Rewriting the Rules:

Labour's Vision for Corporate Governance, Accountability, and Regulation

Labour

IT'S TIME FOR REAL CHANGE

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This Policy Paper sets out a Labour Government's position on transforming the UK's system of corporate governance, company law, executive pay, auditing, and the laws that regulate business to address the problems of lack of accountability, short-termism, corporate regulatory capture, and environmental sustainability. It explains questions that we will consult on in Government, and is an invitation to stakeholders to submit their views on Labour's proposals.

Executive Summary

Today's corporate model is badly broken and urgently needs reforming. Our businesses are the heartbeat of our economy, producing the goods and services we need. And yet the commanding heights of the corporate sector have become beholden to a model in which unfettered profit maximization and extraction has been allowed to override all other considerations. This has been to the detriment of workers, consumers, communities, our environment, and businesses themselves. The relentless pursuit of shareholder value has led to rising inequality, short-termism, asset-stripping of otherwise healthy companies and the neglect of investment for long-term performance. It has also meant the rise of monopolistic behaviour and the subversion of government's ability to regulate the economy in the public interest.

There is an urgent need to rewrite the rules for how businesses operate in the United Kingdom. This policy paper sets out the plan by which Labour will go about that rewrite. We will take on short-termism and corporate greed, make sure good businesses are rewarded and not undercut, and establish new approaches to regulation that ensure companies serve a broader range of stakeholders and operate in the service of wider economic, social, and environmental goals – a new social license to operate.

Since the Global Financial Crisis we have seen all too many examples of today's predatory business model failing consumers, workers and the wider community. This was amply demonstrated by the collapse of Carillion, BHS and Thomas Cook. But these failings go back decades – reflecting cultural problems, regulatory deficiencies, and system-wide shortcomings. We are learning that an extractive economy cannot sit forever alongside a democratic politics. One or the other must prevail. We need an extension of democracy and democratic accountability into the sphere of corporate governance. That's why this paper commits Labour in government to a radical overhaul of company law in order to secure greater democracy and accountability in the business world.

In order to bring about a reorientation of all businesses to longer-term performance goals – including environmental performance in the face of the climate emergency – and to introduce greater accountability to stakeholders and the public, the next Labour government will institute a series of major additions to and reforms of UK company law and business practice. These will include:

- Major reform of the Companies Act. This will ensure companies are oriented towards the long-term, establish a choice for large companies between a new unitary or two-tier board structure, and initiate a review of the need for additional legislative action to encourage longer-term shareholding.

- The establishment of Inclusive Ownership Funds (IOFs). We spell out how these will operate, including through profit-sharing schemes in instances where large companies do not issue dividends, a clearly defined exemption for companies with an existing type of employee ownership scheme, a limit on how much money raised by the IOF will be capped and redistributed, a limit based on UK-based profits for IOF shares, and the direction of IOF returns above the dividend cap to a Climate Apprenticeship Fund.

- A requirement that Labour's entire policy agenda be responsive to the existential threat of climate change. We will adopt new instruments of regulatory enforcement such as delisting dirty companies from the London Stock Exchange where they fail to take adequate steps to curb emissions or otherwise tackle the climate emergency.

- The introduction of greater transparency in executive remuneration contracts. We will introduce new measures such as the disclosure of CEO-to-median employee pay ratios and rules limiting how share options are offered to executives. Executive pay packages will be subject to an annual binding stakeholder vote. Companies will be required to show how they will set about tackling the gender and ethnicity pay gap. The collapse of Carillion will be pursued through all avenues of the law, and a full public inquiry will be conducted. The Companies Act will be amended to prevent companies from neglecting pension deficit recovery payments.

- The structural separation of audit and accounting activities in major auditing firms. This will include more robust rules relating to audit tenders, audit remuneration, audit recruitment, and audit regulation.

- An overhaul of our regulatory architecture to end the risks that arise when the foxes are put in charge of guarding the henhouses. The Labour government will establish a Business Commission, overseen by select committees and subject to freedom of information. We will also end the corporate capture of regulatory institutions as a key part of rewriting the rules for business.

1. Introduction

The corporate model of business enterprise in Britain today is broken and needs a radical overhaul. In a world in which we face the existential threat of climate change and too many of our communities are falling behind or falling apart, the elevation of short-term profit maximization above all other economic, social and environmental considerations has given us a corporate sector that is unfit for purpose. This is increasingly understood by the public and is part of a crisis of confidence in our institutions and in the overall operations of the economy.

The 2008 Global Financial Crisis raised serious questions about business practice and regulation, undermining confidence in business, and spawned some brief soul searching on the part of business and political leaders but resulted in precious little action. These questions have not gone away. Recent corporate failures such as the collapse of Carillion and the downfall of BHS and Thomas Cook remind us of the damage of unchecked and poorly regulated corporate behaviour. They highlight the harm caused when corners are cut in the pursuit of short-term profit – to the detriment of workers, consumers, the community and the environment. They also reveal that key lessons have still not been learned from the 2008 crisis.

