

***Submission to Sir David Walker's Review  
of  
Corporate Governance in UK Banks and Other Financial Industry Entities***



**September 2009**

Contact Details at FairPensions:  
Catherine Howarth  
FairPensions (Fairshare Educational Foundation)  
Trowbray House  
108 Weston Street  
London SE1 3QB  
United Kingdom  
Tel: +44 20 7403 7827  
[catherine.howarth@fairpensions.org.uk](mailto:catherine.howarth@fairpensions.org.uk)

## 1. About FairPensions

FairPensions is pleased to have this opportunity to make this submission to the consultation paper written by Sir David Walker and entitled “*A review of corporate governance in UK banks and other financial industry entities*” (“*the Review*”).

FairPensions is the operating name of Fairshare Educational Foundation, a registered charity<sup>1</sup> that aims to persuade UK pension funds and fund managers to adopt an effective responsible investment (“*RI*”) capability and to monitor and manage environmental, social and governance (“*ESG*”) risks.

RI requires the integration of ESG considerations into investment policy. For this purpose, investment policy includes engagement with investee companies i.e. shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers.

FairPensions believes that RI practices help to safeguard investments and to promote better corporate governance, as well as securing other environmental and social benefits.

FairPensions is supported by a number of leading charities and trade unions, including ActionAid, CAFOD, Community, CWU, ECCR, EIRIS, GMB, NUJ, Oxfam, Traidcraft, Unison, Unite and WWF. We are also supported by almost 5,000 individuals.

Further information about FairPensions and about our approach to RI can be found on our website.<sup>2</sup>

## 2. Scope and Structure of this Submission

This submission is primarily concerned with how far the recommendations of the Review are likely to encourage corporate responsibility on the part of banks and other financial industry entities (BOFIs) and responsible investment on the part of institutional shareholders. We would stress, however, that this concern is largely congruent with the promotion of good corporate governance in general. This is especially true in relation to the need to encourage both corporate managers and institutional investors to embrace long-termism, which is integral to RI.

We are mindful that the Review is being conducted in parallel with the Financial Reporting Council's review of the effectiveness of the Combined Code. We made a submission in May to the initial consultation relating to that review (“*our FRC submission*”). For consistency, therefore, we shall in this submission take as our starting point how the key themes of our FRC submission should be applied in the particular context of the Review. Accordingly, for ease of reference, we have annexed to this submission a copy of our FRC submission (which is also on the FRC website).

In summary, our FRC submission considered that the overriding objective of the Combined Code was to align the interests of all market participants with the long-term interests of the company and of its ultimate owners. We suggested that this required in particular:

(i) the elimination of structural conflicts of interest;

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<sup>1</sup> Registered charity number 1117244

<sup>2</sup> [www.fairpensions.org](http://www.fairpensions.org)

(ii) the greatest possible transparency at every level in order to monitor and, where necessary, improve performance;

(iii) changing the prevalent culture of short-termism among both corporate managers and institutional investors; and

(iv) promoting active share ownership, including coordination between long-only investors.

In this submission, we should like first to comment on some general issues that are raised in the opening sections of the Review (the Preface and Chapters 1 & 2) and then to respond to the specific Recommendations contained in the later Chapters (3 to 7), having regard to the matters discussed in those Chapters.

### 3. Comments on General Issues

#### *(1) The Role of “Prescription” in Promoting Corporate Governance*

The Review adopts the general principle that “*Good corporate governance depends critically on the abilities and experience of individuals and the effectiveness of their collaboration in the enterprise and, despite the need for hard rules in some areas, will not be assured by box-ticking conformity with specific prescription*”.<sup>3</sup> Whilst it is hard to disagree with this sentence on a literal reading, we have some concerns about possible subtexts.

Firstly, we think that a distinction should be drawn between prescriptive rules governing process (as suggested by the (perhaps overused) term “*box-ticking*”), which may well be overly bureaucratic, and rules that regulate relationships within and between market participants, which may often be needed to set the limits within which parties may then operate freely. In particular, as BOFIs will typically be charged with the management of other people's money, we think that it will generally be appropriate to require all parties to observe the fiduciary rule on conflicts of interest that “*a person in a fiduciary position...is not allowed to put himself in a position where his interest and duty conflict*”<sup>4</sup> (our emphasis). This standard should apply not only to BOFIs themselves but to all persons providing services to them that have a bearing on their corporate governance.

Secondly, we would suggest that it is not helpful to speak of “*prescription*” in relation to a “*comply or explain*” regime such as the Combined Code, which by definition is not prescriptive because it allows the freedom not to comply. We note that the Review makes the distinction between prescriptive rules and “*comply or explain*” codes of best practice<sup>5</sup> but many of the respondents to the FRC's consultation did not do so. In our view, the correct question to be considered in relation to the Code is how specific it should be: as to that, although there is clearly a balance to be struck, we think that in general there is a good case for the Code to contain more detailed guidelines, against which compliance or non-compliance could more clearly be demonstrated or explained, as the case may be.

Thirdly, the Review goes on to say: “*So while some of the recommendations of this Review are*

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<sup>3</sup> Page 6

<sup>4</sup> *Bray v Ford* [1896] AC 44

<sup>5</sup> Paragraph 1.2, Page 19

*relatively prescriptive.....most set parameters within which there is need for judgement and flexibility*". We note that in some instances (discussed below) the Review considers the case for prescription in the form of primary legislation or regulation and that it either decides against this or recommends that any such action be postponed in order to allow voluntary arrangements to prove themselves.

Here again, we recognise the need for a considered approach and to beware the false logic of "*Something must be done/This is something/Therefore this must be done*". None the less, we think that the grave implications of any second financial crisis dictate that there be a readiness to embrace reforms, however radical, that offer a reasonable prospect of reducing the danger of a recurrence. Likewise, we think that there should be a presumption in favour of prescription where self-regulation has already had the opportunity to deliver the desired outcomes and has failed to do so: the severity of the threat to our economy and society suggests that we cannot afford the risk of allowing second chances.

