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Disclosure and Engagement: Stakeholder Participation Mechanisms

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Abstract

Over the past years, voluntary self-regulatory instruments like the United Nations Global Compact and the Global Reporting Initiative have become important vehicles through which companies demonstrate their commitment to a more sustainable future, including adherence to environmental and social rules. In the UK, disclosure requirements of companies are to be found in company law and securities law and have recently been increased through the introduction of the strategic report. According to the amended CA 2006, the directors of a company must prepare a strategic report for each financial year of the company. The aim of the strategic report is to provide details on how s. 172 CA 2006 has been applied. The question that this article will address is, with high levels of disclosure, whether or not additional reform is needed, by way of legislative amendments or soft law that will increase stakeholder participation resulting in an engaged stakeholder base during board decision-making?

1. Introduction

Over the past years, voluntary self-regulatory instruments like the United Nations Global Compact and the Global Reporting Initiative have become important vehicles through which companies demonstrate their commitment to a more sustainable future, including adherence to environmental and social rules. Current developments in corporate governance – like Directive 2014/95/EU and the move towards integrated reporting (IR) – have clearly underlined the importance of comprehensive and in depth disclosures where, in addition to established financial factors, non-financial matters (such as environmental, employee, social and human rights issues) are also reported on. In the UK, the *disclosure* requirements are to be found in company law and securities law and have recently been expanded through the introduction of the strategic report applicable to all companies, except for ones qualifying as "small".[3] According to the amended Companies Act ("CA") 2006, the directors of a company must prepare a strategic report for each financial year of the company. The aim of the strategic report is to provide details on how s. 172 CA 2006 has been applied. That provision is a key determinant of the UK corporate governance framework since it establishes, in principle, how directors should prioritise the interests of shareholders and stakeholders. The traditional focus of disclosure is to keep the shareholders informed so as to enable informed decision-making and

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[3] Sections 382-384, CA 2006.

engagement but disclosure will, indirectly, also inform stakeholders albeit that the strategic report is aimed at the shareholders and not the stakeholders.

The focus of this article is stakeholders (rather than shareholders). The strategic report required under s. 414 CA 2006 will inform stakeholders but it will not necessarily result in an engaged stakeholder base that participates in decision-making. During the recent corporate governance reform it was held that "UK company law already enshrines the importance of wider interested groups in corporate governance. Section 172 of the Companies Act 2006 gives directors a responsibility to create successful businesses for the benefit of shareholders, whilst having regard to a range of other interests. The challenge is to ensure that all companies are taking the steps needed to understand and take account of wider interests and different social perspectives. New ways of connecting boards to a wider range of interested groups need to be explored, building on much existing good practice."[4]

This article deals with precisely this issue – disclosure and engagement and the mechanisms to put in place to encourage participation. This can be seen as a two-way process: the company discloses information to ensure that shareholders and stakeholders, in our case, are informed; participation mechanisms are then put in place to ensure participation from stakeholders in the actual decision-making processes. Feedback is then again provided on the results or outcome of the engagement processes. Our high-level approach is aligned with that of Chiu and Baker who argue that there is need for more "emphasis on 'procedural justice', i.e. in the adoption by companies of a framework for corporate governance where the voice of different 'capital' suppliers to the corporation can be heard in such a way that the interests of any one powerful group may be effectively balanced and complemented".[5]

This article forms part of a project on the recognition of ESG issues in the board decision-making process. In the *first* article, forming part of this project[6], we conducted a comprehensive empirical study scrutinising the strategic reports of the FTSE 100 companies from 2015 and 2016, using a methodology involving compliance coding. We found that compliance with the provisions of the strategic report is very high, amounting even to super or over-compliance. These results can shape the ongoing corporate governance debate on stakeholder engagement. Disclosure has traditionally been

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[4] Para 2.1 of the Green Paper and subsequently BEIS, *Corporate Governance Reform: The Government Response to the Green Paper Consultation* (August 2017) <www.gov.uk/government/uploads/system/uploads/attachment_data/file/640470/corporate-governance-refo rm-government-response.pdf> (accessed 4 September 2017) (the "Government's Response").

[5] Iris H-Y Chiu and Roger Barker, *Submission to the Business Skills and Innovation Commons Select Committee: Corporate Governance Inquiry* (October 25, 2016). Available at <SSRN: https://ssrn.com/abstract=2858903 or http://dx.doi.org/10.2139/ssrn.2858903> (accessed on 5 May 2018).

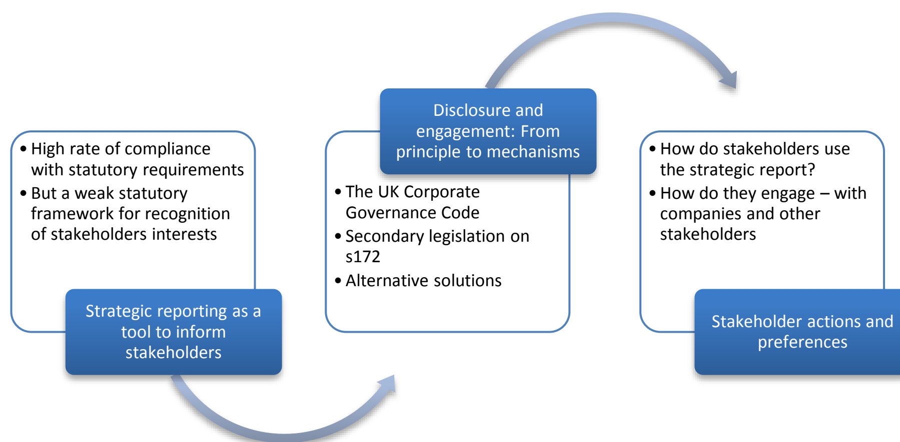
[6] Co-authored by I Esser, I MacNeil and K Chalaczkiewicz-Ladna. See <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049203> (accessed on 4 April 2018).