However, these problems in UK corporate governance and practice - such as excessive short termism - are long-running, and in many cases pre-date the Global Financial Crisis. They are hard-wired into the current corporate approach, which involves the relentless pursuit of shareholder value in a way that too often sacrifices real value. Cases such as Thomas Cook and Carillion show that even shareholders have not been served well by the short-term business model. A number of key studies argue that the short-term focus of shareholders and corporate executives is a major reason for the poor performance of the UK economy. These include reports by parliamentary committees, Tomorrow's Company, the IPPR, the TUC, the Kay Review and reports by Professor Prem Sikka and his research team for the Labour frontbench. Taken together, they make a number of recommendations, from changing the makeup and structure of company boards to allowing stakeholders to vote on executive pay packets, many of which have been included here.

All in all, it is well past time for the rules of the game for business in the United Kingdom to be rewritten – not least to protect good businesses that play by the rules and act responsibly from being undercut by unscrupulous competitors. At bottom, we must once again assert the basic truth that our companies form a part of our society, and must abide by the same norms and rules as the rest of us. It's especially important that business practices change now, to improve confidence in the broader economy and to repair our torn social fabric that has been steadily ripped apart over the course of the last decade and more.

This paper sets out Labour's plans for radically rewriting the rules and levelling the playing field for UK businesses. They are plans for achieving greater *democracy* in the private sector, at the same time as we seek to democratise public services. They will deliver a*ccountability* and *justice* where things have gone wrong, with rules changed so that injustices can be prevented before they occur. We need to work towards greater *equality*, in pay and treatment at work. And we need *power* to be shared more equally right across society.

This paper should be read alongside Labour's existing announcements on public ownership, trade union rights, worker representation, finance and investment, tax, and the environment. It also indicates where, in Government, we will consult on further questions.

More and more obviously, the public wants to see an end to scandals of sky-high executive pay, ordinary investors losing out because of sudden corporate collapses, and inadequate regulation. A Labour government will take a bold new approach to these long-standing problems. This will be done through an extensive process of consultation with businesses and other key stakeholders. Our points of departure for this overhaul of company law and practice are laid out in what follows.

2. Reforming Corporate Governance in Large Businesses

Our economy faces a growing array of challenges, above and beyond the corporate scandals and failures indicated above. These include climate change, the rise of new technologies (including artificial intelligence) and shifting dynamics in the global economy. Our aim in overhauling UK business practice must be to build a sustainable and democratic economy capable of meeting the challenges of the twenty-first century.

Who owns and controls our companies, sets goals and business strategy, and holds management accountable is critical in determining the path those companies take. Creating a new model of business enterprise in the UK will require, amongst other things, a transformation of our shareholder-centric model of corporate governance into a stakeholder model of corporate governance. At the heart of this new approach must be genuine partnership between employees, customers, management and shareholders for the long-term success of companies.

A short-term focus (or short-termism) is embedded within the shareholder-centric model prevalent in large companies in the UK. The pressures to maximise returns to shareholders, many of whom are short-term investors,[1] at all costs have persuaded executives to boost dividends and other forms of shareholders' returns. This is often at the expense of long-term investment, skills, new products, care for customers, the environment and decent wages for employees. The UK's share ownership market has become increasingly fragmented, resulting in shareholdings that are much smaller and more geographically widespread. Recent data suggests that just 16% of the shares in companies listed on the London Stock Exchange were held by overseas investors in 1994, whereas that number is now close to 54%.[2]

The dominant shareholder primacy model that exists in the UK and elsewhere also fails to value the critical role that workers play within a firm and its success. A firm's workers have a long term interest in the success of the business, are integral to the process of production, and have long-term and largely exclusive contractual commitments to the business.

Many European countries have more cooperative and collaborative systems compared to the UK. One model is for companies to choose from two board structures for corporate governance: either a unitary board with elected stakeholder representation or a two-tier board. The supervisory board is elected by employees, shareholders and others who have long term interests of the company. A two-tier board structure facilitates the separation of decisions on day-to-day management and longer term strategic issues, notably the allocation of resources between dividends and investment, and take-overs and mergers.

Regardless of board structure, experience in other European jurisdictions is that direct representation of employees on both unitary and two tier-boards has helped to improve corporate performance and success for the benefit of all stakeholders.[3] The presence of employee representatives on company boards is an aid to collective bargaining, trade union recognition, employee rights, and investment and better industrial relations to ensure that companies prioritise their long-term success.[4] Evidence from European companies also shows that the presence of employee representatives on company boards tends to lower CEO pay and the award of share options.

Labour Proposals

Labour will rewrite the Companies Act to ensure companies are oriented towards the long-term. In its current form, the Companies Act allows room for long-term decision-making: there is an existing duty on a director to "act in a way [s/]he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole."[5] But the obligation to act with a

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[1] See New Economics Foundation, *Shareholder Capitalism: A System in Crisis*, 2017, online at https://neweconomics.org/uploads/files/NEF_SHAREHOLDER-CAPITALISM_E_latest.pdf, at p. 3.
[2] Ownership of UK quoted shares: 2016, Office for National Statistics, 29 November 2017 (https://www.ons.gov.uk/economy/investmentspensions andtrusts/bulletins/ownershipofukquotedshares/2016).
[3] Michael Gold, Norbert Kluge and Aline Conchon, 'In the union and on the board': experiences of board-level employee representatives across Europe, Brussels: ETUI, 2010; Sigurt Vitols and Norbert Kluge, The Sustainable Company: a new approach to corporate governance, Brussels: ETU, 2011.
[4] Michael Gold, Norbert Kluge and Aline Conchon, 'In the Union and on the board: experiences on board-level employee representatives across Europe, Brussels: ETUI, 2010.
[5] Georgina Tsagas, 'Section 172 of the UK Companies Act 2006: Desperate Times Call for Soft Law Measures', 1 September 2017, online at https://www.law.ox.ac.uk/business-law-blog/blog/2017/09/section-172-uk-companies-act-2006-desperate-times-call-soft-law

longer-term set of interests – and a broader range of stakeholders – in mind should be clarified and reinforced in legislation.

