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Response to the Green Paper on Corporate Governance Reform

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Introduction

Thank you for considering this submission. I am a Professor of Finance at LBS, formerly a tenured professor at Wharton, who specialises in corporate governance, executive compensation, and CSR. I have published on these topics in all the top finance journals, plus the *Harvard Business Review*, *Wall Street Journal*, *World Economic Forum*, and *CityAM*. I am Managing Editor of the *Review of Finance*, the #1 finance journal in Europe.

Unusually for an economist, I am focused on the role of business in society – not just for shareholders. I gave a TEDx talk on "The Social Responsibility of Business" with 70,000 views and was named a Rising Star in Corporate Governance for outstanding contributions by someone under 40. I serve on the Steering Group of The Purposeful Company with Andy Haldane (and others), which proposes policy reforms to encourage businesses to pursue long-term purpose rather than short-term profit. I testified orally in the Parliamentary inquiry into corporate governance, and serve on Royal London Asset Management's Responsible Investment Advisory Committee.

Approach

The Green Paper is extremely timely and I fully share the intent to ensure that business works for everyone, not just the privileged few. However, given the substantial risk of unintended consequences, it is essential to base any reform on evidence. The following thoughts are grounded in rigorous academic research, which uses large scale datasets and, in many cases, demonstrates causation rather than correlation. Often views on governance are shaped by a couple of high-profile examples, but they may not be representative, in particular since only the most egregious cases tend to be reported.

Certainly, evidence should not be used dogmatically – we should be guided by evidence, not blindly follow it. Moreover, it is important to be critical of the evidence. There is a huge range in quality of academic evidence, and most papers are wrong, or at best misleading. At the *Review of Finance*, I reject 97% of papers; lower-ranked journals have substantially laxer standards. It is almost always possible to find "evidence" that supports what one would like to show, often ignoring the quality of the journal in which it was published, or whether it has even been published. The peer review process at the very top academic journals is critical to ensure the integrity of evidence. Many papers remain unpublished after several years because they have constantly failed peer review due to major mistakes. Almost all papers I cite here are either published in the very top journals, or "revise-and-resubmits"[1] in them.

[1] In top academic journals, 90-95% of papers get rejected. Only 5-10% get a "revise-and-resubmit" decision, which means that the Editor is giving the authors a chance to address his and the peer reviewers' concerns. Upon a "revise-and-resubmit", the probability of acceptance rises from 5-10% to 65-70%.

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Executive Summary

1. Simple, Long-Term Pay; No Bonuses. Complex, opaque bonuses and LTIPs should be scrapped and replaced by long-horizon equity. This is simple and transparent – the CEO receives only cash and shares. Evidence shows that long-term CEO equity stakes cause not only higher profits, but also innovation and stewardship of employees, customers, suppliers, and society.[2] Employees should also be given equity. They contribute to the firm's success so it is only fair that they share in it too.

2. Focus on Pie-Enlarging, Not Pie-Splitting. There is substantial evidence that responsible stewardship of stakeholders improves long-term shareholder value. Reform should focus on pie-enlarging (improving long-term firm value to benefit both shareholders and stakeholders), not pie-splitting (increasing stakeholders' slice by reducing shareholders' or CEOs'). Board decisions should be taken exclusively by shareholder representatives (after stakeholder consultation). Shareholders are affected by the stewardship of all stakeholders and so have the incentive to take them into account, whereas (say) workers may not be directly affected by environmental stewardship.

3. CEOs *Are* Punished For Poor Performance. Just as there is a very simple measure of how much an investor loses from poor performance – the size of his stake – there is a very simple measure of how much a CEO loses – the size of her stake. These stakes are sizable and lead to severe losses: a 10% fall in the stock price of a FTSE 100 firm is equivalent to a pre-tax pay cut of £1.5 million. The numerous "studies" claiming no punishment are flawed because they ignore this stake and thus are nearly all unpublished. While there are many issues on which there is academic debate (e.g. differences in methodology, disentangling correlation from causation), there is no debate that this stake must be included by *any* top academic. The amount of equity held by a CEO can be unambiguously measured, and it *automatically* falls with the stock price, so causation is immediate.

4. Problems With Pay Ratios. Disclosing pay ratios may backfire for several reasons:

   a. It will decouple pay from long-term performance, non-financial measures of worker welfare (e.g. on-the-job training), and other stakeholders. Indeed, it is critical to distinguish between (i) the quantum of pay and (ii) its link to performance. Trust and fairness depend predominantly on the latter; the public typically does not begrudge high pay (in any profession) if it is seen as merited.

   b. CEOs and workers operate in completely different labour markets, so there is no reason why their pay should be linked. Similarly, CEOs should be held much more accountable for poor performance than workers. Workers should be treated well regardless of the level of CEO pay.

   c. Evidence in both the UK and US[3] shows that high pay ratios are linked to superior long-term performance.

[2] Flammer and Bansal (2017).
[3] See Mueller, Ouimet, and Simintzi (2017) for the UK and Faleye, Reis, and Venkateswaran (2013) for the US.

d. It may have several unintended consequences. CEOs may be less willing to hire low-paid workers, preferring to outsource or automate; compensate workers with cash rather than training and working conditions; and de-emphasize other dimensions of social responsibility.

e. It is not comparable, being lower in investment banks than supermarkets. Even within an industry, median pay depends on the proportion of outsourced and part-time workers, which companies a firm operates in, and the mix of capital and labour.

f. Pay ratio disclosure is costly to implement. The US Securities and Exchange Commission estimates a first-year implementation cost of $1.3b and ongoing annual costs exceeding $520m.

5. Lessons from the EU. The EU Shareholder Rights Directive initially proposed both (i) mandating pay ratio disclosure, and (ii) allowing stakeholders, especially employees, to express a view on the pay report. Both were scrapped after extensive consultation. This is notable since the EU is arguably less business-friendly than the UK, but was still concerned about the negative impact on business.

6. Advisory Say-on-Pay is Working. UK evidence is that advisory say-on-pay is working, and cross-country evidence is that it is more effective than binding say-on-pay. More frequent binding votes may force shareholders to focus excessively on the pay vote rather than other dimensions.

   a. Strengthen Shareholders, Not Shareholder Power. Rather than giving shareholders stronger powers, we should create stronger shareholders – blockholders (large shareholders). This will improve not only say-on-pay voting, but governance more generally.

7. Flexibility, Not Rules. A voluntary approach is superior to a legislative one:

   a. Don't Punish All For the Sins of the Few. Regulation is one-size-fits all when, as per p4 of the Green Paper, it is "a very small number of businesses" that is the problem. In solving these problems, we should not constrain the thousands of businesses who are behaving responsibly.

   b. Commitment, Not Compliance. It is likely to lead to true commitment, rather than minimum compliance. Given the evidence that stakeholder stewardship boosts long-run shareholder value, many companies are already voluntarily embedding purpose in the C-suite. Change takes time, but just as executives should not be short-termist, policy should not be short-termist. Legislation to try to accelerate change may interfere with the change that is already happening.

Detailed Comments

I will focus only on the questions in the Green Paper on which I have the greatest expertise. For each issue, I will first start with the evidence and conceptual arguments, before moving to the answers, because the former lays the groundwork for the latter. I will also answer the questions in a different order to the Green Paper, since responses to some questions feed into responses to earlier questions.