viewed as a mechanism that facilitates the creation of an efficient market in securities by enabling investors to make informed decisions to buy, sell or hold. It has been much less prominent in the discourse on directors' duties, which has focused on the standards of conduct expected from directors and the standard of review to be applied by courts in cases dealing with breach of duty. However, the increased focus on shareholder and stakeholder engagement in corporate decision-making in recent years provides a different perspective on the role of disclosure in terms of its role in facilitating that process. Thus, in the case of institutional shareholders, the type of engagement envisaged by the Stewardship Code is predicated on them having access to sufficient information to enable them engage meaningfully on strategic and governance issues. And while the traditional approach to disclosure, prioritising financial information and an efficient capital market, largely meets that objective, the position is different with respect to stakeholders since they are much less focused on financial information and more concerned about so-called "environmental, social and governance (ESG)" issues. The "business review" was the first step towards recognition of the different disclosure needs of stakeholders and that process has been taken forward more recently through the strategic reporting provisions of the CA 2006.

However, while disclosure has evolved to meet the needs of stakeholders there has been much less focus on their role in engaging in corporate decision-making. Part of the reason is no doubt that while shareholders have a formal role in corporate decision-making (directly through the general meeting and indirectly through the power of appointment and dismissal to the board of directors) stakeholders have no such formal role. Moreover, shareholders have legal remedies available to them in the event that directors do not comply with their duties. Stakeholders are in a weaker position as they lack both of these characteristics. Nevertheless, the logic of the framing of directors' duties (requiring consideration of stakeholder interests) and of strategic reporting (informing stakeholders so that their interests can be articulated and taken into consideration in board decision-making) is that stakeholders should engage with corporate decision-making and that directors must facilitate that process to comply with their duties. While a minimalist interpretation of the statutory provisions may point directors simply to consider stakeholder interests without further ado, strategic reporting does not fulfil its functions unless directors facilitate engagement by stakeholders. Once that principle is accepted there is then a high-level choice as between the creation of a formal participation mechanism for stakeholders or reliance on ad hoc engagement. In either case, several key issues must be resolved: who are the key stakeholders; how does the board hear from those key stakeholders and how does that process feed into decisions of the board of directors? Moreover, since the interests of shareholders and stakeholders are not always aligned, the board requires an appropriate framework for evaluating competing claims in the context of a legal framework that requires stakeholder interests to be considered but ultimately gives priority to shareholders.

The question that this article, the *second* in the series, will address is, with such high levels of disclosure (providing stakeholders with information on how their interests were considered), whether or not additional reform is needed, by way of legislative amendments or soft law, that will increase stakeholder participation resulting in an engaged stakeholder base during board decision-making? Finally, the *last* article, in this series of three, will present and analyse the results of interviews with selected stakeholders (such as environmental organisations, trade unions, consumer bodies, NGOs & social, community and human rights bodies). The interviews will generate qualitative data on the use of strategic reports and especially non-financial reporting and will enable conclusions to be drawn on whether or not the views of the stakeholders correspond with the empirical results on compliance presented in the first article and whether or not the proposed reform suggestions of the Government and the FRC are adequate. In other words, it will gather evidence on whether compliance with strategic report requirements results in a better informed stakeholder base and it will allow us to comment on the impact of the report on stakeholders, in particular, the extent to which strategic reporting forms a basis for stakeholder engagement.

The relationship between the series of articles can be illustrated as follows:



2. Disclosure and Directors' Duties

This section examines the strategic reporting framework in the UK, reports the outcome of our empirical study on compliance with the framework on the part of FTSE 100 companies and then concentrates on stakeholder engagement mechanisms.

a. Directors' Duties: Section 172

Section 172 CA 2006 is perceived by many as one of the most controversial sections of the CA 2006.[7] It generated an enormous amount of debate during the consultation process and when the Companies Bill was going through Parliament.[8] In terms of s 172(1) CA 2006, directors should focus on promoting the success of the company for the benefit of its members and are only subsequently entitled to take into account any other factors.[9] The UK approach is thus based on "enlightened shareholder value" (ESV).[10] It is acknowledged that s 172 CA 2006 underlines the importance of non-shareholders' interests and encourages directors to think about these other interests, but ultimately CA 2006 articulates shareholder primacy since (a) directors have to act in the best interest of the members and consider the interests of wider stakeholders and (b) the other stakeholders listed in s 172 CA 2006 are not entitled to take any actions against the directors.[11] The practical importance of section 172 CA for stakeholders is therefore currently unclear.[12]

b. Statutory Disclosure Requirements

Two key features are evident in the evolution of strategic reporting in the UK. The first is the traditional focus of disclosure on financial information and the needs of shareholders and the second is the role of the "comply or explain" principle in the UK corporate governance framework and in particular in the UK Corporate Governance Code. Thus, as illustrated in table 1, the elements of strategic reporting that are focused primarily on financial performance are the subject of mandatory reporting requirements whereas "ESG" reporting is on a "comply or explain" basis. The underlying logic of such an approach is that the financial strands of strategic reporting are a *sine qua non* for the emergence of informed shareholders who can engage effectively with corporate-decisions (and in the case of institutional shareholders thereby discharge their duty to underlying investors). The "comply or explain" approach to the ESG strand of strategic reporting implies first that disclosure to

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[7] Parker Hood, *Directors' Duties under the Companies Act 2006: Clarity or Confusion?* 13 (1) Journal of Corporate Law Studies 15 (2013); Lady Justice Arden, *Companies Act 2006 (UK): A New Approach to Directors' Duties* 81 Australian Law Journal 162 (2007).

[8] See for example: HL Company Law Reform Bill Deb 6 February 2006, col 252 (Lord Freeman) and the subsequent debate <www.publications.parliament.uk/pa/ld200506/ldhansrd/vo060206/text/60206-28.htm> (accessed 30 July 2017).

[9] For example, the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, the impact of the company's operations on the community and the environment, the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly as between members of the company.

