in resource allocation, which is known as the 'agency problem'. The European Commission's *Corporate Reporting – Improving its Quality and Enforcement: Call for Evidence* gives us the opportunity to provide further insights into this issue.

The current status of corporate governance frameworks across EU countries

Corporate governance frameworks differ significantly from one EU Member State to another. The majority of them have a complex system of regulations for corporate governance, which include guidance from various sources such as legislation, securities regulators, stock exchanges, corporate governance codes and central banks. While some of these rules are mandatory, others are regarded as best practice. Also at play are different interpretations of the comply-or-explain principle, with varying levels of detail required for explanation depending on the Member State. It is clear that the corporate governance framework underpinning corporate reporting varies considerably across the EU, which provides support for the DG FISMA initiative of consulting on the quality of corporate reporting.

Potential costs and benefits of reforms in the EU

The process of implementing a unified and enhanced corporate governance framework for corporate reporting in the EU is not straightforward, and the benefits are not obvious. While academic evidence may suggest that improved reporting and corporate governance are necessary to achieve healthier markets, the costs of complying with new governance rules can be significant. These costs undoubtably include direct administrative expenses as well as unintended economic and social costs. For example, the additional information that is required to be disclosed could be used by competitors, which would increase the economic costs of disclosure. In addition, any change in oversight and governance risks leading to a structural break, which would in turn lead to a loss of consistent time series, which is often as or more informative than absolute levels.

'These non-financial aspects have equal, if not greater, economic significance, as they could help to generate positive externalities that bring the incentives of investors in line with those of other stakeholders.'

Firms may also reduce their risk-taking below optimal levels, and better-governed companies may opt out entirely from listed markets once new corporate governance regulations are established. Instead, they may choose to make themselves private to avoid regulations that their investors consider unnecessary or too costly.

This is precisely why further reforms and their potential benefits must be considered carefully. To do so, Oxera examined the effects of corporate governance reforms in the United States and Italy on three key metrics: the cost of equity at the company level, the quality of accruals, and the corporate governance rating. Our findings indicate that all three metrics improved after the implementation of the reforms, signalling that they led to better corporate governance and higher-quality financial reporting, ultimately reducing investor risk.

This risk reduction not only makes the EU a more attractive investment destination, but also increases the profitability of riskier, innovative projects and firms, which helps to boost the long-term competitiveness of the EU. Additionally, the

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reduction in capital expenses will decrease financing costs for companies that are compliant with the reforms, and increase their profitability. With this increased profitability, companies can contribute to the economy by boosting gross domestic product (GDP) and paying more tax, which can support government spending and increase investments.

The research shows that good reporting does, perhaps as expected, improve capital market performance. It highlights the necessity to put in place internal controls at the executive level to guarantee that management and boards are verifying the accuracy of their reported information, and to re-establish trust in the corporation. Finally, and perhaps most importantly, proper reporting will ensure that investors and other stakeholders reap the benefits of the company's endeavours.

> ‘The good corporate reporting agenda has lofty goals, but achieving them will benefit not only investors but also all other stakeholders.’

Benefits that go beyond the bottom line

Looking beyond the financial benefits, the Commission's proposed framework also focuses on non-financial aspects of corporate reporting such as providing information on ESG.

These non-financial aspects have equal, if not greater, economic significance, as they could help to generate positive externalities that bring the incentives of investors in line with those of other stakeholders.

Many organisations now understand that they must look beyond simply returning value to shareholders; they are recognising that this lone pursuit can have a negative impact on the very fabric of the societies in which their businesses operate.

Against this background, the Commission's proposed framework helps to further align the interests of investors and other stakeholder groups. With access to higher-quality information on financial and non-financial aspects of the companies that they invest in, shareholders and the directors representing their interests will be better placed to make informed decisions in order to promote the wellbeing of employees, the community and the environment.

Preparing for the future

An important topic in today's business environment is how best to enhance stakeholder value. This is a question that businesses in all sectors grapple with, as we are increasingly subject to regulatory scrutiny as well as being scrutinised by consumers and investors. Good corporate governance and reporting are key to the success of any organisation and, as Oxera has demonstrated, are a direct link to the success of the capital markets.

The good corporate reporting agenda has lofty goals, but achieving them will benefit not only investors but also all other stakeholders. It will also improve investor confidence and promote long-term economic growth. This is because strong corporate governance measures will promote transparency and accountability within organisations as well as provide a framework for mutual trust and respect between organisations and their stakeholders – investors, consumers and employees alike.

Find out more about what it means to go Beyond the Bottom Line, and listen to Oxera's latest podcasts on The contribution of good corporate governance to the market valuation of European companies.

Oxera sets the standard for international economics and finance consultancy, providing sustainable business solutions to help create competitive advantages for our clients. We advise and prepare our clients to face the constantly shifting corporate, social, political and regulatory environments. Using a wealth of cross-disciplinary knowledge and multi-faceted perspectives, we look beyond the conventional aspects of an individual situation and connect them to the wider context. With offices in Amsterdam, Berlin, Brussels, Hamburg, London, Milan, Oxford, Paris and Rome, and working with clients around the world, Oxera is a truly international business.

Dr Luis Correia da Silva is a Partner and the Chair at Oxera. He holds a doctorate in Economics and Finance from the University of Oxford and has over 25 years of experience of applying his expertise across a wide range of industries. He provides advice at the board and executive level to companies, regulators and governmental departments in Europe across many sectors, including asset management, banking, communications, energy, securities markets, transport and water. His academic research focuses on financial markets, state aid and corporate control, cost of capital, corporate finance, corporate dividend and capital structure policy, financial regulation and corporate governance, and he has published extensively in these areas. He has advised financial institutions on state aid matters arising from the global financial crisis.

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1. European Commission (2021), ‘Corporate Reporting – Improving its Quality and Enforcement: Call for Evidence’, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13128-Corporate-reporting-improving-its-quality-and-enforcement_en

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