1. Question 6: How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased?

1.1 The Green Paper is absolutely right that pay should be better aligned to long-term performance. Complex, opaque bonuses and long-term incentive plans should be scrapped and replaced by long-horizon equity. The CEO should be paid only with cash, shares (and perhaps debt to deter excessive risk-taking, as shown by Edmans and Liu (2011)). This is simple and transparent. All three elements can be easily valued. We know how much the CEO is paid and under what circumstances.

1.2 I strongly support extending the vesting period of equity. This ties the CEO's pay to the long-term stock price. In the long-run, there is no trade-off between shareholders and stakeholders. The long-term stock price reflects stakeholder value as well as shareholder value (Edmans (2016a)).[4] Tying the CEO to the long-run stock price induces pie expansion that benefits both stakeholders and shareholders, and deters myopic actions to help shareholders at the expense of stakeholders.

1.2.i In the short-term, there is a trade-off. CEOs can cut wages to increase shareholder value at the expense of workers, but in the long-term this erodes shareholder value, as workers leave. Similarly, any short-term stock price manipulation comes to light in the long-term. For example, when inflated earnings are subsequently restated, the stock price falls by 9%.[5] The short-term stock price might depend on investor sentiment or bubbles, but these even out over the long-term – just as retirement advice is to buy stocks for the long-term since bubbles even out.

1.2.ii Even the long-term stock price may depend on factors outside the CEO's control, e.g. stock market upswings leading to "windfalls". However, if the CEO is given straight cash, she will likely invest most of it in the stock market (indeed, as the government encourages the public to do). It is much better if she invests it in her own firm, whose value is more under her control, than other firms. Stakeholder trust is improved if the executive is invested, quite literally, in her firm's success. Note that the CEO would also suffer losses from stock market downturns outside her control, sharing the losses alongside ordinary people who have invested for retirement.

1.3 Causal evidence suggests that longer pay horizons improve shareholder and stakeholder value.

1.3.i Edmans, Fang, and Lewellen (2017) show that, when equity vests, the CEO typically sells it (to diversify). To ensure that she can sell at a high price, the CEO cuts R&D and capex, and just meets analysts' earnings targets - i.e. cuts investment to focus on earnings.

1.3.ii Edmans et al. (2017) show that vesting equity causes CEOs to manipulate news releases to inflate the short-term stock price. CEOs then exploit this by cashing out within 5 days.

[4] See Edmans (2011, 2012) for employee satisfaction, Fornell et al. (2006) for customer satisfaction, Derwall et al. (2005) for environmental efficiency, and Eccles, Ioannou, and Serafeim (2014) for sustainability policies. Flammer (2015) shows that shareholder proposals to improve CSR also improve the stock price.

[5] Palmrose, Richardson, and Scholz (2004).

1.3.iii Flammer and Bansal (2017) show that long-term incentives improve profitability, innovation, and the stewardship of environment, customers, society and, in particular, employees.

1.3.iv Edmans (2011, 2012) finds that employee well-being improves long-run firm value by 2.3-3.8%/year (89% to 184% cumulative). However, the effects take 4-5 years to fully manifest in the stock price. Thus, a five-year horizon is important to induce executives to invest in workers.

1.4 The vesting horizon should extend beyond the executive's departure, or equivalently, shareholding requirements should be imposed post-departure (as in Unilever and Kingfisher).

1.4.i This deters the CEO from taking short-term actions to pump up the stock price, depart, and then cash out (Edmans et al. (2012)). For example, Angelo Mozilo, former Countrywide CEO, made $129m from stock sales after his departure but before the financial crisis. Jim Collins's book Good To Great contrasts "Level 4 leaders", where the firm is only successful under their tenure, with "Level 5 leaders", where the firm's success continues. Extending the vesting horizon beyond the CEO's tenure will encourage "Level 5" thinking and succession planning.

1.5 The optimal holding period is not one-size-fits-all. It should be longer in industries where investments have a long cycle, e.g. pharma. Thus, while guidelines (e.g. five years) may be helpful, they should not be mandatory. This consideration advocates (at most) "comply-or-explain" codes rather than laws.

1.6 Tying the CEO to the long-term stock price ensures that she is punished for poor performance. Paragraph 1.1 of the Green Paper states that "*there is a widespread perception that executive pay has become increasingly disconnected from … the underlying long-term performance of companies*". This perception is unambiguously incorrect. Almost all studies showing this result are unpublished, because they make a major error in measuring incentives. They study how pay (salary, bonus, and new equity grants) changes with performance. But the vast majority of incentives come from the CEO's *existing equity holdings*. These studies – and Figure 1 in the Green Paper – ignore these holdings. It is no surprise that they find that incentives are low, since they miss the vast majority of incentives.

1.6.i As an analogy, it is well-accepted that the size of an investor's stake measures how much he loses from poor firm performance. Similarly, a CEO's stake measures how much she loses.

1.6.ii I recognise that there are many issues on which there is academic debate and lack of consensus, e.g. due to ambiguity in methodology. On this point, however, there is no debate from *any* top academic – the incentive measure must include equity holdings. Indeed, the direct effect of equity holdings is so large that the indirect effect of performance on changes in salary, bonus, and new equity grants can be ignored. There are four academic "handbooks" on executive compensation, and *all four* make this point. (A "handbook" is the "how to" on a topic, similar to a textbook for practitioners, and contains the accepted methodology):

- Core, Guay, and Larcker (2003) write: "*we focus on the incentives to increase the stock price provided by the manager's ownership of equity … the vast majority of a typical CEO's incentives to increase stock price are driven by variation in the value of his stock and option portfolio, that is, not by flow compensation*".
- Frydman and Jenter (2010) write: "*We only consider changes in executive wealth that are driven by revaluations of stock and option holdings. This channel has swamped the incentives provided by annual changes in pay.*"
- Murphy (2013) writes: "*Virtually all of the sensitivity of pay to corporate performance from the typical CEO is attributable to the direct rather than indirect part of the CEO's contract*".
- Edmans and Gabaix (2016) write: "*The vast majority of incentives stem from changes in the value of previously granted stock and options, which swamp changes in cash pay*".

The size of a CEO's stake can be unambiguously measured, just like the size of an investor's stake. We do not even need to keep track of when the CEO accumulated her stake (just as we do not with an investor's stake). Indeed, the measure of incentives stemming from existing equity grants is so widely accepted that it has a simple name, "delta". One can use the term "delta" without explaining its calculation as everyone knows what it means and how it is calculated.[6] Similarly, any paper that omits existing equity is almost certainly rejected.

This view is also held by leading practitioners, not just academics. For example, PwC (2017) write: "*Analysing pay using only flow measures of pay is a bit like analysing investment returns using dividends but ignoring capital gains. In other words, it makes no sense*."

1.6.iii Similarly, I recognise that there are issues on which it is difficult to disentangle correlation from causation. Paragraph 1.4 of the Green Paper states that "*It is difficult to assert with confidence the link between executive pay and long-term company performance … evidence does suggest a correlation between the pay of CEOs and company performance, but it is harder to establish a strong causal link*". This is actually not one of these cases. Poor performance automatically causes a fall in the value of her equity holdings, so causation is immediate.

1.6.iv These stakes, and thus potential losses, are sizable. The average FTSE 100 CEO holds £8 million. A 10% price fall costs her £800,000, equivalent to a £1.5 million pre-tax pay cut.