Although the Review fully recognises both the damage caused by the financial crisis and the need to consider radical measures to prevent a recurrence,<sup>6</sup> we consider that in several key respects its conclusions underestimate the degree of prescription that is called for in response to this challenge.

We would, however, reiterate the point which we made in our FRC submission that even where we would prefer a prescriptive approach to a given problem, we would support changes to the Combined Code that would better address that problem and, to some degree, anticipate the regulation advocated.

## *(2) The Balance between Regulation and Risk*

The Review refers to the "*critical balance*" to be established between, on the one hand, necessary regulatory constraints and, on the other, the ability of a bank's board members to take decisions they consider to be "*in the best interests of their shareholders*". This sets the "*massive dislocation and costs borne by society*" as a result of the financial crisis, and the regulatory action needed to minimise the risk that any such crisis could recur, against "*any undue hampering of the ability of bank boards to be innovative and to take risks.... [which] .... would check the contribution of the banks to wider economic recovery and delay restoration of investor confidence in banking as a sector capable of generating reasonable returns for its shareholders*"<sup>7</sup>.

We consider that preventing a second financial crisis should weigh more heavily in the balance than encouraging innovation and risk-taking in a sector whose misplaced ingenuity and recklessness brought about the first crisis. This is especially so since most economies, including our own, are now in no condition to mount another taxpayer bail-out of the kind that narrowly prevented the complete collapse of the banking system. A second such crisis would therefore entail even more disastrous economic and social costs.

We agree that the banks have a crucial role to play in economic recovery but would suggest that this should lie in sustainable finance and prudent support for responsible borrowers, including sound small and medium-sized enterprises, amongst whom one might expect to find innovation and risk-

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<sup>6</sup> as in Paragraph 1.17, Page 24

<sup>7</sup> Page 6

taking of a more productive and less toxic kind.

Further, because of the banks' systemic role in the economy, it is particularly important that, when making decisions “*in the best interests of their shareholders*”, bank boards take fully into account their “*stakeholder*” duties under Section 172 of the Companies Act 2006, including the requirement to have regard to the likely consequences of any decision in the long term and the impact of the bank's operations on the community. (Whether these statutory provisions need strengthening, we consider below.)

We also agree that it is important that the banking sector be capable of generating reasonable returns for its shareholders (be they private or public), although only if at the same time the banks properly discharge their social functions, including support for business. There is, however, a wider dimension to investor confidence: pension funds and other institutions which have holdings across the investment spectrum have an interest and responsibility in preventing irresponsible behaviour by banks from destroying value not just in their bank shares but throughout their portfolios.

There is a more general point that we wish to make on the subject of risk. The Review recommends a significant upgrading of the risk management function within corporate decision-making and makes detailed suggestions as to how this might be achieved. As we indicate below in our responses to the specific Recommendations, we generally support these suggestions. This support is, however, subject to an overriding caveat, which relates to the difficulty of foreseeing or preventing future catastrophic events.

As the Review points out, “*there is a substantial toolbox of tried and tested techniques for the management and control of financial risk*” which should be drawn on to establish “*appropriate management and control processes.....But many of these processes relate to business models involving exposure to financial risks that can be reasonably dependably measured.....different and potentially much more difficult issues arise in the identification and measurement of risks where past experience is an uncertain or potentially misleading guide*”.<sup>8</sup>

The Review goes on to say that much of recent experience “*can be characterised as marking a failure by boards to identify and give appropriate weight to risks on which they had not previously focussed and which were therefore not captured in conventional risk management, control and monitoring processes*”<sup>9</sup>

The lesson that the Review draws from this analysis is that

“*Alongside assurance of best practice in the management and control of known and reasonably manageable risks, the key priority is for the board's overall risk governance process to give clear, explicit and dedicated focus to current and forward-looking aspects of risk exposure, which may require a complex assessment of the entity's vulnerability to hitherto unknown risks*”<sup>10</sup>

We fear, however, that this may be the wrong lesson. The category of unforeseen events referred to in the Review is that which has been labelled “*Black Swans*”<sup>11</sup> The Review does not give much explanation of quite how one is supposed to identify risks “*where past experience is an uncertain or*

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<sup>8</sup> Paragraph 6.6, Page 80

<sup>9</sup> Paragraph 6.7, Page 80

<sup>10</sup> *ibid*

<sup>11</sup> *The Black Swan: The Impact of the Highly Improbable*, Nassim Nicholas Taleb, Penguin, Allen Lane, 2007

*potentially misleading guide*” nor of why one should place confidence in the predictive power of “*a complex assessment of the entity's vulnerability to hitherto unknown risks*” when that assessment would have to grapple with the far more complex system that is the global economy. Indeed, the Review explicitly recognises that even if every effort is taken, including seeking external advice, there can be no guarantee that “*a wholly unforeseen fat-tail shock will not exert a significant negative impact on the entity at some future point*”.<sup>12</sup>

We are concerned that, in this particular respect, putting in place all the of risk management procedures that the Review recommends<sup>13</sup> could even prove counter-productive, as it might give rise to a misplaced confidence that the risks attaching to potential Black Swans were under control when in reality they were not. As Professor Nassim Nicholas Taleb and others have pointed out, there is a tendency to exaggerate forecasting abilities in this context:

*“Our inability to predict in environments subjected to the Black Swan, coupled with a general lack of awareness of this state of affairs, means that certain professionals, while believing they are experts are in fact not.”*<sup>14</sup>

Given these inherent uncertainties, we suggest that it would be more prudent to concentrate on putting the system in a better state to cope with the next fat tail shock when it arrives.

### *(3) The Balance between Short-term and Long-term Objectives*

#### *The Board*

The Review refers to the balance that needs to be found “*for both boards and shareholders, between short and long-term performance objectives*” and to the particular relevance of this balance to incentive structures and remuneration<sup>15</sup>. We agree, but with the qualification that, in relation to the board's statutory duty under Section 172 “*to promote the success of the company for the benefit of the members as a whole*”, the guiding principle should be the Government's expectation that “*for a commercial company, success will normally mean long-term increase in value*”<sup>16</sup> (our emphasis). Accordingly, whilst there will always be a need to attend to short-term objectives, these should be seen as a means to safeguarding the company's ability to attain its long-term objectives and not as a competing set of targets.