[10] CA 2006, c 46, Explanatory Notes, Commentary on s 172 at <www.legislation.gov.uk/ukpga/2006/46/notes/division/6/2> (accessed 30 July 2017).

[11] Andrew Keay, *Moving Towards Stakeholderism? Enlightened Shareholder Value, Constituency Statutes and More: Much Ado About Little?* 33-36 European Business Law Review 22(1) (2011); Fraser Dobbie, *Codification of Directors' Duties: An Act to Follow?* 11 Trinity College Law Review 18-19 (2008).

[12] Irene-marie Esser and Jean du Plessis, *The Stakeholder Debate and Directors' Fiduciary Duties* 19 SA Mercantile Law Journal 346, 353 (2007).

stakeholders does not play such a central role in the governance framework (and may in appropriate circumstances be omitted without fatally damaging the system); and secondly, that market discipline can provide an effective enforcement mechanism to ensure that adequate disclosure occurs. While the first feature aligns with the current shareholder primacy approach in UK corporate governance, the role of the second is less clear since there is no mechanism for market discipline available to stakeholders analogous to the selling option available to shareholders.

In the light of these observations we now outline the strategic reporting obligations in the UK and then move on to examining compliance and assessing options for reform.

The strategic report, which came into force on 1 October 2013, replaced the business review[13] and together with the corporate governance report,[14] directors' remuneration report and financial statements,[15] and finally, the directors' report[16] form the annual report.[17] The purpose of the strategic report is to inform members of the company and help them assess how the directors have performed their duty under section 172 (to promote the success of the company).[18]

The table below illustrates the key reporting requirements for all companies in the UK (subject to the small exception referred to before):

[13] Formerly regulated in s 417 CA 2006. For in depth analysis of the business review see: Andrew Keay, *The Duty to Promote the Success of the Company: Is it Fit for Purpose?* 19-22 (August 2010) University of Leeds School of Law, Centre for Business Law and Practice Working Paper <www.law.leeds.ac.uk/assets/files/research/events/directors-duties/keay-the-duty-to-promote-the-success.pdf> (accessed 30 July 2017).

[14] FCA, Listing Rules, r 9.8.6(5) and s 419A CA 2006.

[15] Sections 420-422A, s 439-439A CA 2006 (after the changes made by ss 79-82 of the Enterprise, Regulatory Reform Act 2013 c24) and the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 (SI 2013/1981)).

[16] ss 415-419A CA 2006.

[17] Based on s 423 every company has a duty to circulate copies of annual accounts and reports.

[18] Section 414C(1) CA 2006. In 2014, the FRC published a detailed non-mandatory Guidance document supporting the legal requirements for the strategic report, which serves as a best practice statement for all entities preparing the report. FRC, *Guidance on the Strategic Report*, 3 (June 2014) <www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf> (accessed 30 July 2017). The Guidance includes sections on the application of materiality to the strategic report, communication principles and content elements (see: sections 5, 6 and 7 respectively). An updated edition of its Guidance on the Strategic Report was open for consultation until October 2017. The draft amendments also aim to strengthen the link between the purpose of the strategic report and the matters directors should have regard to under s 172 CA 2006. Most importantly, the Guidance encourages companies to disclose information on how companies have considered the interests of broader stakeholders, to inform members of the company and help them assess how directors have performed their duty to promote the success of the company.

Table 1: Reporting requirements in the UK based on s 414C CA 2006 (Strategic Report)

Issue to be disclosed	Type of disclosure (mandatory or "comply or explain")
A fair review of the company's business and a description of the principal risks it faces (s 414C(2) CA 2006)	Mandatory
An analysis using financial key performance indicators (i.e. factors by reference to which the development, performance or position of the company's business can be measured effectively), and where appropriate, an analysis using other key performance indicators, including information relating to environmental matters and employee matters (s 414C(4), (5), (6) CA 2006)	Mandatory (Where a company qualifies as medium-sized in relation to a financial year (see ss 465-467 CA 2006), the review for the year need not comply with the requirements of subsection (4) so far as they relate to non-financial information.)
The main trends and factors likely to affect the future development, performance and position of the company's business (s 414C(7)(a) CA 2006)	Mandatory (For quoted companies only)
Information about environmental matters, the company's employees, social, community and human rights issues (s 414C(7)(b) CA 2006)	"Comply or explain" (For quoted companies only)
A description of the company's strategy and business model (s 414C(8)(a), (b) CA 2006)	Mandatory (For quoted companies only)
Gender diversity (s 414C(8)(c) CA 2006)	Mandatory (For quoted companies only)

Non-financial reporting in the UK is also influenced by Directive 2014/95/EU. Member States had to finalise the transposition of this Directive into national legislation by 6 December 2016.[19] The relevant provisions came into effect on 26 December 2016 and apply to companies and qualifying partnerships, specified in s 414CA CA 2006, with financial years beginning on or after 1 January 2017. According to s 414CA CA 2006, a non-financial information statement must be issued by a traded company,[20] a banking company,[21] a company carrying on insurance market activity[22] or groups which are not small or medium-sized and which exceed on their balance sheet dates the criterion of the average number of 500 employees. The management report must include a non-financial statement containing information to the extent necessary for an understanding of the undertaking's development, performance, position and impact of its activity, relating to, as a minimum,

[19] To bring the UK position in line with the 2014/95/EU Directive, the Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations inserted new provisions on non-financial information into the Companies Act 2006 (ss 414CA and 414CB into the CA 2006).

[20] "Traded company" means a company any of whose transferable securities are admitted to trading on a regulated market – see: s 474(1) CA 2006. A "traded company" is a broader term than a "quoted company" (i.e. a company to which apply non-financial reporting requirements under s 414C(7) CA 2006).

[21] "Banking company" means a person who has permission under Part 4A of the Financial Services and Markets Act 2000 (c. 8) to accept deposits, other than– (a) a person who is not a company, and (b) a person who has such permission only for the purpose of carrying on another regulated activity in accordance with permission under that Part – see: ss 1164(2) and (3) CA 2006.