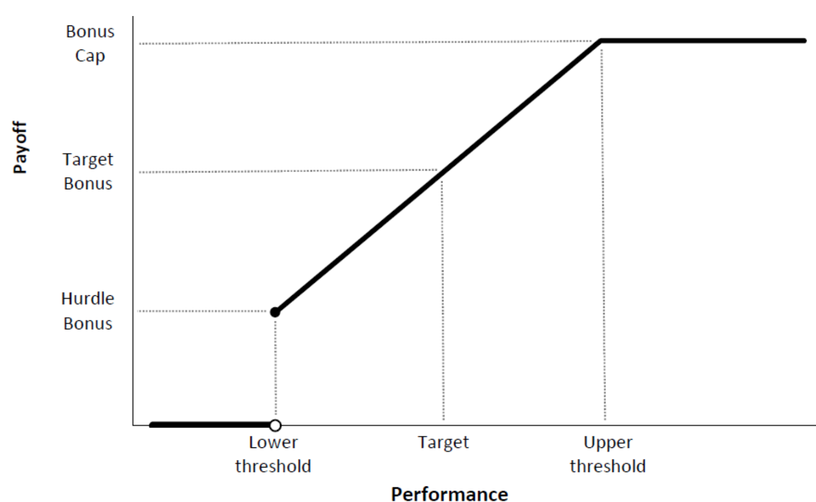
1.7 I have seen arguments that long-term payouts have little effect because CEOs discount future payouts. This argument confuses the *value attached* by the CEO to these payouts with their *incentive effect*. I agree that an undiversified CEO may value £1m of stock, with a 5-year vesting period, at less than £1m and that this may require a modest increase in pay. (Perhaps she would be willing to give up £900,000

[6] The only possible methodological choice is whether to scale the measure. However, regardless of the scaling, *all* measures contain only incentives from previously-granted equity.

of guaranteed salary to receive this £1m. Similar to the cost of a risk management system, this £100,000 difference is worth paying to ensure correct decisions. Average FTSE 100 firm size is £8bn, so if short-term incentives cause myopic actions that reduce firm value by 5%, this is worth £400m).

However, this does not mean the incentive effect falls. Assume that, by taking long-term actions, the CEO adds 5% to the 5-year equity return. The "baseline" value of the equity could be +20% or -20% due to factors outside her control – equity is indeed risky. But, long-term actions increase the future value of equity by 5%, regardless of market conditions. If there is a downturn, long-term actions boost the stock return from -20% to -15%. If there is an upturn, they boost it from +20% to +25%. Either way, long-horizon equity provides effort incentives – consistent with the evidence in paragraph 1.3.

1.8 In contrast, LTIPs and other bonuses encourage short-term behaviour and gaming. The following is the payoff schedule of a typical bonus plan (Edmans, Gabaix, and Jenter (2017)):



No bonus is paid until performance reaches a lower threshold, then it jumps to the "hurdle bonus". The bonus is capped at an upper threshold. In the middle there is a "target" performance level at which a "target" bonus is awarded. Note that the "target" performance level is often set to be reasonably achievable, leading to public distrust as bonuses are paid for reasonable, not exceptional, performance.

1.9 The key drawback of bonuses is that they are non-linear. Shareholders and society benefit continuously from better performance. A disastrous firm is worse than a bad firm, and a great firm is better than a good firm. However, the bonus is zero below the threshold, regardless of whether the firm is bad or disastrous. This in turn leads to undesirable actions:

1.9.i If the firm is just below the lower threshold, the executive has incentives to

- Gamble. If it succeeds and she beats the threshold, the bonus jumps. If it fails and performance becomes disastrous (rather than bad), the bonus remains zero, so there is no downside.
- Cut investment (e.g. R&D, employee training) to beat the threshold.

1.9.ii If the firm is well below the lower threshold, so that the executive has no hope of reaching it, she may shirk or engage in accounting manipulation (e.g. book revenues next January rather than this December).

1.9.iii If the firm is above the upper threshold, then the executive will become excessively risk-averse and "coast" rather than being innovative and trying to move performance from good to great.

1.10 In contrast, the value of stock rises continuously with performance. Thus, the executive is punished from disastrous rather than bad performance, and benefits from great rather than good performance.

1.10.i For example, Google was already a good firm. Yet, potentially due to its stock compensation, executives restructured it into Alphabet, invested in self-driving cars, and launched Pixel to take on the world's largest company (Apple) on its most popular product (the iPhone). These innovations are risky, but exactly what we want to encourage.

1.11 Bennett et al. (2016) find that performance-contingent bonuses lead to CEOs taking short-term actions to meet the goals (cutting R&D and increasing accruals), as well as performing just well enough to meet the goal but going no further to avoid ratcheting up future goals.

1.12 In addition to the perverse effects on executive behaviour, bonuses are opaque and complex. They are very difficult to value and it is unclear what the bonus depends on, leading to concerns about unfairness. Performance targets are sometimes lowered, and the RemCo has flexibility on which performance metrics to weight. For example, Bob Dudley's £14m pay package at BP in 2015, despite the stock price falling by over 15%, was fully consistent with the remuneration policy approved in 2014 by 96% of shareholders. This policy set targets on safety and operating performance, which BP met almost fully, in part since they were revised downwards after being initially set.

1.13 One supposed advantage of LTIPs is that they are worth zero for bad performance, where shares are still worth something, giving rise to concerns that executives are rewarded for failure. However, as Paragraph 1.64 of the Green Paper suggests, the amount of restricted stock could be substantially smaller than LTIPs, so that their ex-ante value is approximately the same.

1.14 Employees should also be given stock. Workers also contribute to the firm's success, so it is fair if they share in it. If CEOs are given LTIPs but employees are given stock, the LTIP might pay out even when the stock price falls, leading to concerns of "one rule for them, another rule for us". Giving both CEOs and workers stock mean that both gain when the stock price rises. Indeed, Hochberg and Lindsey (2010) show that broad-based equity plans improve operating performance. Note that a smaller % of workers' pay should be in stock than CEOs', so that they bear less risk of fluctuations in firm performance.

1.15 In sum, I strongly support extending the horizon of equity, including beyond the executive's departure. I also strongly support scrapping LTIPs and replacing them with long-horizon stock.

2. Question 5: Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality?

2.1 Rather than disclosing performance targets, such targets should be scrapped altogether because they encourage manipulation. Bonuses should instead be replaced with stock with long vesting periods (see Section 2).

2.1.i If targets are to be used, I do not support mandatory disclosure. Otherwise, companies may adopt financial targets, as they are less commercially sensitive than non-financial targets (e.g. successful execution of a given strategy). This in turn further exacerbates the problem of short-termism.

3. Question 4: Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons … be avoided? Would other measures be more effective?

3.1 Public trust, perceptions of fairness, and concerns about income inequality are very important issues. I share the intent behind ratio disclosure, but it may actually do far more harm than good.

3.2 The rigorous evidence is that high pay ratios are actually linked to superior long-term performance:

3.2.i Mueller, Ouimet, and Simintzi (2017) show that, in the UK, high pay ratios are associated with higher long-term profitability and firm value.

3.2.ii Faleye, Reis, and Venkateswaran (2013) study US data and summarize their results as follows:

- "We find that employees do not perceive higher pay ratios as an inequitable outcome.
- We do not find a negative relation between relative pay and employee productivity.
- We find that firm value and operating performance both increase with relative pay."

3.3 There are several potential reasons for this positive link

3.3.i High executive pay attracts and incentivises top talent, increasing the size of the pie for all.