Although one of the main themes of the Review is the encouragement of long-termism, it found “*no practical way of harnessing such enhanced emphasis on the longer-term to greater specificity in statute than is currently provided in Section 172*”.<sup>17</sup> This view seems to be largely based on the assumption that any such statutory change would involve diluting the primacy of the duty of BOFI directors to shareholders in order to “*accommodate a new accountability to other stakeholders*” and that the likely consequences of this would include a shareholder exodus from the sector, a rise in the cost of capital for BOFIs, and the board being distracted from its key focus on “*monitoring risk and*

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<sup>12</sup> Paragraph 6.21, Page 86 (See also Paragraph 6.22.)

<sup>13</sup> e.g. in Paragraphs 6.13 & 6.14, Page 83

<sup>14</sup> *The Black Swan*, Taleb, 2007, Page xx

<sup>15</sup> Page 6

<sup>16</sup> Lord Goldsmith, Lords Grand Committee, 6 February 2006, *Hansard* column 255

<sup>17</sup> Paragraph 2.7, Page 31

*setting the risk appetite*”<sup>18</sup>.

Even if that argument be correct (which we do not necessarily accept), it overlooks the possibility that Section 172 could be usefully strengthened without departing from the principle that the company is to be run for the benefit of its shareholders. For instance, the section could be amended so as make it clear that the board's overriding duty is to promote the long-term success of the company, rather than, as at present, merely requiring them to have regard to, amongst other matters, the likely long-term consequences of any decision.

As another example, the existing requirement that the directors have regard to “*the impact of the company's operations on the community and the environment*” could be expanded to include specifically the impact on the integrity of the financial system and on the economy as a whole. This would tie in well with the greater focus on the control of systemic risk that was heralded in the Turner Review.<sup>19</sup>

We believe that there is also a strong case for further secondary legislation. In particular, we suggest that regulations should be made under Section 416(4) of the Companies Act 2006 to require directors' reports to state the policies which the company has in place to ensure that ESG-related risks and other longer-term considerations are monitored and managed and also to state the actions taken or planned in pursuance of such policies. This is the mechanism already envisaged for the reporting of companies' greenhouse gas emissions<sup>20</sup> and it would be consistent with that for it to be used in relation to other ESG matters. By virtue of Section 430 of the Act, this additional information, being in the directors' report, would be available on a public website. Such reporting would be beneficial for institutional and individual investors in encouraging assessment of the longer-term financial sustainability of the company.

In the particular context of BOFIs, amendments of the above kind could contribute to what we believe to be an urgent social requirement: ensuring that both the economic and environmental externalities generated by BOFIs are fully disclosed and controlled. In this context, we agree with the Review that a function of regulation is “*internalising the externalities involved in banking and other financial business, which , as is now painfully apparent, have been in recent experience massively negative for society as a whole*”<sup>21</sup> We think, moreover, that although the Review understandably focuses on the financial and economic consequences of the latest crisis, it is important to use this opportunity to reform both regulation and corporate governance so as to promote responsible long-termism that has regard also to wider social and environmental issues, including the increasing risks arising from climate change.

In this regard, we agree with the view of Professor Benjamin J. Richardson that

*“Financial institutions have systemically been remote to the environmental and social consequences underlying their decisions to provide corporate capital. Traditionally, financiers have not been held accountable for the downstream impacts of the transactions they fund.....Hence, we may legitimately construe financial institutions as unseen polluters, who wittingly or unwittingly contribute to environmental and social problems they sponsor and profit from.”*<sup>22</sup>

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<sup>18</sup> Paragraph 2.9, Page 31

<sup>19</sup> [www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf) - see especially pages 86 to 93

<sup>20</sup> Section 85(1)(a), Climate Change Act 2008

<sup>21</sup> Paragraph 1.3, Page 20

<sup>22</sup> *Socially Responsible Investment Law: Regulating the Unseen Polluters* , Richardson, Oxford University Press,

Accordingly, we think that statutory requirements in relation to BOFIs should explicitly provide for them to have regard to the social, economic and environmental impacts of the entities and projects that they finance.

Amendments of the kind suggested above would not necessarily entail any reduction in the role of the Combined Code and we therefore do not think that statutory changes and amplification of the Code should be seen as in any way mutually exclusive.

For all the above reasons, we therefore question the Review's conclusion that there is no scope for statutory amendment in this respect.

### *Shareholders*

We agree with the statement in the Review that “[a] core challenge is the agency problem, the seriousness of which is a direct function of the distance between owner and manager”.<sup>23</sup> We think, however, that in the present context “owner” has to be given a wider meaning than the institutional shareholder: it must extend to the individual end-beneficiaries, such as a pension fund members and life and pension policyholders.

This greatly increases the agency problem, as at every link of the investment chain there is the risk of misalignment of, on the one hand, the interests of the active market participants and, on the other, the interests of the generally passive and relatively powerless “ultimate owners”. It was mainly for this reason that in our FRC submission we laid such emphasis on the elimination of such conflicts of interest.

From this perspective, it is obvious that one cannot simply rely upon long-term institutional investors (or their agents) spontaneously to pursue the active engagement policies that market theory might suggest. Indeed FairPensions’ research on asset managers and UK occupational pension funds has produced strong evidence that many institutional investors do very little proactive engagement with companies to manage risks<sup>24</sup>. It is therefore necessary to identify the most effective ways to encourage them to do so, and in particular to decide in each case whether this should be achieved through regulation or self-regulation.

In this regard, we think that a striking and, we have to say, depressing aspect of the Review's criticisms of the culture of short-termism amongst many institutional investors and of inadequate engagement by long-only investors is how much these echo the words of the Myners Review,<sup>25</sup> published over eight years ago. This suggests that little, if any, progress has been made since then.