[22] An "authorised insurance company" means a person (whether incorporated or not) who has permission under Part 4A of the Financial Services and Markets Act 2000 (c. 8) to effect or carry out contracts of insurance – see: s 1165 (2) CA 2006.

environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters.[23]

Table 2: Contents of the non-financial statement based on s 414CB CA 2006

Issue to be disclosed	**Type of disclosure (mandatory or 'comply or explain')**
Information relating to, as a minimum: environmental matters, the company's employees, social matters, respect for human rights and anti-corruption and anti-bribery matters (s 414CB(1) and (4) CA 2006)	"Comply or explain"
A brief description of the company's business model (s 414CB(2) (a) CA 2006)	Mandatory
A description of the policies pursued by the company in relation to such non-financial matters (s 414CB(2) (b) CA 2006)	Mandatory
The outcome of the policies pursued by the company in relation to such non-financial matters (s 414CB(2)(c) CA 2006)	Mandatory
A description of the principal risks relating to such non-financial matters and how the company manages such risks (s 414CB(2)(d) CA 2006)	Mandatory
A description of the non-financial key performance indicators relevant to the company's business (s 414CB(2)(e) CA 2006)	Mandatory

In order to prevent duplication, if a non-financial information statement complies with s 414CB (1) to (6), the strategic report of which it is part is deemed as fulfilling some of the requirements[24] for non-financial information which are already contained in section 414C CA 2006.[25] Finally, s 414CB does not require disclosure of information about impending developments or matters in the course of negotiation if the disclosure would, in the opinion of the directors, be seriously prejudicial to the commercial interests of the company, provided that such non-disclosure does not prevent a fair and balanced understanding of the company's development, performance or position or the impact of the company's activity.[26]

During June 2018 the Companies (Miscellaneous Reporting) Regulations 2018 was published. It expands the required content of the strategic report and the directors' report. In their strategic report, companies will be required to include a "Section 172(1) Statement" describing how directors have

[23] Section 414CB(1) CA 2006
[24] Section 414C(4)(b) CA 2006; s 414C(7), except as it relates to community issues; s 414C(8)(b), s 414C(12), so far as relating to the provisions mentioned in paragraphs (a) to (c).
[25] Section 414CB(7).
[26] Section 414CB(9). This type of information is also exempt from immediate, on-going disclosure under art 14(4) of the Market Abuse and Accepted Market Practices Directive (Directive 2003/6/EC of 28 January 2003) ("MAD").

had regard to the matters set out in section 172(1)(a) to (f) CA 2006 when performing their duties under section 172. This statement will also have to be made available on a website. For quoted companies, this will make no practical difference because they are already required to make their annual report available on a website and the statement will be a new component of this report. Unquoted companies, however, are not required to publish their annual report on a website and will need to make arrangement to ensure that the section 172(1) statement is available on a website. In their directors' report, companies will need to provide a summary of how their directors have engaged with employees, how they have had regard to employee interests, and the effect of that regard, including on the principal decisions taken by the company during the financial year. This expands on the information about employee engagement matters that companies already have to include in their directors' report. In addition, companies will need to provide a summary of how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others, and the effect of that regard, including on the principal decisions taken by the company during the financial year.

The contents of the statement will depend on the individual circumstances of each company, but companies will probably want to include information on some or all of the following:

- The issues, factors and stakeholders the directors consider relevant in complying with section 172 (1) (a) to (f) and how they have formed that opinion;
- The main methods the directors have used to engage with stakeholders and understand the issues to which they must have regard;
- Information on the effect of that regard on the company's decisions and strategies during the financial year. The Financial Reporting Council is revising its Guidance on the Strategic Report and has agreed to include guidance to help companies decide how to report.

So the key question is, with such substantial reporting requirements, is more needed to have an informed and engaged stakeholder base? To answer this question, we need to examine first companies' actual compliance with the relevant statutory reporting requirements and, secondly, whether the information that is disclosed actually results in a better informed stakeholder base. Following that analysis we move on to consideration of alternative mechanisms to inform stakeholders and facilitate engagement with companies.

c. Empirical study on compliance with statutory disclosure requirements

During 2017 we undertook an empirical study[27] of compliance with the strategic reporting obligations where we scrutinised the strategic reports of the FTSE 100 companies from 2015 and 2016 using a methodology involving compliance coding. That study is especially significant as the practical implications and relevance of the production of a strategic report by company directors have not been discussed in depth in prior literature. It provides empirical evidence on compliance with the relevant statutory provisions and provides some preliminary insights on the manner in which companies consider environmental, social and governance (ESG) issues in decision-making and the extent to which disclosure represents an effective strategy for engaging stakeholders in that process.

We reached a number of conclusions based on the results of that research:

The main conclusion was that compliance with strategic reporting obligations is very high, amounting even to super or over-compliance. Such a high standard of disclosure is surprising, especially taking into consideration the mainly "comply or explain" nature of non-financial reporting. The logic of "comply or explain" is that it permits flexibility, yet this has not been the outcome in this instance. Only three variables produced low or very low compliance rates. The worst results were achieved in the context of "the role and objective of the strategic report". The second worst result was produced against a "forward looking orientation" of the company. Thirdly, in comparison to the other non-financial variables, the disclosure rates relating to "human rights issues" were relatively low.

With regard to the other variables, the quality of disclosure was high or extremely high. Companies scored very well in the context of "describing the company's strategy and business model & review of the company's business and the principal risks and uncertainties facing the company". In addition, the remaining non-financial variables in the strategic report (i.e. regarding environmental matters, Greenhouse gas emissions (GHG), employee considerations, gender diversity and social & community matters) produced very good results. The disclosure rates regarding GHG emissions were the highest. The second best result involved employee considerations. The compliance rates regarding three other non-financial variables were also very impressive.