3.3.ii High executive pay is due to strong long-term company performance, again increasing the pie.

3.3.iii High executive pay motivates employees to stay at the firm, work hard and get promoted. Indeed, promotion prospects mean that entry-level employees willingly work for low pay at the start. We should consider the trajectory of worker pay across a career, not just at a point in time.

3.4 The first two reasons highlight a major concern with pay ratios: they are about splitting a fixed pie. The assumption is that, by reducing the CEO's share of the pie, there is more for employees. Instead, the focus should be on incentivising CEOs to grow the pie for the benefit of all. Average CEO pay in the FTSE 100 is £5m. Average firm size in the FTSE 100 is £8b. Thus, paying to attract a CEO that adds just 1% more to firm value is 32 times (80/2.5) as effective than halving the CEO's pay.

3.4.i Indeed, while critics typically focus on errors of *commission* (bad actions such as allegedly excessive CEO pay), much more detrimental for society is errors of *omission* (failure to take good actions, such as innovation). Those losses can be substantial. For example, if Google had not developed such an efficient search engine or mapping device, or banks not developed an online system so quickly, ordinary people's lives would be much more difficult. (Indeed, the UK has led the way in Chip & PIN and contactless payments, being years ahead of the US, so avoiding these errors of omission can create substantial value).

3.4.ii This perspective also changes the view that only the elites have benefited in recent years. While average incomes have risen more slowly than top incomes (see paragraph 3.5 for reasons),

ordinary people have benefited in many non-financial ways, such as access to online banking, shopping, and customer reviews. These innovations have transformed their lives, often at zero cost. The focus should be on incentivizing executives not to coast but to increase the pie for all, rather than holding down their share to the detriment of the overall pie.

3.5 Arguments against high pay ratios are typically based on fairness and equality. Both notions are important, but both must be critically discussed.

3.5.i Fairness does not mean equality, but that the reward is commensurate with contribution. A fair grade on a test does not mean that everybody receives the same grade. In a corporate context, the evidence shows that CEOs have a substantially greater effect on firm value than employees.

- Excessive executive pay can indeed demoralize workers. However, "excessive" pay is pay unmerited by performance. Pay should depend upon performance, not average pay. An executive cannot excuse poor performance (and thus demand high pay) by claiming that workers are still well-paid. While fairness must indeed be improved, the best way of doing so is to tie pay to long-term value creation rather than short-term profit: see section 1. The public typically does not begrudge high pay (in any profession) if it is seen to be merited.
- Improvements in disclosure, e.g. on net pay and the link between wealth and performance (discussed later in paragraph 3.10.i), will help alleviate any demoralising effect.

3.5.ii Pay ratios aim to achieve equality by bringing the CEO down. Instead, equality is best achieved by incentivizing the CEO to bring everyone else up. By tying the CEO's pay to the long-run stock price, the CEO has incentives to treat workers well. Equality is not best solved by making everyone equally poor.

3.6 CEO and workers compete in very different markets, and so there is no reason for their pay to be linked – just a solo singer's pay bears no relation to a bassist's pay, or an athlete's to a physiotherapist's.

3.6.i Gabaix and Landier (2008), one of the most influential finance papers of the millennium, shows that the rise in pay ratios can be fully justified as efficient. To illustrate their argument with an analogy, Wayne Rooney is not more talented than Pele, but is paid far more because football is now a multi-billion dollar industry, due to a global marketplace. Even if Rooney is only slightly better than the next best striker, this can have a huge effect on Man United's profits.

3.6.ii Just as the football industry has got much bigger, so have firms. Firms also now compete in a global marketplace, and so it is worth paying top dollar for top talent. Average firm size in the FTSE 100 is £8b. Thus, even if a CEO contributes only 1% more to firm value than the next-best alternative, this contribution is worth £80m – much higher than the £5m average salary. As we can see from the significant number of non-UK CEOs in the FTSE 100 (and UK executives abroad), there is an international market for top executives and the UK must remain

internationally competitive. While salary is not the only determinant of an executive's decision whether to locate in the UK, we must also ensure that we do not reduce the non-monetary attractions of working in the UK (e.g. by promoting a distrustful anti-business environment).

3.6.iii The Gabaix-Landier hypothesis is not just an abstract theory, but can be tested. They show that the increase in pay between 1980 and 2003 (in the US) can be fully explained by the rise in firm size over that time. An update studying 2004-11 shows that subsequent changes were also linked to firm size – in 2007-9, firm size fell by 17%, and CEO pay by 28%.

3.6.iv Turning to the UK, paragraph 1.3 of the Green Paper quotes a concern that "*rising levels of executive pay over the last 15 years has not been in line with the performance of the FTSE over the same period*." The flatness of the FTSE is an often-quoted statistic, but misleading. The FTSE 100 is driven by the very largest firms since it is value-weighted. In contrast, the (equal-weighted) average market cap in the FTSE 100 has grown by 5.6% per year since 1996. In addition, the starting point of the "flat FTSE" statistic is often hand-picked to be 2000, when the stock market was at its peak. I choose 1996 because this is the first year in which final salary pensions are properly included in pay figures.

3.6.v Relatedly, one reason for the rise in reported pay levels is that the measure of CEO pay did not include pensions in the past. The changing ways of measuring pay are a critical reason for the rise in the reported pay ratio over time but ignored in most discussions of the rise.

3.6.vi What we see with executive pay is seen throughout society – executives are not anomalous. Small differences in performance lead to large differences in reward among athletes, musicians, and actors. Kaplan and Rauh (2010) show that high CEO pay has not been a major cause of the rise in inequality – it has risen much more slowly than pay in law, hedge funds, and PE/VC. CEOs are only a small subset of elites in general. While inequality is a critical social issue, it is much better addressed by broader measures, e.g. a high income tax for incomes above £1 million. It is not clear why CEOs should be targeted more than other high earners.

3.6.vii The same argument does not apply to employees. A CEO's actions are typically scalable (see Edmans, Gabaix, and Landier (2009) for evidence). For example, if the CEO implements a new production technology, or improves corporate culture, this can be rolled out firm-wide, and thus has a larger effect in a larger firm. 1% is £10m in a £1b firm, but £80m in a £8b firm. In contrast, most employees' actions are less scalable. An engineer who has the capacity to service 10 machines creates £50,000 of value regardless of whether the firm has 100 or 1,000 machines. In short, CEOs and employees compete in very different markets, one which scales with firm size and the other which scales less so. Thus, the pay ratio is a misleading number.

3.6.viii The above assumes that a CEO is important to firm value. One criticism is that she is only one of many employees. However, there is abundant evidence supporting the importance of CEOs.

The papers in paragraph 1.3 show large effects of CEO contracts. Moreover, increasing the CEO's equity stake (and not changing anything else) improves firm value by 4-10% per year.[7]

3.7 There are several other concerns with disclosing pay ratios (see also Murphy (2012)):

3.7.i A focus on the ratio may lead to a decoupling of pay from performance. A CEO might be able to justify high pay, despite poor performance, if workers are overpaid.

- It is critically important to separate two issues: the quantum of pay, and its relationship with performance. As Jensen and Murphy (1990) wrote in a famous *Harvard Business Review* piece, entitled "CEO Incentives – It's Not How Much You Pay, But How", "*The critics have it wrong. There are serious problems with CEO compensation, but "excessive" pay is not the biggest issue. The relentless focus on* how much *CEOs are paid diverts public attention from the real problem* – how *CEOs are paid.*" Fair pay is critically important to win the public's trust, but fairness is pay that is not linked to performance, rather than being high *per se*. The focus should be on linking pay to performance (see Section 1), rather than attempting to address the quantum in isolation via ratio disclosure.