Labour have already committed to amending company law so that directors owe a duty to promote the success of the company for the benefit not only of shareholders, but of employees, customers, the environment and the wider public. **We will also supplement our existing commitment to workers-on-boards by giving large companies the choice of adopting a unitary or two-tier board structure**.[6]

A two-tier board involves an executive board, responsible for the day-to-day operations, and a supervisory/stakeholder board that guides and monitors that executive board. The supervisory or stakeholder board is made up of stakeholders (such as customers, employees, and long-term shareholders). It will be essential to ensure that the supervisory/stakeholder board does not become a body merely to be consulted, with inferior power. The supervisory/stakeholder board should have overall power to steer the strategic direction of the company.

A unitary board involves stakeholders (including customers, employees, and long-term shareholders) occupying a specified number of seats on the board. A revised Companies Act should allow companies to elect whether they opt for a unitary or supervisory/stakeholder board.

We will also **review whether more legislative action is necessary to encourage long-term shareholding**. In France, strengthened voting rights are given to those who hold shares for at least two years. In Germany substantial shareholdings are given to public regional and national banks, which have an interest in the long-term stability of large and middle-sized companies located in their territory. We will look into the viability of such measures, through discussions with the National Investment Bank and its network of regional development banks. We will also consider whether there should be restrictions on voting on take-overs and other specified resolutions based on the length of share-ownership.

Legal backing for longer-term decision-making, different models of board design, and a review of improving shareholding will help bring about a move away from short-termist thinking.

3. Inclusive Ownership Funds

Labour will broaden the ownership base of UK businesses to give more workers a stake in the companies where they work, which is widely held to boost productivity, advance longer-term thinking and produce other key economic and other benefits. In 2018 the Shadow Chancellor John McDonnell announced that a Labour Government would require large companies, defined as those with more than 250 employees, to transfer 1% of their shares into 'Inclusive Ownership Funds' (IOFs) until the Fund owned 10% of the company. Shares would be owned collectively by employees, with dividend payments distributed up to a maximum of £500 per employee per year. Payments above the capped amount would be transferred to a general fund. At the time of the announcement, it was indicated that we would consult further on the details of how the policy would be implemented. In 2019 the Bernie Sanders Presidential campaign team announced a version of the IOF policy, with a proposal for

[6] This was proposed by, amongst others, Prem Sikka et al, *A Better Future for Corporate Governance: Democratising Corporations for their Long-Term Success*, September 2018, online at http://visar.csustan.edu/aaba/LabourCorpGovReview2018.pdf

Democratic Employee Ownership Funds, which would involve 2% of stock being given to workers every year until a company is 20% owned by employees.[7]

Private companies may have shares but not issue dividends. They (and possibly other organisational forms like LLPs) could be exempted from the IOF policy, but this would leave many workers in large companies unable to benefit from the IOFs. A preferable alternative, which a Labour Government will deliver, is **a profit-sharing scheme that would achieve 'equivalent benefits' to an IOF for relevant companies that do not issue dividends**. Profit-sharing schemes usually involve pre-tax profits, but 10% in pre-tax profits would give workers in private companies a significantly larger benefit. So a modified profit-sharing solution would involve the transfer of 10% of post-tax profits. Equivalent 'voice rights' would be stipulated, including the right to be consulted on key decisions and the right to inspect a company's books. Profit-sharing schemes are not unusual in other countries. France recently announced a form of mandatory profit-sharing for companies with more than 50 employees.[8]

Different approaches have been suggested for determining which 'large companies' will be required to establish IOFs. The best approach is to adopt the standard definition of a 'large company' in the Companies Act.[9] This has the advantage of making avoidance harder. **A Labour Government will use this definition of 'large company' when implementing the IOF policy.**

An Employee Ownership Trust is the most similar existing employee ownership scheme but is not exactly on par with an IOF: it involves tax benefits (no capital gains tax is paid when a controlling interest in a company is sold to an EOT) and 'voice rights' are different. We will, therefore, allow an exemption for Employee Ownership Trusts where they benefit all employees and where greater than 10% of equity is vested in employees. **An exemption should operate where an Employee Ownership Trust benefits all employees and involves a 15% equity stake for employees**. This will encourage EOTs, but does not create an overly wide loophole that firms might use to try to escape the IOF. We will review employee ownership schemes to ensure that the exemption is workable, and to ensure that employee ownership schemes advance worker voice in a way that is aligned with the goals of the IOF policy.