It is worth considering the reasons for these surprisingly high disclosure levels, especially regarding non-financial considerations. It is argued here that this super compliance could be a result of various factors (or a combination of them). First, the companies could be genuinely interested in providing comprehensive answers, as non-financial considerations are important from the company's

[27] See <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3049203> (accessed on 4 April 2018). The significance of this research is based on its breadth and depth – i.e. collection of 2600 observations and the analysis of strategic reports and other sustainability reports of the FTSE 100 companies in 2015 and 2016. The study specifically concentrated on two issues. First, its aim was to provide concrete evidence on compliance with the provisions of a strategic report, especially the extent to which non-financial issues are considered by the companies. Secondly, it evaluated the type and quality of information received by stakeholders, from the company, based on the strategic report.

perspective or there might be an actual and strong recognition of stakeholder interests (however, this is a very optimistic perspective). Secondly, diligent non-financial reporting could be purely an effective marketing tool. The companies might be aware that investors, financial institutions and stakeholders are also relying on strategic reports or ESG reports in their assessment of the companies and by comparison with companies from the same sector.[28] However, it is worth highlighting that the sustainability language does not always guarantee the sustainable approach and could be exactly an indication of misleading marketing, greenwashing[29] or effective reporting skills. The high disclosure rates and over compliance could also be a consequence of a "tick-the-box" exercise or corporate managers disclosing only information showing the corporation in a favourable light.[30] Finally, another conclusion, based on the results of this empirical study, could be that over compliance is used as a strategy to pre-empt stakeholders being directly represented in company decision-making (e.g. through board membership). On that reading, disclosure is a more acceptable solution than direct representation.

This empirical study clearly shows that the companies are producing vast amounts of non-financial information in their strategic and additional sustainability reports. However, it does not provide clear evidence on whether compliance with the strategic reporting requirements results in a better informed stakeholder base or whether it facilitates more effective interaction between stakeholders and companies. We aim to provide evidence on this issue derived from the third stage of our research in due course. In the meantime we move on to consider relevant reforms that have recently been proposed (and some implemented already) in the UK.

3. Stakeholder Engagement: Proposed Reform

In August 2017 the Government suggested strengthening stakeholders' interests through improved reporting, UK CG Code changes, raising awareness and more guidance.[31] Four reform proposals in this area were suggested in the Government's Response to the Green Paper:

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[28] Betty Moy Huber and Michael Comstock, *ESG Reports and Ratings: What They Are, Why They Matter* (27 July 2017) <https://corpgov.law.harvard.edu/2017/07/27/esg-reports-and-ratings-what-they-are-why-they-matter/> (accessed 14 August 2017).

[29] Beate Sjåfjell, *Dismantling the Legal Myth of Shareholder Primacy: The Corporation as a Sustainable Market Actor* 12-13 (February 2017) University of Oslo Faculty of Law Research Paper No 2017-03 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2912141> (accessed 14 August 2017).

[30] Barnali Choudhury, *Social Disclosure* 13(1) Barkley Business Law Journal 185, 187-188, 197 (2016).

[31] See here the Green Paper 34-42 and the Government's subsequent response 24-35. The current intention is to bring the reforms into effect by June 2018. See also, on this issue, Georgina Tsagas, *Section 172 of the Companies Act 2006: Desperate Times Call for Soft Law Measures* (July 2017) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2996090> (accessed 4 September 2017). See further ICSA and the Investment Association, *The Stakeholder Voice in Board Decision Making: Strengthening the Business, Promoting Long-term Success*, 4 (September 2017)

1. Introducing secondary legislation to require all companies of a significant size (private as well as public) to explain how their directors comply with the requirements of section 172 CA 2006 to have regard to employee interests and to fostering relationships with suppliers, customers and others.
2. Inviting the FRC to consult on the development of a new Code principle establishing the importance of strengthening the voice of employees and other non-shareholder interests at board level as an important component of running a sustainable business. As a part of developing this new principle, the Government invited the FRC to consider and consult on a specific Code provision requiring premium listed companies to adopt, on a "comply or explain" basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce.
3. Asking ICSA (the Governance Institute) and the Investment Association to complete their joint guidance on practical ways in which companies can engage with their employees and other stakeholders at board level.
4. Inviting the GC100 group of the largest listed companies to complete the work it is undertaking to prepare and publish new advice and guidance on the practical interpretation of the directors' duty in section 172 of the Companies Act 2006.

Of these four action points, number 1 was introduced through the Companies (Miscellaneous Reporting) Regulations 2018, as discussed above.[32] The FRC did respond to action 2, as during December 2017, it launched its consultation on proposed changes to the UK Corporate Governance Code.[33] For our purposes the following principles and provisions, which were part of Section 1 (leadership and purpose) of the proposed, draft Code, are of relevance:

"Principle C: In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties."

"Principle D: All directors must act with integrity and lead by example in the best interests of the company. The workforce should be able to raise concerns in relation to management and colleagues where they consider that conduct is not consistent with the company's values and responsibilities."

and

<www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=press/2017/2017-09TheStakeholderVoiceinBoardDecisionMaking.pdf> (accessed 12 October 2017) on guidance issued to companies with the aim to help companies to consider stakeholders' interests when taking strategic decisions.

[32] See https://www.legislation.gov.uk/ukdsi/2018/9780111170298. Subject to Parliamentary approval, the new requirements will apply to company reporting on financial years starting on or after 1 January 2019. The first actual reporting under the new regulations will therefore start in 2020.

[33] See <www.frc.org.uk/consultation-list/2017/consulting-on-a-revised-uk-corporate-governance-co> (assessed on 4 April 2018).

“Provision 3: The board should establish a method for gathering the views of the workforce. This would normally be a director appointed from the workforce, a formal workforce advisory panel or a designated non-executive director. There should also be a means for the workforce to raise concerns in confidence and (if they wish) anonymously. The board should review this and ensure that arrangements are in place for the proportionate and independent investigation of such matters and for follow-up action.”