3.7.ii The level of CEO pay has a very small effect on firm value (0.06%). Far more important is the horizon of pay (see paragraph 1.3). Boards, investors, and society could focus excessively on this ratio, while ignoring the other (more important) dimensions.

- Indeed, shareholders typically do not see pay as excessive. The common argument is that high pay results from dispersed shareholders. Private equity shareholders are engaged and reform many things in a company, even firing the CEO. However, they rarely cut pay. Instead, they tie pay more closely to performance. Since this change improves performance, the level of pay actually increases (Cronqvist and Fahlenbrach (2013)). Thus, engaged shareholders do not reform the pay ratio but other, more important dimensions.

3.7.iii Where the level of CEO pay is an issue, it is a symptom of a more general corporate governance problem (e.g. of dispersed shareholders): see paragraphs 4.7-4.9. Focusing on the pay ratio may allow a firm to put a sticking-plaster over the more general problem by fixing the ratio.

3.7.iv The ratio will automatically vary across industries and so is not comparable. For example, it is lower in Goldman Sachs than John Lewis, but because mid-level bankers are well-paid, rather than because executives are not. Even within-industry comparisons are misleading since median pay will depend on the proportion of outsourced and part-time workers (likely excluded from the ratio), which countries a firm operates in and local wage costs, and the capital-labour mix.

3.8 More serious that being simply uninformative, pay ratios may drive unintended behaviour.

[7] Von Lilienfeld-Toal and Ruenzi (2014).

3.8.i CEOs below the median may increase the ratio to the median.

3.8.ii CEOs may be less willing to hire low-paid workers, instead to outsource or automate.

3.8.iii CEOs may compensate their workers with cash salary, rather than on-the-job training, superior working conditions etc. since only the former affects the pay ratio.

- I am not assuming that pay ratios will be used blindly and all other measures will be ignored. Qualitative dimensions could be separately disclosed, but quantitative dimensions will always attract more attention – just as A-level league tables substantially impact school choice, even though schools can disclose extra-curricular activities. Other quantitative dimensions of CEO pay (e.g. horizons) could also be disclosed. However, the pay ratio will likely get far more focus since it is emotive. Indeed, the current discussion of ratios typically excludes reference to non-financial worker pay, other stakeholders, or long-term value.
- A substantial literature (e.g. Maslow (1943), Herzberg (1956)) shows that, after their basic physical needs are met, employees are primarily motivated by qualitative dimensions such as opportunities for advancement, and meaningful work. Thus, a focus on pay ratios will encourage CEOs to pay workers in a form that they value less.

3.8.iv CEOs may focus exclusively on increasing worker salary, rather than other dimensions of social responsibility (such as customers, suppliers, and the environment).

3.8.v If the CEO has underperformed (and is paid less), this may be a pretext to reduce or not increase worker pay, to keep the ratio roughly constant. But, the CEO should be held much more accountable for poor performance than workers. Workers should be treated well regardless of the level of CEO pay. For example, former Burberry CEO Christopher Bailey's pay fell by 75% due to poor performance. Worker pay did not fall to maintain a ratio in even the same ballpark, nor should it have done. Ratio disclosure may make underperforming CEOs look good.

3.9 Ratio disclosure is costly to implement. The US Securities and Exchange Commission estimated a first-year cost of $1.3bn and ongoing annual costs exceeding $520m. There is often no centralised payroll system; in a global firm, employees are hired and paid locally, and the employment regulations are local. Transmitting this information to a UK HQ is expensive, particular given the recent EU Data Protection Directive that tightens rules on data transfers outside the EU.

3.10 However, disclosure can be improved along several other dimensions. All cost little to implement:

3.10.i Firms should disclose not only the executive's pay over the last year(s), but also the change in her wealth. As per paragraph 1.6, disclosing this change in wealth may substantially increase the public's perception of fairness. For example, contrary to the belief that Bear Stearns CEO Jimmy Cayne got off scot-free from his firm's collapse, his wealth fell by $950m.

3.10.ii Firms should disclose not only the percentage change in the firm's stock price over the last year(s), but the *pound sterling* change in firm value, perhaps benchmarked to a peer group. For example, if the stock price rose by 5% in an £8b firm, this is a rise of £400m. Since CEO pay is a *pound sterling* number, this allows for an apples-to-apples comparison.

- Of course, the £400m increase cannot be entirely attributed to the CEO; it may stem from other employees. However, with this number, the public can back out what the CEO's contribution must be for pay to be fair. If the CEO's pay is £5m, then if it is plausible that she is responsible for 1.25% of the value increase, then her pay is fair.
- Such a measure also helps balance out the cost of the CEO with her potential value creation, i.e. highlights pie-enlarging rather than just pie-splitting.

3.10.iii Firms should disclose *hypothetical net* executive pay as well as gross. This will improve perceptions of fairness by taking into account something that the government is already using to reduce inequality – income tax.

- A witness submission to the Corporate Governance Inquiry wrote that "*chief executives took home £4.1m*" in 2010. In fact, after taxes, they likely "took home" around £2-2.5m.
- We will not know the exact net pay, since this will depend on the executive's tax status. However, firms can disclose a hypothetical net pay based on income tax rates. While not perfect, this is a much closer measure of how much the executive actually takes home.

3.10.iv Firms should disclose the vesting schedule of equity. A CEO with £100k of equity vesting in 1 year and £1m in 5 years will likely have a longer horizon than one with £1m vesting in 5 years and £100k in 1 year. This leads to transparency of how much the CEO is paid and when.

3.10.v Firms should disclose their executive contracts. At present, these contracts are available upon request at an AGM, so they are not considered confidential. Making them available online would significantly increase transparency, in particular on performance criteria and horizons. Relatedly, the end date of contracts should be disclosed in annual reports, given evidence that impending contract termination has a causal effect on behaviour. As the termination date approaches, the quality of innovation and the resources allocated to exploratory R&D fall (Gonzalez-Uribe and Groen-Xu (2016)) and risk-taking falls (Cziraki and Groen-Xu (2016)), potentially because CEOs act excessively conservatively to maximize the chances of renewal.

3.11 In sum, I strongly do not support pay ratio disclosure, and do not believe that any modification will avoid the unintended consequences of such disclosure. However, I do support the disclosure of (i) The change in the executive's wealth; (ii) The (peer-adjusted) pound sterling change in firm value; (iii) The hypothetical net pay to the executive; (iv) The horizon of her entire equity portfolio; (v) The full executive contract, and highlighting the end date of the contract.

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

4.1 Shareholders already have strong powers on pay. Say-on-pay votes give them more voice on pay than almost any other corporate decision (investment policy, CSR, geographical expansion).

4.2 The evidence is that the UK's current advisory regime is working. It has led to (Ferri and Maber (2013)):

4.2.i Higher value for firms with excessive CEO pay, particularly if coupled with poor performance

4.2.ii The elimination of notice periods longer than 1 year (which made it costly to fire executives)

4.2.iii The removal of "retesting provisions" (which lowered targets after they were initially set).