Some companies have a very broad global base and smaller UK operations. As a matter of principle, it seems unfair to allow UK workers to benefit disproportionately from global activities, especially if this involves a transfer of wealth from the Global South to the UK. It is possible, and desirable, to limit 'IOF shares' and the profit-sharing equivalent to UK profits declared as part of corporation tax. **A Labour Government will specify that IOF shares will be based on, and limited to, UK profits.** This would mean that 'IOF shares' would not be the same in value as other company shares. Some of the companies with a global reach inflate figures on an IOF; limiting the IOF in this way can address this inflation. With a robust Fair Tax Programme to tackle tax avoidance and evasion, as well as a strong anti-avoidance provision in IOF legislation, risk of further profit-shifting can be mitigated.

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7 See https://berniesanders.com/issues/corporate-accountability-and-democracy/

8 See https://www.lexology.com/library/detail.aspx?g=453c69e4-c618-42cf-b5f6-b184cffcc005

9 https://www.dlapiper.com/en/uk/insights/publications/2018/12/uk-corporate-governance-reforms-how-do-they-affect-premium-listed-companies/. The legal definition of a large company is one that does not qualify to be a micro-entity, a small company, or a medium-sized company. A company is medium-sized if it meets two out of three of the following criteria: turnover of no more than £36 million; balance sheet assets of no more than £18 million; and having not more than 250 employees.

Payments above the cap will go to a Climate Apprenticeship Fund. Businesses will be able to determine funding for skills development to tackle the climate emergency. Remaining money left over once the cap is exceeded for workers will therefore not go into a 'general pool', but will be directed towards addressing the existential threat of climate change.

Independent estimates have estimated that the policy could raise £2.0 billion for workers in total and £0.7 billion for the Climate Apprenticeship Fund after five years, with an average annual payout per worker of £181 in five years' time.[10] **To limit the amount going to the Climate Apprenticeship Fund we stipulate that not more than 25% of money raised by the IOF should go to the state.** The cap will rise in whatever way necessary beyond £500 to limit the Climate Apprenticeship Fund share to 25%. This means from the Treasury's point of view the capping of dividends will be revenue-neutral.

4. The Listing of Companies and Climate Change

Businesses will hardly be able to remain viable in a world of catastrophic climate collapse. Tackling climate change requires urgent, coordinated action from both the public and private sector. Under Labour, climate action will be part of a new set of minimum requirements akin to a social license to operate.

There are existing decarbonisation initiatives in the private sector in the United Kingdom. Businesses have been set up to track carbon emissions, develop climate-friendly products (as alternatives to fossil fuel products), and to support a just transition that keeps global temperatures within acceptable limits.

But far more needs to be done. In late 2018 the Intergovernmental Panel on Climate Change spoke of the need for urgent action to keep global warming to 1.5 degrees above pre-industrial levels – in order to prevent rising sea levels, diminishing Arctic sea ice, and more extreme weather.[11] The Labour Party has set out ambitious plans for public ownership of energy distribution and transmission networks, decarbonisation of the economy, electric vehicles, and offshore wind, amongst other measures. A recent expert briefing endorsed by the Party also set out a plan to end energy waste, decarbonise heat, decarbonise electricity, and balance the system.[12]

Labour Proposals

The imperative for further action means that under Labour **companies will be delisted from the London Stock Exchange** where they are not taking adequate steps to tackle the climate emergency.[13] The Shadow Chancellor has said that there is a need for "weeding out" companies "that are not taking

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[10] See Mathew Lawrence and Loren King, 'Examining the Inclusive Ownership Fund', Common Wealth, 13 November 2019, available online at https://common-wealth.co.uk/examining-the-IOF.html. These are rounded figures.

[11] See https://www.ipcc.ch/2018/10/08/summary-for-policymakers-of-ipcc-special-report-on-global-warming-of-1-5c-approved-by-governments/

[12] *Thirty Recommendations by 2030*, Expert Briefing for the Labour Party, online at https://labour.org.uk/wp-content/uploads/2019/10/ThirtyBy2030report.pdf

[13] See Larry Elliott and Richard Partington, 'Labour weighs up delisting UK firms if they fail to fight climate change', *The Guardian*, 10 May 2019, online at https://www.theguardian.com/business/2019/may/10/labour-delist-uk-firms-failing-to-fight-climate-change-john-mcdonnell

[climate change] seriously". He has noted that delisting is a "signal … that we're being serious", and shows "we're going to use every lever of government we possibly can to enable that to happen."

Companies already have to meet London Stock Exchange and Financial Conduct Authority standards for listing, including standards under the UK Corporate Governance Code. The Corporate Governance Code and any other relevant legislation will be amended to set out a new minimum standard for listing relating to evidence of necessary action being taken to tackle climate change.

We will specify in detail the standard for listing in government, building on the recommendations of the independent panel commissioned by the Shadow Chancellor, *Finance and Climate Change: A Progressive Green Finance Strategy for the UK*.[14] Other countries include substantive requirements for listing; Norway, for example, requires minimum gender representation on boards as a precondition of listing.[15]

This goes with the grain of business trends. Businesses are calling, in various coalitions, for companies to improve climate-related financial reporting and for all companies to prepare decarbonisation plans. Requiring companies to tackle climate change as a condition of listing translates this commitment into legislation, making demonstrable action on climate change a new minimum standard of operating in the modern business environment.