“Provision 4: The board should explain in the annual report how it has engaged with the workforce and other stakeholders, and how their interests and the matters set out in section 172 of the Companies Act 2006 influenced the board’s decision-making.”

During July 2018 the final Code was published.[34] The final provisions and principles are in line with those proposed in the draft Code, except that reference is now made to the above mentioned Regulations. It is stated, in the context of Provision 5, that the Companies (Miscellaneous Reporting) Regulations 2018 require directors to explain how they have had regard to various matters in performing their duty to promote the success of the company in section 172 CA 2006. The Financial Reporting Council’s Guidance on the Strategic Report supports reporting on the legislative requirement.

The new Principles D and E are similar to the above mentioned (draft) Principles C and D dealing with effective stakeholder engagement and participation from, these parties. The board should also ensure that workforce policies and practices are consistent with the company’s values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

Provision 5 is similar to the above mentioned, draft, Provision 3 where it refers to various workforce engagement mechanisms, operating on a “comply or explain” basis. Draft Provision 4 dealt with disclosure in the annual report relating to the issues mentioned in section 172 specifically. Previously we argued, and also submitted comments to the FRC, that this provision does not specify how these goals should be achieved. We also argued that there is an overlap between draft Provision 4 and the statutory strategic reporting requirements[35] as the aim of both is to provide details on how s 172 has been applied.[36] Also, draft Provision 4 stipulated only that this information should be included in the

[34] See https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf (assessed on 31 July 2018).
[35] Section 414ff CA 2006.
[36] However, the application of the Code and the strategic report is slightly different. The Code applies to all companies with a premium listing of equity shares and the strategic report requirements apply to various companies on a mandatory or “comply or explain” basis as explained in Table 1 above.

annual report, but it does not specify whether it refers to the governance or strategic report section of the report.

It was our view that reporting on compliance with s 172 should take place only within the strategic report. It is not clear why it has to be dealt with in the Code. Overall, we argued that draft Provision 4 should be deleted as it would be an additional layer of disclosure which seems to be excessive in view of the current legislation. This provision has been reworded as it now states that the board should understand the views of the company's key stakeholders and describe in the annual report how their interests and the matters set out in section 172 CA 2006 have been considered in board discussions and decision-making. Reference is then made to the new Regulations. There is thus a much clearer link to the legislative position. This is a welcomed move. Companies are, however, now required to produce various reports and not the same requirements apply to all types of companies. There is thus still lack of a holistic approach in the context of reporting.

The FRC also released Guidance on Board Effectiveness as part of their consultation on the Corporate Governance Code.[37] The Guidance on Board Effectiveness (the Guidance) is intended to assist companies in applying the principles of the UK Corporate Governance Code (the Code). It sets out good practice suggestions for meeting the Principles and Provisions of the Code and is not intended to be prescriptive.

A consultation – which was open until 24 October 2017 – on an updated edition of its Guidance on the Strategic Report is another welcome development.[38] The proposals reflect the enhanced disclosures that certain large companies are required to make following implementation of the EU non-financial reporting directive[39] in respect of the environment, employees, social matters, respect for human rights and anti-corruption and anti-bribery matters.[40] Moreover, the draft amendments also aim to strengthen the link between the purpose of the strategic report and the matters directors should consider under s 172 CA 2006. Most importantly, the Guidance encourages companies to disclose information on how companies have considered the interests of broader stakeholders, to inform members of the company and help them assess how directors have performed their duty to promote

[37] See <https://www.frc.org.uk/getattachment/fe7a3cc7-e076-4ee4-ad1e-5f6aa91b2159/Proposed-Revisions-to-the-UK-Corporate-Governance-Code-Appendix-B-Dec-2017.pdf> (assessed on 4 April 2018). The final version was published in July 2018: <https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF>.

[38] FRC, Draft Amendments to Guidance on Strategic Report: Non-Financial Reporting (August 2017) <https://frc.org.uk/getattachment/9e05c133-500c-4b98-9d76-497172387bea/;.aspx> (accessed 4 September 2017). See here for the final Guidance that was issued during July 2018: https://www.frc.org.uk/news/july-2018/revised-guidance-on-the-strategic-report.

[39] Under the newly inserted ss 414CA and 414CB CA 2006.

[40] There are references to the new provisions throughout the amended Guidance.

the success of the company.[41] Although the Guidance on the Strategic Report is non-mandatory, this amendment is especially significant as it strengthens the importance of stakeholders' interests.

With regard to action 3, the relevant guidance was issued at the end of September 2017, with the aim to help companies to consider stakeholders' interests when taking strategic decisions.[42] Whilst companies have freedom in setting out their relations with stakeholders, 10 core principles that should be followed by the boards were offered and also practical advice is given, i.e. case studies from listed companies on how to implement these principles. Just to mention a few principles,[43] first, boards are asked to identify and keep under regular review, who they consider their key stakeholders to be and why. Secondly, boards should determine which stakeholders they need to engage with directly, as opposed to relying solely on information from management. In addition, the board should report to its shareholders on how it has taken the impact on key stakeholders into account when making decisions. Further, the board should provide feedback to those stakeholders with whom it has engaged, which should be tailored to the different stakeholder groups.