4.3 We can also learn from the 11 countries globally that have implemented say-on-pay. Correa and Lel (2016) find that it reduces pay levels by 7% and increases firm value by 2.4%. Moreover, advisory say-on-pay is more effective than binding say-on-pay, potentially because investors are reticent to vote "no" if a "no" vote is binding and thus likely to cause disruption, or executives require higher pay to compensate for the risk of a voided contract (as any stakeholder would do).

4.4 The evidence does not suggest that advisory votes are ignored and shareholders need more "teeth"

4.4.i In the UK, a company that receives less than 80% shareholder support increases its support the next year by an average of 17% (source: PwC). Thus, firms do respond to shareholder concerns.

4.4.ii Ferri and Maber (2013) find that a say-on-pay dissent vote of 20% (well below a majority vote) results in boards implementing 75-80% of shareholder requests on pay.

4.4.iii As the Green Paper notes, the average support is 90-95% and only six companies have lost a vote. Thus, it is not clear that there is a problem that shareholders need more power to fix.

4.5 Thus, when shareholders vote, their votes already have substantial power. Instead, the focus should be to encourage voting in the correct way. Two dimensions can be improved:

4.5.i As the Green Paper notes, 28% of votes in FTSE 100 companies are not cast.

- Note that increasing turnout alone should not be the focus. If these non-voters are uninformed, the quality of decision-making would not be improved by them voting. Instead, we should ensure that these votes go to informed voters.

4.5.ii Even the 72% of votes that are cast may be used in an uninformed manner, for example if the shareholder uses a "rule-of-thumb".

4.6 Out of the options presented:

4.6.i I oppose Option (i) to introduce annual binding votes. The evidence that advisory say-on-pay is working, and that it works better than binding say-on-pay.

4.6.ii I support Option (ii), to "introduce stronger incentives for a company losing its annual advisory vote". It is correctly targeted at the few firms that lose their advisory vote.

- The Purposeful Company's Interim Executive Remuneration Report similarly advocates an escalation mechanism after losing advisory votes.[8]

4.6.iii I strongly oppose Option (iii), to set an upper threshold on total annual pay. This is dangerous as it can lead to executives "coasting" when they approach the threshold, and settle for good rather than great performance (see paragraph 1.7).

- It is also not clear why an upper threshold is needed. If justified by performance (enlarging the pie), it is not at the expense of anyone. The rhetoric of pie-splitting induces mediocrity.
- Paragraph 1.25 of the Green Paper suggests solving this issue by setting an upper threshold on the number rather than value of shares. Even simpler would be to pay in long-term shares only, rather than LTIPs (see paragraph 1.10), which would avoid the need for any threshold.

4.6.iv I support part of Option (iv). I do not think that the existing binding vote should be more frequent for all firms. Too frequent votes could divert investor attention excessively to the pay vote rather than monitoring a firm's innovation and CSR. Indeed, many investors have said that the current focus on pay already distracts them from other forms of engagement. They appoint directors to determine compensation, and many of them issue remuneration principles that already provide directors guidance[9]; they would like directors to do this job rather than passing the decision back to shareholders. It is not clear why investors should have a special vote on pay rather than other decisions delegated to directors, e.g. monitoring of innovation and CSR. However, for some firms, more frequent votes may be desirable. This should be left to shareholders, so that they can determine the optimal frequency for their particular firm.

- In the US, there is a "frequency vote" at least once every six years to determine whether the say-on-pay vote will occur every 1, 2, or 3 years. (Say-on-pay is advisory in the US).

4.6.v I support part of Option (v): greater RemCo involvement with shareholders. This is desirable, because shareholders ultimately bear all the consequences of executive pay, including any effect on stakeholder morale or executive treatment of stakeholders.

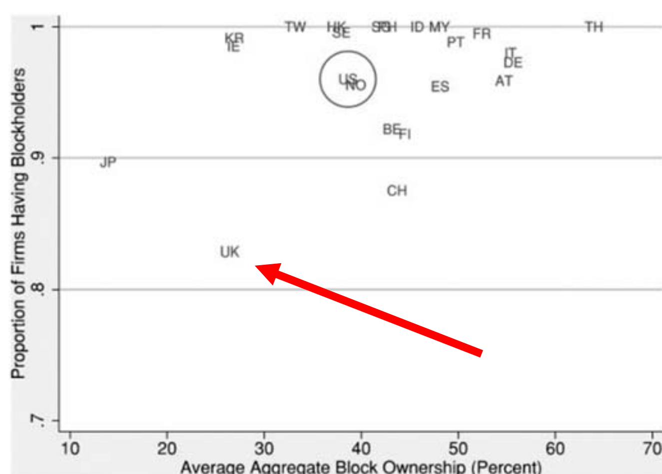
- I do not support engagement with employees on executive pay. I strongly support employee engagement for issues in which they have expertise (see paragraph 1.3.iv), and on their own pay. However, executive pay is an extremely complex decision – e.g. the discussion of

[8] If a company loses the advisory vote in any year or receives 25% or more "no" votes two years in a row, it must bring forward its remuneration policy to the next AGM as a Special Resolution requiring 75% to pass.
[9] See, for example, https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2016/11/Hermes-Corporate-Remuneration-Principles-141116.pdf

performance-based versus time-based vesting for equity. Even compensation committees and consultants cannot agree. Employees may focus more on more observable criteria, such as pay ratios, rather than more important dimensions such as horizon. Employees leave a company's R&D policy to scientists; incentive design requires similar expertise.

- Employee support may be heavily influenced by management's treatment of employees, rather than other stakeholders. While employees are critical, so are other stakeholders. Since shareholders are ultimately affected by the stewardship of all stakeholders, they have the incentive to evaluate management performance on all dimensions. Pay may become a political process where executives take short-term actions to win worker support, e.g. boosting short-term worker pay at the expense of long-run training, or other stakeholders.

4.7 A sixth, broader and more far-reaching option should be considered. Instead of giving shareholders stronger power, the focus should be on creating stronger shareholders: blockholders (large shareholders). Large stakes give a shareholder "skin in the game" to engage in extensive research on the correct way to vote. The following chart from Holderness (2009) shows that the UK is a global outlier in having few blockholders (defined here as a 5% shareholder):



4.8 Moreover, blockholders can improve corporate governance generally, over and above "say-on-pay" voting. Blockholders can promote long-term value creation in two ways:

4.8.i Engagement / Voice. A blockholder's large stakes give him both the *incentives* to engage with a firm (since he has skin-in-the-game) and the *power* to do so (due to voting rights). Engagement can involve not only disciplining management (e.g. curbing excessive pay or empire building), but also advising management (e.g. proposing new strategic directions, revamping culture, and acting as a sounding board). There is significant evidence on the benefits of engagement for shareholder and stakeholder value.[10]

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[10] Becht, Franks, Mayer, and Rossi (2009), Carleton, Nelson, and Weisbach (1998), Dimson, Karakas, and Li (2015), Brav, Jiang, Partnoy, and Thomas (2008), Brav, Jiang, and Kim (2015), Brav, Jiang, Ma, and Tian (2016).

4.8.ii Monitoring / Exit. A fragmented shareholder has too little "skin-in-the game" to analyse a company's intangible assets (such as culture). He will thus focus on freely-available short-term earnings – "the market sells first and asks questions later." In contrast, blockholders' large stakes give them the incentives to ask questions first and analyse long-term value (Edmans (2009)). If a firm has delivered low earnings due to investment, blockholders will not sell (and may buy more). Informed blockholders insulate managers from the need to cater to short-term pressures, and free them to focus on long-term purpose. Warren Buffett is an example.