Thus the Review, referring to the “*greatly increased focus on short-term horizons*”, comments

*“Key elements here are the increased weight placed on full reporting of company performance on a quarterly basis, increasing short-term pressures on market valuations which inevitably feed back to the way in which chief executives and, by inference, their boards seek to run their businesses and the pressure exerted by relative benchmarks that have sharpened fund manager attention to short-*

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<sup>23</sup> Paragraph 1.11, Page 22

<sup>24</sup> [http://www.fairpensions.org.uk/fairpensions\\_pdf/FundManagerRanking08.pdf](http://www.fairpensions.org.uk/fairpensions_pdf/FundManagerRanking08.pdf)

<sup>25</sup> *Institutional Investment in the United Kingdom: a Review* Paul Myners, March 2001



term performance.”<sup>26</sup>

Yet, as the Review says,

*“There is...some evidence that a strategy of concentrated governance intervention can lead to abnormal returns against benchmarks.....the larger, long only funds such as life assurance and pension funds are likely to be owners of significant stakes in major companies over an extended period, consistent with the long term horizons of their business model (as in life assurance) or the underlying beneficiaries (as in pensions). The notion that consistently successful market timing of stock transactions outweighs any potential benefits from appropriate engagement activity seems highly improbable.”<sup>27</sup>*

The above quotations may be compared with the following similar statements in the Myners Review:

*“A further problem is that of timescales. The accusation that “the City is short-termist” has been around for a long time, under various guises. In the case of institutional investors, the culprit traditionally cited ....is the quarterly trustees' meeting, which leads to quarterly appraisal of managers. This in turn makes fund management firms' internal appraisal and monitoring systems focus strongly on short-term performance.”<sup>28</sup>*

*“The most powerful argument for intervention in a company is financial self-interest, adding value for clients through improved corporate performance leading to improved investment performance. One would expect that for institutional investors with long-term liabilities, such an approach to investing would appeal.”<sup>29</sup>*

We think it is significant that the Myners Review was followed by a sustained self-regulatory process on the part of the pensions industry which was designed to implement the Myners Principles (in their various incarnations), including those relating to active share ownership and transparency. This process is currently “owned” by the Investment Governance Group established after the last review of the Principles in 2008.

We consider that the Review's findings are evidence that self-regulation has been tried and found wanting in respect of shareholder engagement on long-term issues. As stated in our FRC submission, our own research confirms this picture.

We agree with Lord Myners' recent assessment that it is time to “break out of the current approach to shareholder engagement, which has made no real intellectual progress over more than a decade”.<sup>30</sup>

Consequently, we believe that there should be no further delay in regulating to promote engagement by long-term investors. We would suggest a two-pronged approach:

Firstly, institutional investors should be required to state publicly their policies on engagement with

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<sup>26</sup> Paragraph 1.12, Page 22

<sup>27</sup> Paragraph 5.16, Page 64

<sup>28</sup> Myners, 2001, Paragraph 51 Page 10

<sup>29</sup> *ibid*, Paragraph 5.76, Page 90

<sup>30</sup> *Financial Times*, August 13, 2009

investee companies on ESG matters and to report on the actions taken or planned to implement those policies, whether by the institutions themselves or by their fund manager agents under their mandates. In the case of listed institutions, this information could be included in the directors' report pursuant to regulations under Section 416(4) of the Companies Act, in the same way as is suggested above in relation to companies' internal policies. In the case of pension schemes, equivalent provisions could be inserted in the investment regulations (which already require schemes to state their policies (if any) on engagement),<sup>31</sup> and in the disclosure regulations (which are currently under review by the DWP).<sup>32</sup>

Secondly, there must be full disclosure of voting records. In our view, without such openness neither regulation nor best practice codes will achieve the desired results. As we said in our FRC submission, we consider that the reserve powers under Section 1277 of the Companies Act should now be exercised so as to require all institutional investors to disclose their voting records and to make these available on public websites.

A particular advantage of a mandatory approach in this context would be that it could provide for a universal standard of reporting which would permit much better comparative analyses of performance to be carried out by end-beneficiaries and other interested parties than is feasible under the current system. We think that the need for consistency here outweighs any advantages of the “flexibility” that the Review seeks to preserve under the “*comply or explain*” regime<sup>33</sup> (although there would be nothing to prevent institutional investors' providing any additional information or analyses which they considered appropriate).

For example, the current Myners Principle 5 (Responsible investment) recommends that a statement of the scheme's policy on responsible ownership should be included in the scheme's Statement of Investment Principles but adds nothing more specific than “*Trustees should report periodically to members on the discharge of such responsibilities*”. Likewise, Principle 6 (Transparency and reporting) merely states that “*Trustees should provide regular communication to members in the form they consider most appropriate*”.

Neither Principle contains any explicit mention of voting disclosure. There are only general accompanying references to the Institutional Shareholders' Committee's Statement of Principles, which is reproduced in Annexe 8 of the Review (“*the ISC Statement*”).

With best practice guidance that is so unspecific, it is hardly surprising that transparency is neither as common nor as consistent as it needs to be. This reinforces the case for a statutory solution.

We should also like to comment here on the suggestion made by Lord Myners, after the publication of the Review, that, because of the public interest case for increasing the influence over corporate governance of long-term investors, such investors might be accorded some form of preferential voting rights.<sup>34</sup> This idea has scarcely been greeted with universal acclaim and we appreciate the difficulties which it raises.

None the less, we were interested to note the comments on this topic made by Dr Roger Barker, Head of Corporate Governance at the Institute of Directors, in a recent letter to the *Financial*

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<sup>31</sup> SI 2005/3378

<sup>32</sup> SI 1996/1655 (in relation to occupational schemes)

<sup>33</sup> Paragraph 1.25, Pages 26 & 27

<sup>34</sup> *Financial Times*, August 13, 2009

*Times*<sup>35</sup>. As Dr Barker pointed out, if Lord Myners' proposal encouraged a concentration of voting power with more active investors, then

*“As in a private equity ownership situation, greater effective control would provide such investors with a strong incentive to engage actively with boards in the interests of shareholder value creation”.*

As the phenomenon of the “ownerless corporation” is such a serious threat to long-term engagement, we agree with Dr Barker that Lord Myners' suggestion should be given more serious consideration.