This diagram illustrates the original reform proposals (Government's Response):

4. Evaluation of the proposed reform on stakeholder engagement and suggested changes

The FRC correctly pointed out that companies can do more to recognise that other stakeholders play a significant part in promoting the long-term success of the company.[44] However, the primary focus of

[41] See also other references to stakeholders' interests: sections 5 and 7, paras. 5.3, 5.4, 5.7, 7.2, 7.10 and 7.18.
[42] ICSA and the Investment Association, *The Stakeholder Voice in Board Decision Making: Strengthening the business, promoting long-term success*, 4 (September 2017), <www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=press/2017/2017-09TheStakeholderVoiceinBoardDecisionMaking.pdf> (accessed 12 October 2017).
[43] See p 6 for the 10 core principles.
[44] FRC, Proposed Revisions, para. 4.

the revised Code is on the workforce and not wider stakeholders (in passing, the change from 'employee' interests to "workforce" considerations is a welcome development and should also be reflected in s 172). The revised Code acknowledges the importance of a wider stakeholder focus, but in practice it concentrates only on the workforce, by discussing the adoption of one of three employee engagement mechanisms – a director appointed from the workforce, a formal workforce advisory council, or a designated non-executive director.[45]

During the consultation period of the revised Code the question was posed whether or not the proposed methods in draft Provision 3, referred to above, are sufficient to achieve meaningful engagement. Provision 3 stated that the board should establish a method for gathering the views of the workforce. In particular, the Revised Guidance on Board Effectiveness ("Guidance") contains very useful advice on gathering the views of the workforce.[46] However, it was (and is) our view that the engagement methods suggested in Provision 3 (now 5), and listed above, should apply to all stakeholders rather than only to one group. The Revised, final, Guidance clearly refers to stakeholders more widely (paras. 40 – 46) and the new Code should be in line with the Guidance.

Various responses were submitted during the Government's Corporate Governance reform consultation and some are particularly helpful when considering the best way forward in recognising the interests of stakeholders.[47] During the consultation many companies and their boards recognise the wider societal responsibilities that they have and the benefit they gain through wider engagement around their business activities.[48] On the actual mechanisms various possibilities were discussed and most respondents agreed that companies should seek to strengthen the voice of stakeholders but there was no consensus on which of the three proposed options (for employee engagement) would work best. Designation of existing NEDs to ensure that the voice of stakeholders is heard at board level was the most favoured mechanism.[49] Respondents suggested that a designated non-executive director should be able to meet management, workforce and unions to discuss matters of concern; should have access to employee engagement survey results and other statistics; should be able to consult key suppliers; and should be able to review customer feedback including complaints. It was also suggested that there could be more than one designated non-executive director acting as a point of liaison for different stakeholder groups including workers, suppliers, customers, consumers, community, and

[45] Section 1, Provision 5 of the new Code.
[46] FRC, Proposed Revisions, Appendix B paras. 31-36.
[47] See https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf (Government's Response) (assessed on 20 July 2018).
[48] Government's Response, para 2.1 and 2.3. Of these 210 (around 86%) agreed that the stakeholder voice should be strengthened with only 33 (around 14%) disagreeing.
[49] Government's Response, para 2.9.

environmental groups.[50] The main risk highlighted with this option was that designating a single non-executive director to this role could undermine a sense of collective board responsibility for stakeholder engagement. It was also mentioned that if it is expected from these designated NEDs to promote, rather than channel, the interests of particular groups, the role could potentially conflict with the duties that directors hold in common and compromise independence. There were also concerns that designated non-executive directors could find themselves isolated on the board, unable to provide an effective challenge. Many responses emphasised that combining the roles of designated non-executive directors with advisory panels would be preferred as it will ensure a direct route to the board but with a variety of views being maintained.[51] Many responses favoured an advisory panel, but concern was expressed if this is to operate on a mandatory basis, concerns were also raised as to how this panel will be chosen, whether it will have any "teeth" and how representative it will be. A number of responses dealt with individual stakeholder representatives on boards, with generally 40% of respondents favouring such an approach, the vast majority wanted to retain the unitary board structure and was concerned that this will not be possible with stakeholder representation on boards.

In view of the reform proposals, discussions and above observations we suggest the following changes relating to engagement mechanism. First, all references to "workforce" in Provision 3 (now 5) should be replaced with "stakeholders". Secondly, we suggest combining an advisory stakeholder panel (including the representation of the workforce) and a designated non-executive director representing all stakeholders. The stakeholder panel could meet outside the board and report to the board through a designated NED. This could be a route to get the views of all stakeholders heard at board level, whilst still achieving the aim to protect the workforce. The biggest challenge with regard to the suggested stakeholder panel concerns setting out an effective mechanism to determine the composition of the panel and the representation of the interests of all stakeholders. To achieve this goal companies could advertise recruitment to the panel on their websites or publish surveys annually. Alternatively, stakeholders could be obliged to create a central organisation (divided into sub groups) representing their interests, which could be a point of reference for the companies. Other challenges include the role and working pattern of the advisory panel, cooperation between the panel and board and reporting of the NED to the board.

In this context reference to the South African Social and Ethics Committee ("SEC") is relevant and we are of this view that a mechanisms similar to this committee can be useful in the UK context and will, potentially, address the problems identified above i.e., to maintain a collective view, not create a conflict of interest in the context of directors duties. We also make certain recommendations relating to the enforcement issue mentioned before and the composition of such a committee. The SEC creates

[50] Government's Response, para 2.10.
[51] Government's Response, para 2.16.

a statutory solution and could be applied with adjustments to the UK. In brief, based on s 72 of the South African Companies Act 2008 (read with Companies Regulation 43) every state owned company, every listed public company and any other company that has, in any two of the previous five years, had a public interest score of at least 500 points (the number of employees and the turnover are some of the factors that will determine if a company is obliged to have such a committee) must appoint an SEC. The aim of this Committee, consisting of at least 3 directors one that has not been involved in the day-day management of the company for at least 3 years, is to draw certain matters to the attention of the board and to then report to the shareholders. These matters include: social and economic development, good corporate citizenship, the environment, health and public safety, consumer relationships, labour and employment. This committee is dealt with in legislation in South Africa, but a similar committee could be provided for in the UK Companies Act as part of the current strategic reporting framework. It would make sense if this committee is mandatory. The same sample of companies that have to produce a strategic report should also have such a committee in place. The UK is characterised by a flexible system that operates on a "comply or explain" basis but we are of the view that this would not be sufficient in this context. We argued before that there is no mechanism for market discipline available to stakeholders analogous to the selling option available to shareholders. A mandatory committee, considering ESG issues, will also provide a level-playing field for stakeholder engagement, as we argue below.