5. Tackling the Scandal of Executive Pay

We will broaden the stakeholder governance of compensation in companies and tackle the scandal of excessive executive pay that often bears no relationship to corporate performance. The success of any company is the product of the collective effort of all workers and a company's wealth should therefore be fairly distributed. All workers should be rewarded for their hard work, and higher pay and extra rewards can act as an incentive for performance. However, it has become normalized that some executives collect remuneration packages completely unrelated to corporate performance or the long-term success of the company.[16] According to the High Pay Centre, after just three working days in 2019, the UK's top executives made more money than the typical UK full-time worker will earn in the entire year.[17]

Eight years of austerity have sharpened inequality. Too many workers are stuck in low paid, insecure jobs, while, over the past twenty years, the pay of the average FTSE-100 CEO has gone from around 60 times that of their average employee to nearly 150 times in 2017.[18] In the financial year ending 2017, the average income of the richest fifth of households before taxes and benefits was 12 times greater than that of the poorest fifth.[19] After inflation, the average worker in Britain still earns less

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[14] See https://labour.org.uk/wp-content/uploads/2019/11/12851_19-Finance-and-Climate-Change-Report.pdf
[15] For more discussion, see https://blogs.eui.eu/genderquotas/wp-content/uploads/sites/24/2015/03/Executive-summary-Norway-Teigen.pdf
[16] See Zlata Rodionova, 'Link between high executive pay and performance "negligible", study finds', *The Independent*, 28 December 2016, available online at https://www.independent.co.uk/news/business/news/high-executive-pay-performance-ceos-link-negligible-study-a7498441.html,
[17] See http://highpaycentre.org/pubs/remco-reform-governing-successful-organisations-that-benefit-everyone
[18] High Pay Centre http://highpaycentre.org/files/Shackleton-Top-Dogs-Chap-2.pdf
[19] Office of National Statistics, Effects of taxes and benefits on UK household income: financial year ending 2017, London: ONS, 20 June 2018.

than they did a decade ago. The average total pay packet is now worth £470 per week in real terms (constant 2015 prices), compared with a pre-recession peak of £473 per week in April 2008.[20]

Long-Term Incentive Plans (LTIPs) are set by remuneration committees and are the most popular form of long term share award for senior executives of listed companies in the UK.[21] They have accelerated the sharp increase in executive pay and bonus packages over recent years. The misuse of LTIPs can be seen in the instance of the collapsed construction firm Carillion. Its senior executives presided over low levels of investment, declining cash flow, rising debt and a growing pension deficit. Yet the pay of directors rocketed. Its three non-executive directors collected more than £60,000 each for working around one day a month.[22] Research from the TUC found that over a third of FTSE-100 companies have executive directors from other companies sitting on their remuneration committee.[23] This raises questions about the impartiality and independence of these committees, since those responsible for determining executive pay are personally incentivised to maintain a high rate for executives.

The mounting disparity between workers and executives is bad for businesses and is harmful to the reputation of UK companies. Excessive executive pay skews the executive's responsibilities and shifts focus away from accountability, sustainable investment and productivity of the companies they run towards the security of their LTIPs. Similarly, excessive executive pay can negatively impact the morale of the wider workforce, as workers see their pay stagnate and cost of living increase, whilst the pay of the senior executives at their company grows ever higher. Disproportionately high pay for senior executives is often justified by over-valuing the significance of their decisions on company success. Companies believe that to attract and retain the best global talent they must offer competitive pay packets and view it as an investment in the company's future. However, this investment could instead be made in the workforce or new plant and machinery – all of which are vital to the ultimate success of any company.

Gender pay also reflects a broken corporate model. According to the Government's Hampton-Alexander review, only 32.1 per cent of board members of FTSE 100 companies are women, which falls short of their target of 33% target.[24] Yearly gender pay reporting shows that almost 8 in 10 companies pay male employees more than women. Labour is committed to requiring all private and public employers to obtain government certification of their gender equality practises or face fines and further auditing.

All companies with more than 250 employees have a statutory duty to publish the breakdown of pay between their male and female employees – but there is currently no statutory requirement to publish the pay disparity between employees of different ethnicities. According to the ONS there exists a pay gap between different ethnicities, with the percentage difference in median hourly pay between people of a White ethnicity and all those who belong to an ethnic minority group to be largest in

[20] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/november2019

[21] https://www.twobirds.com/~/media/pdfs/expertise/employment/employment-incentive/long-term-incentive-plans-and-deferred-bonus-plans.pdf

[22] See Prem Sikka et al, *Controlling Executive Remuneration: Securing Fairer Distribution of Income*, November 2018, available online at http://visar.csustan.edu/aaba/LabourExecutiveRemunerationReview2018.pdf, at p. 8.

[23] TUC, *A Culture of Excess: The pay of FTSE-100 remuneration committee members*, 2015, available online at https://www.tuc.org.uk/sites/default/files/Acultureofexcesspay2.pdf, at p. 6.

[24] https://ftsewomenleaders.com/

London at 21.7%,[25] Labour has already committed to introducing equal pay audits and will consider initiatives to tackle ethnic bias, including exploring the practicalities of rolling out name-blind recruitment practices if necessary.