#### *(4) International Regulation and UK Competitiveness*

The Review states that “*solid progress*” towards “*international convergence in corporate governance standards.....should be an urgent and high priority for the Treasury and the FSA*”<sup>36</sup>. We agree, sharing as we do the widespread view that there is a pressing need for worldwide institutions and arrangements to be put in place for the better regulation of entities that are transnational or are able to migrate easily between jurisdictions.

As stated in the Review<sup>37</sup>, an important related question is whether, in the absence of adequate international measures, domestic reform of remuneration (for example, of the kind suggested in the Review) could threaten the UK's competitive position in financial services, with the companies or individuals affected being attracted to laxer regimes. We note with concern the FSA's recent assessment of the limited progress that has so far been made in this regard and how that has influenced the softening of the original proposals for their Remuneration Code, which were referred to in the Review.<sup>38</sup>

In our opinion, this threat should not be allowed to deter reform. Generally, we share Sir David's own reported view that

*“If we are driving people away from London with the types of standards I am proposing, you have to question whether we would want to keep them anyway.”*<sup>39</sup>

Our primary reason for agreeing with this is not the (well-founded) public disapproval of excessive or perverse remuneration but our apprehension that the short-term benefits of any further earnings and tax receipts from the kind of high-risk, short-term practices of which such pay structures are both a cause and a symptom would, as before, be negated in a second financial collapse.

As to the related debate that is now taking place over whether there is an optimum size for the financial services' sector in the UK economy and whether, within the sector, distinctions should be made between what are judged to be more or less socially useful activities,<sup>40</sup> our general view is that

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<sup>35</sup> *Financial Times*, August 19, 2009

<sup>36</sup> *The Review*, Page 7

<sup>37</sup> For instance, in paragraph 1.26, page 27

<sup>38</sup> Paragraphs 7.3 to 7.7, pages 91 & 92

<sup>39</sup> *The Sunday Times*, 19 July 2009

<sup>40</sup> e.g. Lord Turner's remarks in *Prospect* magazine, September 2009, pages 32 -41 (and see equally the comments of the other participants in that discussion)

the key question is not the size of the sector but the precise nature of its activities. We think that question itself raises the issue of how to make the actors in the sector subject both to a true and open market which responds to the real needs of the rest of society and to a proper degree of regulation in the public interest. We also think that for the future a central role for the financial sector, as for other sectors, is to contribute to the building of a truly sustainable economy, having regard in particular to the challenge of climate change. This should give ample scope for socially useful financial innovation.

#### 4. Comments on the Review's Specific Recommendations

##### ***Board size, composition and qualification***

###### ***Recommendation 1***

***To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development, to be reviewed annually with the chairman.***

We agree.

This recommendation is particularly relevant to the tension between independence and experience which the Review identifies: one of the reasons for increasing diversity on boards is to bring in fresh perspectives and combat “*groupthink*”, yet an NED who lacks knowledge of the enterprise will be unable to contribute usefully to discussions or to challenge the executive effectively, even if he or she has the requisite qualities of character and independence.

The most thorough and rigorous induction programme, followed by further training and development, is so important a part of the solution to this problem that we would suggest that consideration be given to the banking industry (and other BOFIs) making more of a collective effort to organise formal training sessions for potential and recent recruits to the ranks of NEDs.

This would have the further advantage of giving tangible proof of the industry's real commitment to diversity and should encourage more candidates to apply. In other words, it could be a component in an “outreach” programme for NEDs.

An industry-wide training scheme could also help counteract any tendency for individual inhouse induction and development programmes to be “captured” by the executive, which could undermine the objective of fostering constructive challenge on the part of the NEDs.

Naturally, we are not suggesting that such external programmes would be in any way a substitute for enterprise-specific induction and development, merely that they could be a useful supplement.

###### ***Recommendation 2***

***A BOFI board should provide dedicated support for NEDs on any matter on which they require advice separate from or additional to that available in the normal board process.***

We agree. This is clearly supportive of the NEDs' independence and was called for in our FRC submission.

### ***Recommendation 3***

***NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere.***

We agree that a greater time commitment is appropriate but have some concerns that even the increased minimum days suggested may still be too little. We have in mind in particular the case of recently appointed NEDs who have been recruited more on the grounds of their personal qualities than for extensive previous experience. Inevitably, to some extent such recruits will initially have to “learn on the job” before they can make their full contribution but it is clearly in everyone's interests that their learning curve be as steep as possible. We would therefore suggest that in such cases consideration be given to requiring a greater time commitment for a suitable period after their first appointment.

It would be necessary to balance any such special requirement against the imperative of encouraging rather than deterring new recruits but this should not be a serious problem if, for example, the initial time commitment were about double that suggested in the Review.

In this context, we would refer to the endorsement in our FRC submission of the suggestion in a recent *Financial Times* editorial that the FRC review of the Code offers an opportunity for a voluntary time-limited quota to achieve at least 30 per cent female directors of listed companies within ten years, using the “*comply or exchange*” mechanism to require companies with a lower proportion to explain if they proposed to fill a vacancy with a man. Since then, research carried out by The Co-operative Asset Management has revealed that women occupy only 242 out of 2,742 seats on the boards of FTSE 350 companies, with the five banks covered in the survey having one executive director and six NEDs out of a total of 70 seats.<sup>41</sup>

We do not think that sufficient attention has been paid to the anomaly that, on the one hand, a common explanation of the under-representation of women in senior echelons is that, because of family commitments, they are more likely to take career breaks or opt for part-time work during critical periods in their careers and yet, on the other hand, they are at least as under-represented in non-executive directorships, which are the quintessential part-time job, and which will remain so even with the proposed increased time commitments. This suggests that other factors are at work, including entrenched attitudes which need to change.