In this context it is important to provide stakeholders with feedback/report back on the results achieved through the relevant participation mechanisms. Since board decision-making encompasses many different considerations it would be important for stakeholders to know what influence, if any, their views had on the process. The annual or strategic report can assist but is not always adequate as it is really aimed at the shareholders. Other ways could be explored here to report back to the stakeholders, i.e. separate CSR reports or website links.[52]

Also, we recommend the following changes regarding the Guidance in the context of Provision 5. The advice on gathering the views of the workforce (paras. 50-56) should be applicable to all stakeholders. Finally, at para 45, the 2018 Board Effectiveness Guidance refers directors briefly to the Guidance prepared by the ICSA/IA.[53] There should be a clearer link between these documents. At least, the 10 Core Principles[54] from the ICSA/IA Guidance should be repeated in the Guidance. Ideally, both

[52] See <https://www.icsa.org.uk/assets/files/free-guidance-notes/the-stakeholder-voice-in-Board-Decision-Making-09-2017.pdf> (accessed 24 May 2018).
[53] ICSA and IA, *The Stakeholder Voice in Board Decision Making: Strengthening the Business, Promoting Long-term Success* (2017). <www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=press/2017/2017-09TheStakeholderVoiceinBoardDecisionMaking.pdf> (assessed on 4 April 2018).
[54] For example, boards should identify, and keep under regular review, who they consider their key stakeholders to be and why and boards should determine which stakeholders they need to engage with directly, as opposed to relying solely on information from management. See p 6 of the *Stakeholder Voice* document.

documents should be merged to make the guidance more accessible as currently there is some repetition between them (i.e. Core Principle 1 of the ICSA/IA Guidance on the identification of stakeholders is repeated at para. 42 of the Guidance).

Another relevant question posed during the consultation process of the revised Code asked whether specific reference to the UN Sustainable Development Goals (SDGs) or other NGO principles, either in the Code or in the Guidance is necessary. Our view is that specific reference is not needed. Sustainability should be achieved by compliance with s 172 and the strategic reporting provisions, rather than by the reference to the UN SDGs or other NGO principles in the Code. These principles might be unknown to many companies and crucially could make reporting more cumbersome.

To summarise, the revised Code represents a step forward in recognising the role of wider stakeholders in the company but there are concerns relating to the focus on a specific stakeholder group and the enforcement of the engagement mechanisms. Finally, the Guidance should be amended to reflect the interests of all stakeholders and should be better linked with the ICSA/IA Guidance.[55]

This diagram illustrates our proposed way forward:

5. Conclusions

There are extensive disclosure obligations relating to non-financial information in place in the UK resulting in a, potentially, informed stakeholder base. The empirical study forming the first part of our

[55] See also the response received from Cass Business School, Frank Bold and Sheffield Institute of Corporate and Commercial Law on the FRC Consultation of the Corporate Governance Code stating that "Finally, we think that the Code would benefit from using the multiple-capitals model advocated by the International Integrated Reporting Framework and South African King IV Report because it provides a clearer definition of what success of the company means" at <https://www.frc.org.uk/getattachment/c7aefb17-1132-4eb6-9d8c-70af8a8bc5dd/Cass-Business-School,-Frank-Bold-Sheffield-Inst;.aspx> (assessed on 27 May 2018).

research clearly shows that companies are producing vast amounts of non-financial information in their strategic and additional sustainability reports and that they do comply with the statutory disclosure requirements. However, there is as yet no research providing clear evidence on whether strategic reporting results in a better informed stakeholder base or whether it facilitates more effective interaction between stakeholders and companies.[56] Nevertheless, the Government is interested in strengthening the voice of stakeholders and have proposed various solutions to achieve this aim. This article evaluated those options and suggested a number of participation mechanisms that would ultimately lead to engaged stakeholders. We conclude that disclosure is not sufficient in itself. For stakeholders to be fully engaged they need adequate information, in the form of disclosure, but they also need mechanisms to facilitate participation from their side. Our view is that statutory support for such a principle would be appropriate so as to link effectively with the statutory obligations in respect of directors' duties and strategic reporting. That would leave companies some flexibility in selecting appropriate mechanisms to suit their circumstances but ensure that stakeholders operated under a consistent framework.

These reform proposals will be tested in the next stage of our research by interviewing selected stakeholders such as environmental, human rights, climate change, labour, consumer and equality organisations and NGOs. Evidence obtained from the interviews will be relevant for various purposes: it will assist relevant companies, governments and agencies in understanding the implications of ESG legal obligations in practice and the policy changes that may be feasible to make ESG work more effectively in that context; it will benefit stakeholders specifically as it will assist them in using the information provided in the company's reports to exert influence over board decision-making; and it will also assist private sector actors, such as investors and banks, to understand how ESG reporting and CSR more broadly can generate improvements in markets and institutions by building trust in the role of private capital in promoting policies that carry benefits for society at large as well as for shareholders.

We hope that the proposals made in this article, based on doctrinal and comparative research and backed by empirical results will help shape future policy-making. We agree with Chiu and Barker when they state that "We believe that treating corporate governance and company law reforms as public policy choices that need to be made in order to advance a more legitimate corporate economy

[56] See, however, Charlotte Villiers, *Corporate Reporting and Company Law* (Cambridge Studies in Corporate Law, 2006) on the problems with financial reporting and the failures of the annual reports, e.g., to address the needs of its users. See also Gill North, *Effective Company Disclosure in the Digital Age* (Kluwer Law International, 2015).

based on long-term value creation is the correct approach".[57] More effective participation mechanisms for stakeholders would be a good starting point in that process.

[57] Iris H-YChiu and Roger M Barker, *Corporate Governance and Investment Management The Promises and the Limitations of the Financial Economy*, 446 (EE Elgar, 2017).