There needs to be a recognition that companies' success and profits are due to the collective endeavour of all workers, whether at the top or at the bottom. The logical consequence of this is that the wealth of the company should be shared more equitably. That's why Labour has committed to introduce an Excessive Pay Levy on companies and a 20:1 pay ratio between lowest and highest paid employees in the public sector.[26] We will also move towards a 20:1 pay ratio between lowest and highest paid employees in companies bidding for public sector contracts. A 20:1 ratio means someone earning the living wage, just over £16,000 a year, would permit an executive to be earning nearly £350,000.

Labour Proposals

We will ensure that there is a clear distinction between the base fixed salary (which may include contributions to pensions and benefits) and a variable element related to incentives and targets, which might form part of a long-term incentive plan (LTIP). **As part of redrafting the Companies Act, a Labour Government will introduce a transparency requirement for executive remuneration contracts** to ensure that there is clarity about what part of remuneration involves a base fixed salary, and what part might be variable.

All large companies will be required, as part of annual reporting, to disclose the ratio of total CEO remuneration to median employee pay and the steps being taken to reduce it. Directors will be required to explicitly state in their annual report that no employee has received pay less than the Real Living Wage – which will be a statutory requirement under a Labour Government. These transparency and probity measures will help to ensure that large companies have, in their ongoing consideration, inequality between pay within their business. As part of reviewing the Companies Act, we will investigate the mechanisms available to publish the name and number of employees (analysed by gender and ethnicity) earning more than £150,000 per annum in brackets of £10,000. This may be a valuable tool for improving pay transparency.

If a situation arises where executives are required to hold shares in the company they must be purchased with their own resources rather than provided by the company. The purchase, holding and disposal of such shareholdings must be disclosed. Frequently, share buyback programmes use corporate resources to increase short-term returns to shareholders, including the value of share options held by corporate executives. Such practices deplete resources for investment and are undesirable. **If share options are to be offered to executives for any reason, they must also be offered to all employees on the same terms in quantity and price**. All decisions about granting shares and share options should be the responsibility of the company board (or stakeholder board, in the case of two-tier boards), and must be published.

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[25] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/articles/ethnicitypaygapsingreatbritain/2018#introduction

[26] See Labour Party, *For the Many Not the Few*, 2017 election manifesto, online at https://labour.org.uk/wp-content/uploads/2017/10/labour-manifesto-2017.pdf. An Excessive Pay Levy is a graduated tax on companies offering remuneration of more than £300,000 (at a 2.5% rate), £500,000 (at a 5% rate), and £1 million (at a 7.5% rate).

The board (or supervisory/stakeholder board, where appropriate) should have full and final responsibility for crafting all executive remuneration contracts. It may have to be advised by a remuneration committee and if such a committee is created it must have representatives of employees and other stakeholders. The composition of such a committee and the mechanism for selection will have to be published. Its reports will have to be available to all stakeholders. Any remuneration advisers used by the company will have to report directly to the board or the remuneration committee. The consultants' reports and any other advice on executive remuneration obtained by the company to support the level of remuneration package will have to be filed at Companies House and published on the company's website.

We will ensure that **all executive remuneration packages in large companies are subject to an annual binding vote by stakeholders**, including shareholders, employees and consumers. Stakeholders must approve the remuneration principles or guidelines for future executive compensation packages in a binding vote on an annual basis. Key management personnel named in remuneration reports shall be excluded from casting any votes. The system will be one-person, one-vote.

Companies must also, as part of annual reporting, set out their policy for tackling the gender and ethnicity pay gap, outline the progress made since the last report and their renewed target to reduce it.

We will ensure that all available legal avenues (including if appropriate a criminal investigation) are pursued against those responsible for the collapse of Carillion. It will be the subject of a full public inquiry, whether as part of reforms to reverse outsourcing or the 12-month public inquiry into the finance industry or as a standalone public inquiry. As part of considering the circumstances of the Carillion collapse, consideration will be given as to whether there should be a cap on how much individuals appointed by special managers can charge for work undertaken following a company's collapse.

We will ensure, as part of a review and redrafting of the Companies Act, that companies are prevented from neglecting pension deficit recovery payments in order to deliver executive bonuses, dividends, and pay.

6. Audit Industry

The foxes are increasingly being put in charge of the henhouse when it comes to company audits. Currently, the audit sector is failing to meet the needs of markets, investors, employees, pension scheme members, and taxpayers. It has failed to raise concerns about of the poor state of finances, accounting and governance at Carillion, BHS, and elsewhere. The UK financial sector has also been involved in numerous accounting, auditing and governance failures. Despite this, the regulators have continued to rely upon auditors to alert them to potential problems.

Audits are important for transparency and are a vital means of determining corporate accountability. The 'Big Four' auditors – KPMG, Deloitte, PricewaterhouseCoopers ('PwC'), Ernst & Young ('EY') – dominate the FTSE-350 audits, though they are occasionally challenged byBinder Dijker Otte ('BDO') and Grant Thornton. This leaves the UK's biggest businesses with little choice as to which auditor to choose – as, in reality, not all major auditors will be competing for the same contract, further reducing competition, and in most cases a number of conflicts of interest preclude one or more of the auditors from tendering the contract.