Given that there must be many women not currently in full-time work who possess relevant professional qualifications and / or business experience (even if at sub-board level) and who would be able to make the necessary time commitment, this would seem to be the most obvious group in which to find some of the new NEDs who will be needed to make up for the likely reduction in the number of non-executive directorships that any one individual will be able to hold if this Recommendation is adopted.

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<sup>41</sup> *The Observer*, 23 August 2009

#### **Recommendation 4**

***The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberations, above all on risk strategy.***

We agree. If any industry-wide programmes of the kind suggested in our comments on Recommendation 1 were established, it would be appropriate for the FSA to have an oversight role over these, in view of its general supervisory function in this regard.

#### **Recommendation 5**

***The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.***

We agree.

#### **Functioning of the board and evaluation of performance**

##### **Recommendation 6**

***As part of their role as members of a unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.***

We agree with this Recommendation, as will everyone. We also agree with the Review's suggestion that this readiness to challenge should be incorporated in the letter of appointment and serve as a guidance in the FSA authorisation process.<sup>42</sup>

We remain concerned, however, that further measures are needed to convert this aspiration of constructive challenge into reality. As the Review points out, this principle is already very clearly stated in the Code but this was not enough to secure its observance in some of the key BOFI board decisions taken in the build up to and during the recent crisis.<sup>43</sup>

In this connection, we would refer to the suggestions in our FRC submission relating to the changes which we believe should be made to the Code in order to tighten the criteria for independent NEDs

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<sup>42</sup> Paragraph 4.11, Page 51

<sup>43</sup> Paragraphs 4.9 & 4.10, Page 51

and to strengthen their position relative to the executive directors. We do not agree with the view that structural changes of this kind are less important than behavioural changes: on the contrary, we remain convinced that structural changes can have an important influence on behaviour.

#### ***Recommendation 7***

***The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with the clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.***

In view of the many and heavy responsibilities of the chairman, as detailed in the Review, we think that there is a strong case for the role to be generally expected to be full-time, especially in the case of a FTSE 100 BOFI. Given the public interest dimension in the activities of BOFIs, we think that part-time chairmanship might well be seen as inappropriate, particularly in the wake of the latest crisis.

In any event, if the chairmanship is to take priority over other any other business time commitment, this should rule out the holding of any other directorship of a listed company, as it is hard to see how the chairman would be in a position to guarantee the requisite commitment and availability to discharge the responsibilities of that role.

#### ***Recommendation 8***

***The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.***

We agree.

#### ***Recommendation 9***

***The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.***

We agree.

#### ***Recommendation 10***

***The chairman of a BOFI board should be proposed for election on an annual basis.***

As we said in our FRC submission, we believe that all board members should be subject to annual re-election.

### ***Recommendation 11***

***The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.***

We agree.

### ***Recommendation 12***

***The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate. Where an external facilitator is used, this should be indicated in the statement, together with an indication of whether there is any other business relationship with the company.***

Our comments on this Recommendation are combined with those on Recommendation 13, below.

### ***Recommendation 13***

***The evaluation statement should include such meaningful high-level information as the board considers necessary to assist shareholders' understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.***

We support the principle of evaluation and, in particular, of external evaluation. We also agree with the indicative questions to be addressed in the evaluation that are set out in Appendix 5 to the Review. We consider, however, that Recommendations 12 and 13 are inadequate in several respects.

Firstly, we think that in no circumstances should the external evaluator have any other business relationship with the company or be permitted to have one for a substantial period (at least five years) after the evaluation. The importance of the evaluation for board members and the extreme sensitivities involved would constitute a completely unacceptable conflict of interest.

Secondly, and for similar reasons, we think that the external evaluator should not be appointed by the board but by the shareholders, normally on the recommendation of the corporate governance committee.



Thirdly, we note that the Review rejects any immediate adoption of the proposal that the external evaluator should attest the accuracy of the evaluation statement in the annual report.<sup>44</sup> We disagree: this would be an essential safeguard in an area where the board members could have a clear conflict of interest. Moreover, where the statement in the annual report contains a statement, in the words of the Review, “*that necessary actions have been or are being taken to remedy any material weaknesses identified in the evaluation process*”<sup>45</sup> the evaluator's attestation should confirm whether, in the evaluator's opinion, the measures in question are appropriate and adequate.

Fourthly, we also note that the Review rejects the suggestion that there be provision “*for an advisory vote on the evaluation statement which would provide an opportunity for voting to take note of the statement or, if shareholders had concerns, to signal their dissatisfaction*”. This rejection is on the grounds that the introduction of the evaluation statement will be “*a significant step in itself*”<sup>46</sup> and, taken together with the annual election of the chairman, is enough change to be going on with. We find this argument unconvincing and we favour the immediate introduction of provision for an advisory vote on the evaluation statement.

### ***The role of institutional shareholders: communication and engagement***

#### ***Recommendation 14***

***Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for the changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.***

We agree.

#### ***Recommendation 15***

***In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board a indication of whether and how it proposes to respond.***

We agree.

#### ***Recommendation 16***

***The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles of Stewardship.***

We agree. In our FRC submission we called for the existing section 2 of the Combined Code,

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<sup>44</sup> Paragraph 4.31, Page 58

<sup>45</sup> Paragraph 4.28, Page 58

<sup>46</sup> Paragraph 4.29, Page 59

relating to institutional shareholders, to be expanded so as to give equal attention to these entities as to listed companies. We think, however, that the Review's suggestion of two separate codes is preferable, provided that the proposed Principles of Stewardship are not subject to a softer regime than the renamed Corporate Governance Code and that, in particular, there is a full “*comply or explain*” system.

If, as we hope, the FRC takes on this additional role, we think that it will be important for the personnel of the FRC, including the committees charged with overseeing the development and operation of the Principles, to include representatives of the “*ultimate owners*” of the assets under management, such as pension fund beneficiaries and life assurance policyholders. This would help to ensure a public interest perspective on the “*agency problem*” and to counter any risk of regulatory capture by the various intermediate interests in this field. We suggest, therefore, that consideration be given at an early stage to the mechanisms whereby this might be achieved. Possibilities might include representatives of consumer groups and of trade unions, member-nominated pension scheme trustees, and, not least, individual scheme members and policyholders.