Blockholders also discipline managers against pursuing the short-term. With fragmented shareholders, a manager may inflate the short-term stock price by cutting investment. An informed blockholder will notice such myopic behaviour and sell her stake. The threat of such disciplinary "exit" deters a firm from acting myopically to begin with.

Key to exit is that the blockholder displays *conditional*, not unconditional loyalty. A blockholder who remains with the firm, even if it acts myopically (such as VW's shareholders), will not exert governance. Indeed, Buffett sells if the firm has not built its brand after several years. Causal evidence shows that stock liquidity improves firm value since it enhances blockholder discipline.[11] Contrary to misperception, selling in the short-term does not mean taking a short-term perspective. What matters is not whether an investor *trades* in the short- or long-term, but whether she trades on short-term or long-term *information*. Blockholders, due to their large stakes, have incentives to gather long-term information. Uber's customers recently deleted their accounts to discipline management[12]; similarly, shareholders who sell their shares in a non-purposeful company are exerting discipline rather than being short-termist. We should promote *large* shareholders with long-term perspectives, not *long-term* shareholders who entrench management by remaining with the firm regardless of performance.

4.9 Potential ways to encourage blockholding are as follows. Note that, before considering any such policies, it is critical to ensure that their adoption does not disadvantage minority shareholders (in particular retail shareholders). The discussion of the merits of blockholders does not all imply that retail shareholders have no value, merely that skin-in-the-game gives more incentives and clout:

4.9.i Disclosure Relaxation. At present, investors have to disclose when they have acquired a 3% stake. This makes it costly for an investor to build (say) a 5% stake. After he has acquired 3%, he must disclose her stake. This pushes up the stock price and makes it more expensive for him to buy the remaining 2%. As a result, shareholdings typically cluster at 2.9%. 46% of FTSE 100 companies have at least one investor with a 2.9% stake.

[11] Fang, Noe, and Tice (2009), Bharath, Jayaraman, and Nagar (2013), Edmans, Fang, and Zur (2013).
[12] I am not taking a stand as to whether Uber's actions merited such discipline; merely emphasising that customers had the disciplinary device of "exit" available to them and that customer discipline is typically seen as desirable.

- The UK's disclosure requirements are abnormally stringent compared to the US and EU, where the lowest disclosure threshold is 5%.
- In the UK, directors are required to call a general meeting only if requested by the holders of 5% of shares. This engagement threshold is inconsistent with the 3% disclosure threshold and means that, 3%, in some firms, no single shareholder has the power to call for meetings.
- The US introduced a more relaxed disclosure requirement (Schedule 13G) for investors that do not seek to take control, and so there is less concern with minority shareholder expropriation. Yet, such blockholders can still monitor, and so should be encouraged. The UK should consider a relaxed disclosure requirement for such blockholders. Edmans, Fang, and Zur (2013) show that 13G blockholders significantly improve operating performance.

4.9.ii Structured Access. Investors have substantial concerns about receiving intangible information in company meetings, even though such information may aid engagement and monitoring. Clarifying what information they can and cannot receive without violating insider trading laws would improve engagement and monitoring for the benefit of minority shareholders (and society) also. This must be done in a way that does not disadvantage minority shareholders.

4.9.iii Collective Engagement. Active engagement often involves collaboration between shareholders. Many institutional investors are wary about collaborating as it may (unintentionally) lead to information sharing and thus being classified as an insider. The Investor Forum has significantly facilitated collaboration for intensive and wide-ranging engagements, but there is no similar framework for routine or specific engagements. It would be useful to both clarify and, if necessary, weaken any restriction on collaboration.

- An example of a weakening of restrictions is the SEC's relaxation of proxy rules in 1992[13], allowing shareholders to communicate freely. This led to institutional ownership improving innovation (Aghion, Van Reenen, and Zingales (2013)).

4.9.iv Voting With Borrowed Stock. Some commentators have expressed concerns that the stock lending market allows arbitrageurs to borrow votes and sway decisions (e.g. M&A outcomes), even if they have a small actual stake in the firm. However, Christoffersen et al. (2007) show that stock lending can lead to votes going to informed investors, and may potentially address the "low turnout" issue. One potential way to prohibit "bad" stock lending but not "good" stock lending is to allow borrowed stock to be voted only if it is borrowed by blockholders, who have skin-in-the-game and are likely to be informed.

[13] This relaxation exempted shareholder communications such as public statements of their voting intentions and/or voting rationale (including public speeches, press releases, newspaper advertisements, and internet communications) from the definition of a proxy solicitation

5. Question 7: How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened?

5.1 I strongly support stakeholder engagement but not board representation. For ease of exposition I will refer to worker representation, but the same arguments apply to other stakeholders.

5.1.i Gorton and Schmid (2004) find that German firms, where one-half of the supervisory board contains workers, trade at a 31% valuation discount to those with one-third representation.

5.1.ii Faleye, Mehrotra, and Morck (2006) study US firms where employees own a large stake and are thus involved in governance. Such firms "*invest less in long-term assets, take fewer risks, grow more slowly, create fewer new jobs, and exhibit lower labour and total factor productivity*." The finding of *both* lower productivity *and* fewer new jobs is consistent with (the opposite of) pie-enlarging. If firms are unproductive, they are unable to create new jobs.

5.1.iii Masulis, Wang, and Xie (2017) also study US firms where employees own a large stake, and examine the consequences for M&A. Their voice *"entrench[es] incumbent managers only when employees are well treated. When employees hold larger equity positions, acquirers make more unprofitable acquisitions, but are less likely to receive disciplinary takeover bids … when employees hold large voting blocks, potential worker-management alliances can exacerbate manager-shareholder conflicts and facilitate managerial extraction of private benefits."*

5.1.iv I have seen "evidence" that employee representatives on boards are perceived favourably by other board members. Almost all of the papers cited are unpublished. Moreover, other board members' perceptions are less relevant than productivity, growth, and job creation. Making other board members happy is not sufficient if it does not feed through into these outcomes.

5.2 In addition to evidence on worker representation/control, there is evidence that measures to protect workers make them worse off, by leading to the protection of existing jobs rather than the creation of new ones, the substitution of capital for labour, or stifling business growth and thus job creation.

5.2.i Agarwal et al. (2016) study the largest public workfare programme in the world and show that it reduced permanent employment by 10%. Firms respond to the restrictions by mechanization.

5.2.ii In an extremely highly-cited paper, Botero et al. (2004) study employment, collective relations, and social security laws in 85 countries and find that heavier regulation of labour is associated with lower labour force participation and higher unemployment, especially of the young.

5.3 Directors' fiduciary duties under Section 172 of the Companies Act are to have regard to workers. While "have regard to" is accused of being weak, since shareholders still have primacy, paragraph 1.3.iv shows that treating workers fairly improves long-run stock returns. Thus, even if directors hypothetically cared only about shareholders, it would still be in their interest to take workers into account.

5.3.i Indeed, companies are *already* voluntarily improving employee well-being. Starbucks, Wal-Mart, and JP Morgan have all recently increased worker pay, without legislation. Companies pay to partner with the likes of Blueprint for Better Business, Tomorrow's Company, and Big Innovation Centre, to implement purpose. According to a senior executive, "Social purpose is deeply in the C-suite. Everyone – but everyone – is seriously thinking of purpose." There is far more to be done, but we are moving in the right direction.