A report by the House of Commons Library[27] highlights a range of serious challenges to the goal of delivering independent and robust audits, as well as problems arising from limited competition within the industry. The big audit firms are now too big to fail: if just one were to withdraw from the auditing sector it would drastically decrease the audit choice for FTSE 100 companies of auditing firms. Auditing firms are hindered by a variety of conflicts of interest: for example, they must win and retain engagements from companies in order to generate revenue, but simultaneously objectively scrutinize the company's reports. This conflict becomes most acute when the company's performance does not align with market expectations. It places auditors in a compromised position whereby they risk damaging the close working relationship required with the company management and potentially jeopardising future audit contracts.

The efficacy of joint audits has been debated in recent reports by the Competition and Markets Authority (CMA).[28] The Authority outlines the risks of two firms not coordinating their audit plan, working methods, approach to materiality, sampling thresholds, extent of tests and sharing of files. It notes that the junior partner in the joint audits can be bullied by the larger firm into giving an unwarranted audit opinion and thus erode its independence. The report highlights examples of where joint audits have been unsuccessful at preventing poor auditing.

Labour proposals

Labour will establish a new statutory body to conduct audits.[29] Its purpose will be to conduct real-time audits of banks, building societies, credit unions, insurers and major investment firms. The auditor will not be dependent on fees from client companies and as a result could become independent and robust. Through this new statutory body, the regulator will be able to enforce prudent financial reporting practices and change the culture and practices at financial enterprises. It will also receive an early warning of emerging issues. The statutory body will have responsibility for conducting real time audits of banks, buildings societies, credit unions, insurers and major investment firms. This new body will work closely with the financial sector regulators who shall have unhindered access to the files of the statutory auditor.

Under Labour, major firms will not be allowed to continue to act like a cartel, driving down standards, damaging the wider economy and our business community. The audit business of accounting firms **should be structurally separate** and auditors or their associates prevented from selling any non-auditing services, with the exception of delivering statutory returns, to clients. Relatedly, the audit industry needs to be restructured: financial auditors must act exclusively as auditors, as is the norm in almost all other sectors. The firms must be restructured and focus exclusively on audits and with no possibility of engaging in the sale of non-auditing services to anyone as the lure of consultancy fees has constantly undermined auditor independence and quality of audits. It will be a criminal offence for statutory auditors of large companies and any entities related to them to offer or perform non-auditing services for audit clients.

[27] https://researchbriefings.parliament.uk/ResearchBriefing/Summary/CBP-8385

[28] See https://www.gov.uk/government/news/cma-recommends-shake-up-of-uk-audit-market.

[29] See Prem Sikka et al, *Reforming the Audit Industry*, December 2018, available online at http://visar.csustan.edu/aaba/LabourPolicymaking-AuditingReformsDec2018.pdf

The Competition and Markets Authority's *Statutory Audit Services Market Study* recommended an operational split between audit and non-audit practices amongst the Big Four auditors. But the study rejected structural separation. It claimed that large audit firms are part of global networks, and that a structural separation would only work best if carried out internationally. It also mentioned "one-off costs associated with a structural split", and risks to choice.[30]

The arguments for an operational separation over a structural separation are not persuasive. An operational separation does not eliminate conflicts of interest. A structural separation does not prevent big firms from developing international networks. It simply requires that auditing needs to be the primary concern of audit firms.Of course, it is true that a structural separation will operate most effectively if achieved internationally. But the perfect should not be the enemy of the good.

Audit tenders should be publicly available and auditor files should available for stakeholder scrutiny, to enable stakeholders to see the basis of auditor selection.

Members of the audit team should not be allowed to join the staff of the audit client for five years after ceasing to be a member of the audit team.

Large companies must be required to change audit firms, partners and entire audit staff at least once every five years. This will be accompanied by a ten year cooling-off period: both the outgoing firm and audit personnel cannot return for another ten years.

Auditing firms will not be permitted to write their own accounting, auditing and financial reporting rules. These rules need to be made by Parliament and designated independent regulators.

Accounting trade associations must not be permitted to act as regulators and effectively write accounting rules for businesses controlled by their members.

We will regulate to ensure auditing firms provide socially useful information about their operations, including information about their offshore links, captive insurance companies, political links, audit failures, cooperation with regulators, regulatory action, lawsuits and profits from practices that would be deemed unfair. This will enable stakeholders to make informed judgments about the desirability of appointing certain firms as auditors.

The Competition and Markets Authority, or the relevant regulatory authority, will examine the auditing industry at five yearly intervals, until such time that its structure and practices change to secure a high degree of competition and choice to deliver value for money and high quality audits to protect stakeholders.

7. A New Regulatory Architecture

[30] Competition and Markets Authority, *Statutory audit services market study*, 18 April 2019, online at https://assets.publishing.service.gov.uk/media/5d03667d40f0b609ad3158c3/audit_final_report_02.pdf, at p. 189.[31] Prem Sikka et al, *Regulatory Architecture to Enhance Democracy and Business Accountability* (2019) at p. 7.