### ***Recommendation 17***

***The present best practice “Statement of Principles – the Responsibilities of Institutional Shareholders and Agents” should be ratified by the FRC and become the core of the Principles of Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.***

Our comments on this Recommendation are combined with those on Recommendation 18.

### ***Recommendation 18***

***The ISC, in close consultation with the FRC as sponsor of the principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.***

We agree in principle that the FRC should sponsor a code governing the responsibilities of institutional shareholders. Indeed, this could be seen as implicit in Recommendation 16. We have, however, substantial reservations about the particular procedure that is envisaged here.

Firstly, we do not think that the current ISC Statement should necessarily be assumed to be a fully satisfactory basis for the Principles of Stewardship. In particular, we consider that the principles are inadequate in relation to ESG matters. (In this context, it is perhaps noteworthy that the Statement of Principles does not even refer to long-termism.) In this connection, we would suggest that much could be learnt from the United Nations Principles for Responsible Investment, to which many UK institutional investors are already signatories and accordingly subject to the UNPRI's own “*comply or explain*” regime.<sup>47</sup> We hope, therefore, that the FRC will approach the drawing up of the Principles of Stewardship with an open mind and that it will not simply adopt the ISC Statement, at least in its present form.

Secondly, we believe that the FRC should assume full responsibility and control of the Principles of Stewardship and that the ISC should not play a continuing formal role. We think that Lord Myners

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<sup>47</sup> The Principles and a full list of signatories are on the website [www.unpri.org](http://www.unpri.org)

recently raised a fundamental question when he remarked

*“I find myself wondering whether a body funded by and controlled by industry trade bodies and without a budget or a permanent secretariat is the best model”<sup>48</sup>*

We consider that in view of the conflicts of interest to which the ISC will inevitably be subject, given its constituent members, it is not appropriate that it be involved in a quasi-regulatory capacity.

### ***Recommendation 19***

***Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.***

As we have said earlier in this submission, we believe that reporting on engagement should now be placed on a statutory basis. Until such time as that is the case, however, we support this Recommendation. We suggest, furthermore, that where the FSA considers that an institution which has committed to the Principles has consistently failed to observe them, there should be a recognised procedure for requiring the institution to signify this on its website. Names of these institutions should also be posted on the FSA's own website. This would prevent institutions from deriving an unfair market advantage by associating themselves with the Principles without implementing them. (This would to some extent mirror the expulsion procedure under the UN PRI.).

### ***Recommendation 20***

***The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all the institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a “comply or explain” basis.***

We agree, and think that The Pensions Regulator (which chairs the Investment Governance Group) should also encourage commitment to the Principles of Stewardship amongst the community it regulates.

### ***Recommendation 21***

***To facilitate effective collective engagement, a Memorandum of Understanding should be***

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<sup>48</sup> Speech to Investment Management Association, 19 May 2009, Paragraph 34 [http://www.hm-treasury.gov.uk/speech-fsst\\_190509.htm](http://www.hm-treasury.gov.uk/speech-fsst_190509.htm)

*prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate, to the Memorandum of Understanding on collective engagement.*

We agree. We think that the recruitment of foreign long-only investors to the cause of better corporate governance and, indeed, international regulation is of the utmost importance. As stated in our FRC submission, we think the code (or now, Principles of Stewardship) should give specific encouragement to collaborative engagement.

#### **Recommendation 22**

*Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.*

As already stated, we believe that this should now be dealt with under the reserve powers in the Companies Act but, as in the case of Recommendation 19, in the absence of legislation, we would support this Recommendation. We would, however, reiterate the need for a universal common form of disclosure in order to facilitate comparative analysis.

#### **Governance of risk**

#### **Recommendation 23**

*The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of England and other authoritative sources that may be relevant for the risk policies of the firm.*

We agree but subject to the caveat, which we have already expressed, that attempts to predict Black Swans are likely to prove futile and that this should always be taken into account in any assessment of the degree of risk to which the BOFI is exposed.

#### **Recommendation 24**

*In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would*

***require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.***

We agree.

#### ***Recommendation 25***

***The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.***

We agree.

#### ***Recommendation 26***

***In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.***

We agree, although it is a mark of the reckless incompetence of some recent corporate behaviour that so obvious a recommendation needs to be made.

#### ***Recommendation 27***

***The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and progress of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.***

We agree. We do not, however, agree with the Review's rejection of the suggestion that there be an advisory shareholder resolution on the risk report on the grounds that "experience and time is needed for the development of such separate reporting" and that the question of an advisory resolution "can and should be reviewed later"<sup>49</sup>. In view of the central importance of risk control, we believe that there should be immediate provision for an advisory resolution. Furthermore, we consider that if shareholders reject the risk report the chairman of the risk committee should resign.

#### ***Remuneration***

#### ***Recommendation 28***

***The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.***

We agree.

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<sup>49</sup> Paragraph 6.29, Page 89

### **Recommendation 29**

***The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year, exceeds or might be expected to exceed the median compensation of executive board members on the same basis.***

We agree. Our FRC submission called for the remit of the remuneration committee to be extended to senior executives.

### **Recommendation 30**

***In relation to executives whose remuneration is expected to exceed that of the median of executive board members, the remuneration committee should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.***

We agree.

### **Recommendation 31**

***The remuneration committee report should disclose for “high end” executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.***

We agree. The names of the individuals falling in each band should also be disclosed.

### **Recommendation 32**

***Major FSA-authorized BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of “high-end” executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of “high end” remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.***

We agree.

### **Recommendation 33**

***Deferral of incentive payments should provide the primary mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that a least one-half of variable remuneration offered in respect of a financial year is in the form of a long-***

***term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.***

As will be apparent from our FRC submission, we agree that remuneration should be structured so as to be aligned with the long-term interests of the company. We have, however, a number of concerns about this Recommendation.