5.3.ii In addition to the above recent examples, Marks & Spencer has prioritized employee well-being since the 1930s; Unilever has run the Lamplighter programme since 2001 to promote worker (mental and physical) health, nutrition, and well-being, and had various prior initiatives.

5.4 It is difficult for a worker representative to "represent" all workers. A worker representative cannot be representative. Workers comprise different pay grades and locations; many decisions (e.g. automation) may benefit one group (e.g. IT workers) at the expense of others (e.g. manual workers). In contrast, shareholders are generally aligned as all benefit from improved long-run value.

5.5 Worker representation is not a panacea. The worker representative is one of many board members. If the firm has a culture of treating workers poorly, it will ignore the worker representative, or many decisions will take place outside the boardroom in "backroom" discussions. Other firms have a culture of treating workers well despite no worker representative. Thus, firms should focus on culture change throughout the organisation, rather than the superficial solution of putting a worker on the board.

5.6 One claimed advantage of worker representation is that workers could see inside a boardroom, and that this transparency would reduce the perception of business as untrustworthy. However, there are much more effective methods of increasing transparency in ways visible to all workers (and indeed all stakeholders), not just to the worker representative. For example, many companies are reporting on many measures of stakeholder performance in their annual report.[14] The Investor Forum is encouraging companies to hold Stewardship & Strategy Forums, the minutes of which could be made public.[15]

5.7 Under shareholder governance, there is a clear criterion to determine payments to stakeholders – market prices. Since stakeholder governance fails to define a clear objective, it provides no guidance how to make trade-offs among stakeholders, and so decision-making becomes a political process. Denis (2016) argues, "*If management is to ignore market values ..., by what alternative means should they determine how much value to take away from one set of stakeholders (the shareholders) and give to another set of stakeholders (the employees)? … There will be at least as many different opinions about this as there are types of interested parties. Whose opinion will prevail?*" Firms consult customers (through market research), but do not put them on the board; the same approach should be taken for all stakeholders.

[14] See, for example, Marks & Spencer's Plan A report.

[15] See http://media.wix.com/ugd/1cf1e4_4ccfaa9726d749f8bf7acd8f67f11595.pdf for a template agenda, which includes items on culture, stakeholder management, and ESG management.

5.8 Erroneous arguments for worker representation are as follows:

5.8.i Workers are aligned with the firm's long-term interests. But workers can immediately leave, whereas large shareholders cannot do so without lowering the stock price.

5.8.ii Workers will consider other stakeholders. As per paragraph 1.2, shareholders are the bottom-line claimant, and so harmed by poor treatment of workers, suppliers, customers, or the environment. Workers are not the "bottom-line" claimants and are not always affected by the stewardship of other stakeholders. For example, workers may oppose the closure of a polluting factory, or oppose the Night Tube even if customers support it.

5.8.iii Shareholders are diversified but workers are not, and thus workers care more about long-term value. This argument is conceptually incorrect, and confuses the return of a stock with its risk. Improving long-run value raises the long-run return of a stock. All shareholders, regardless of whether they are risk-averse or risk-neutral, benefit from an increase in long-run value. Workers' risk aversion means they may prioritise risk reduction over value creation. Long-run investment – including the creation of new jobs – involves significant risk. Shareholders will make these investments if they increase long-run return, but workers will be more concerned about preserving their existing jobs. This may explain the findings in paragraph 5.1.ii.

5.9 We must be very careful not to significantly reduce shareholder rights, as this may make it even less attractive to equity-finance businesses, and further exacerbate the bias towards debt financing.

5.10 Out of the options presented:

5.10.i I support Option (i) to create stakeholder advisory panels on a comply-or-explain basis. Shareholders and stakeholders should work in partnership to enlarge the pie for all. However, these panels may not be simple to design, since in the typical highly international FTSE 100 firm, the vast majority of employees are overseas. This calls for allowing for flexible approaches. For example, webinars may be preferred to physical panels in some firms.

5.10.ii I oppose Option (ii) to designate particular directors to represent specific stakeholders. This could absolve other directors of the responsibility to consider these stakeholders and lead to a divisive pie-splitting mentality where (say) the customer and worker advocates conflict.

5.10.iii I strongly oppose Option (iii) to appoint individual stakeholder representatives to company boards for all the reasons discussed in this section. Moreover, mandating stakeholder representation sends the wrong message. It suggests that "consulting stakeholders is bad for firm value, so we must pass a law to achieve it". Instead, we should emphasise that stakeholders and executives are in partnership - it is in a firm's interest to consult stakeholders.

5.10.iv I support Option (iv) to strengthen reporting requirements related to stakeholder engagement. This will lead to greater transparency on how firms are taking into account stakeholders.

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

6.1 Please see my responses in paragraphs 4.7-4.9. In particular, creating large shareholders and allowing only them to borrow stock will ensure that investors have the incentive to vote in an informed manner, and that votes are not lent to uninformed shareholders. What matters is not the percentage turnout in votes, but the quality of voting decisions.

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

7.1 I support part of Option (i): requiring the RemCo to consult shareholders. I strongly oppose requiring it to consult employees, for the reasons given in paragraph 4.6.v.

7.2 I support Option (ii) on a comply-or-explain basis. Requiring the RemCo chair to have experience is sensible. However, there may be exceptional situations where this restriction would be detrimental, for example if the current RemCo chair has suddenly departed and none of the existing board has 12 months' experience. In such a case, it may be preferable to appoint an existing director than an outsider with experience but not of that particular firm. Comply-or-explain would allow for this flexibility.

8. Question 9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change?

8.1 I strongly support a voluntary approach, since it is likely to lead to commitment rather than compliance.

8.1.i A company that does not care about stakeholders will do the minimum possible to comply with the law; a company that wishes to pay its executives as much as possible will find a way to circumvent the regulations. Indeed, 80 years of history in the US has shown this (Murphy (2012), Edmans (2016b)).

8.1.ii The evidence that stakeholder stewardship improves long-run shareholder value should be widely publicised. This will lead to companies voluntarily taking stakeholders into account.

- This approach is similar to the government's health policy. Rather than fining individuals who do not eat five portions of fruit and vegetables a day, the government sets guidelines and publicises the substantial evidence that healthy eating and exercise are good for your health. This leads many individuals to voluntarily go above and beyond these guidelines.

Re-Statement of Approach

This section aims to summarize the overall approach that underpins my responses to each of the questions in the Green Paper. This approach can be applied to other questions that I have not answered.

1. Identify and frame the problem with great clarity. Ensure that diagnosis precedes treatment.
2. Base the diagnosis on truly rigorous evidence. Practitioner evidence and experience are very important, but should be supplemented by academic evidence, which is large-scale and aims to disentangle correlation from causation. Given the huge variation in quality of academic evidence, any evidence used should be of the highest quality, and either published or revise-and-resubmits in the top journals or (for new papers) be written by people with a strong track record of publishing in the top journals.
    a. A good rule-of-thumb to avoid confirmation bias is to ask ourselves: "Would I believe a study by the same authors, published in the same journal, that found the opposite result". If the answer is "Yes", this gives us confidence that it is the quality of the evidence, rather than the result that it shows, that is what is leading us to quote it
3. Design reforms that clearly build on and respond to the issues identified in the diagnosis.
4. For proposals that have had widespread publicity but do not meet the rigorous criteria set out in points 1-3, ensure that any postulated advantages of implementing them are not stated in isolation but accompanied by a full recognition of the identified negative consequences, especially where they are based on rigorous research findings.

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