The number of regulators increased after the financial crash but they are often weak and unaccountable. Regulation is there to protect the public and promote broader systemic stability, but it is not currently delivering. In the area of finance, the Financial Services Authority was replaced by the Financial Conduct Authority and Prudential Regulation Authority in 2013. The FCA is "supposedly independent" but has been criticised for failing to bring cases against senior financiers.[31] Some other areas lack a regulator; other areas have multiple regulators resulting in duplication, waste, obfuscation and lack of focus. Regulation by professional bodies is plagued by by conflicts of interest. There have been widespread calls for reform and it is time these were heeded. A Labour government will move to enact a much-needed overhaul of our system of regulation to ensure that it serves the public interest.

There are major gaps: for example, no central enforcer of UK company law. Regulation of the accounting industry is patchy. The big four firms, which are closely aligned with financial institutions, dominate the audit industry. Financial reporting has shifted, from having as its main purpose the accountability of companies, to being an arcane art. Few standards exist on auditor accountability to the public. The Financial Reporting Council comprises individuals with close associations to big accountancy firms; its meetings are lacking in transparency and its committee dealing with discipline is made up of a narrow set of stakeholders. The UK Combined Code of Corporate Governance still lacks a statutory basis and generally requires companies to explain their approach, rather than harder-edged compliance. Insolvency is another field where there is regulatory weakness, with five regulatory bodies cutting across each other. The Takeover Panel is partly controlled by professional financial associations (such as the ABI, CBI, and UK Finance), which can appoint 12 panel members.

There are at least 41 financial sector regulators. Regulators are meant to address financial conduct, prudential regulation, money laundering, economic crime, and a range of other challenges. A separate set of dispute resolution bodies exists and the public is poorly represented on boards of regulators.

There are grave consequences stemming from this confusingly labyrinthine system of regulation. Fake companies have been formed at dubious addresses. Companies have used the word 'bank' in their name without any checks. The RBS Global Restructuring Group fiasco highlighted flaws across the regulatory architecture, including amongst insolvency practitioners, as did the collapse of Carillion in 2018. Scandals at HBOS and in relation to tax avoidance have raised similar questions about regulatory negligence. Parliamentary committees and the media are having to fill the gap left by the inadequacy of regulation. Critics have noted that the FRC is too close to industry. Attempts to combat money laundering are manifestly inadequate. There is a limited ability for the public to request information about regulatory bodies, as too many are outside the scope of freedom of information law. All in all, regulatory bodies appear to be failing to protect society.

Labour proposals

Labour will legislate to establish a Business Commission. We will set up the Companies Commission, Finance Commission, and Enforcement Commission, along with an associated ombudsman and supporting staff. A streamlined design for the Business Commission – with the right delineation of responsibilities for the Companies Commission, Finance Commission, and Enforcement Commission – can help to close the gaps in regulation and establish and more robust and independent regulatory system. Further work will need to be done to define the scope of the Companies, Finance, and

[31] Prem Sikka et al, *Regulatory Architecture to Enhance Democracy and Business Accountability* (2019) at p. 7.

Enforcement Commissions. The Business Commission should integrate the accounting, auditing, insolvency, and financial sector regulators. The Companies Commission will have responsibility for auditing, accounting, and insolvency. The Enforcement Commission could have a regional presence. All the commissions should have open meetings and publicly available minutes, agendas, correspondence, and working papers. An independent Ombudsman could adjudicate on disputes between regulators and stakeholders. The Business Commission can be funded by licence fees from regulated entities, but any revenue from fines must be redirected to the regulatory apparatus and/or used to compensate victims.

Labour will commit to select committees having oversight of the Business Commission. However, the Commission will be institutionally independent from government and Parliament. This will help to ensure that Parliament plays a role, for example in financial regulation. While there are risks to capture of legislators, there is also a risk of a democratic deficit growing when regulation is overly technocratic. The Business Commission will be independent, but can be responsive to directions from Parliament about particular regulatory priorities.

The Business Commission will be made up of commissioners and a Supervisory Board. Similarly, the three supporting commissions will have commissioners and supervisory boards attached to them. There is much merit in the supervisory board model, in order to ensure regulators remain connected to a wide range of stakeholders and accountable to the community.

All commissions will be subject to the Freedom of Information Act. They will make agendas and minutes of meetings publicly available. They will endeavour to involve the public, through working papers and reports, in an effort to democratise regulation. There is a need for greater transparency in regulators' activities, to increase public confidence and to allow scrutiny by NGOs and civil society.

A Labour Government will seek to end the corporate capture of regulatory institutions, and will actively work to shift regulatory culture. Some of this will be achieved through political and civil service leadership, in addition to legislation.

In government we will consult on what relationship the Enforcement Commission should have to prosecutors. We will also continue to consider the best relationship between Parliament and the Business Commission, and the relationship between the Ombudsman for these commissions and the courts. Finally, it will be worth inquiring further into whether there should be an appeal from Ombudsman decisions to the general courts, or whether the Ombudsman should be separate from the courts.

Our corporate model is badly broken and is not serving our economy, the environment or wider society. Good responsible businesses are vulnerable to being undercut by unscrupulous competitors. Labour in government will move to institute a radical overhaul of UK company law and practice in order to bring about real change in the corporate sector on the basis of a new social license to operate backed by regulation and enforcement mechanisms. The above changes, when enacted as a package, should bring greater democracy, justice, and accountability to the world of business – achieving a step change in corporate governance and regulation that will support efforts to tackle the climate emergency, improve long-run economic performance and realise greater equality across society.