Firstly, although we accept that deferral should be the primary mechanism for this purpose, we wish to comment on the more general statement of policy that

*“This Review makes no proposal that levels of remuneration should be capped; the focus throughout is on the structure of remuneration, provisions for deferment, appropriate linkage to performance and fuller disclosure”.*<sup>50</sup>

The Review apparently concludes that this is all that needs to be said on the question of the quantum of pay, as distinct from its structure. We would question this. Ultimately, the cost of all the remuneration received, in whatever form, by all the professionals in and around the investment chain is borne by the ultimate owners, including taxpayers, pension scheme beneficiaries and policyholders. It is therefore a matter of public interest whether these earnings are subject to the discipline either of a true market or of effective regulation or whether, on either of those measures, they are excessive. Institutional shareholders have a key fiduciary responsibility in this context to monitor and influence the levels of remuneration in their investee companies, as is further discussed below under Recommendation 36.

Secondly, we would suggest that the absolute amount of remuneration could affect the efficacy of partial deferral as an incentive for long-termism. For example, if a BOFI employee receives very high short-term pay over a number of years, one might expect that any deferred element would have less influence over his or her behaviour.

Thirdly, as we said in our FRC submission, a deferral period of three years seems far too short, when measured against the timescales of typical long-only investors. Similarly, even a five year deferral cannot be said to represent long-termism. We think that there is a case for much longer deferral, perhaps more akin to pension entitlements. This could have the further advantage that if the relevant performance criteria were not met, the withheld benefits could simply be forfeited, which is a far more practicable mechanism than clawback.

#### ***Recommendation 34***

***Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than***

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<sup>50</sup> Paragraph 7.1, Page 90

*on compassionate grounds.*

We agree.

### **Recommendation 35**

***The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and the NEDs on the board.***

We agree.

### **Recommendation 36**

***If the non-binding resolution on a remuneration committee report attracts less than 75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.***

We suggested in our FRC submission that where shareholders reject the remuneration report in respect of directors or senior management, the chairman of the remuneration committee should resign. As already mentioned, our FRC submission called for the annual re-election of all directors.

We also proposed in our FRC submission a statutory change to make the shareholders' advisory vote on remuneration binding (and that in the meantime the Code should provide that the vote should be treated as binding). We note that the Review rejects the idea of such a change, on the ground that the remuneration report “relates to effectively contractual commitments given to executives within the framework of a policy already implicitly or explicitly approved by shareholders”.<sup>51</sup>

We do not accept that this is an insuperable barrier to reform. For example, it could be provided that all such contractual commitments were subject to shareholder confirmation; appropriate provisions for adjustment in the event of shareholder approval being withheld could also be devised. In any case, if the remuneration in question were clearly within the framework already approved by shareholders, it is presumably unlikely that it would be rejected; it is when this is not so apparent that there is likely to be concern. In this context, we think that the Code should provide for exceptional individual pay packages to be put to shareholders for approval wherever practicable.

### **Recommendation 37**

***The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.***

There should be complete transparency in relation to pension and other benefits, including, as we said in our FRC submission, full disclosure of their cost to the company where this is not immediately obvious. This transparency should extend to the naming of the individuals in question.

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<sup>51</sup> Paragraph 7.22, Page 99



### **Recommendation 38**

***The remuneration consultants involved in the preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.***

Our comments on this Recommendation are combined with those on Recommendation 39.

### **Recommendation 39**

***The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.***

In view of the widespread concern at the harmful influence of remuneration consultants for the reasons detailed in the Review,<sup>52</sup> we agree that there is a need for a code of practice. We consider, however, that the proposals outlined in Recommendations 38 and 39 are unsatisfactory for several reasons.

Firstly, we think that the proposals envisage an unacceptable degree of self-regulation, which is unlikely to serve the public interest. We do not think that it is self-evident that “*For it to be fully effective, the code needs to be “owned” by those who prepared and are committed to it*”.<sup>53</sup> We therefore suggest that, instead of the code's merely being “*deposited with and available on the website of the FRC, with the listing of consulting firms that have committed to it*”,<sup>54</sup> the FRC should assume responsibility for the code and should regulate it on a similar basis to that outlined in our response to Recommendation 18 in relation to the Principles of Stewardship.

Secondly, as stated in our FRC submission, we think that remuneration consultants should report exclusively to the remuneration committee and /or the shareholders.

Thirdly, as suggested above in relation to board evaluators, we think that remuneration consultants should be appointed by the shareholders, normally on the recommendation of the remuneration committee.

Fourthly, again as suggested in respect of evaluators and as stated in our FRC submission, we believe that the entity to which the remuneration consultants belong should have no other business connections with the company.

Finally, on the question of the integrity of the consultant's advice, the Review identifies the problem that “*in the remuneration area....rumour, speculation and obscurity seem to abound*”<sup>55</sup>. The disclosure of individual executive's remuneration, as suggested in our response to Recommendation 31, should eliminate that problem.

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<sup>52</sup> Paragraphs 7.34 & 7.35, Pages 103 & 104

<sup>53</sup> Paragraph 7.37, Page 104

<sup>54</sup> Paragraph 7.37, Page 105

<sup>55</sup> Paragraph 7.36, Page 104

***Submission to the Financial Reporting Council's Review  
of the Effectiveness of the Combined Code***



**May 2009**

**Contact Details:  
Catherine Howarth  
FairPensions (Fairshare Educational Foundation)  
Trowbray House  
108 Weston Street  
London SE1 3QB  
United Kingdom  
Tel: +44 20 7403 7827  
[catherine.howarth@fairpensions.org.uk](mailto:catherine.howarth@fairpensions.org.uk)**

## ***Submission to The Financial Reporting Council's Review of The Effectiveness of the Combined Code***

### **1. About FairPensions**

FairPensions is pleased to have this opportunity to make this submission to the consultation paper entitled “Review of the Effectiveness of the Combined Code” issued by the Financial Reporting Council (“The Consultation Paper”).

FairPensions is the operating name of Fairshare Educational Foundation, a registered charity<sup>56</sup> that aims to persuade UK pension funds and fund managers to adopt an effective responsible investment (“RI”) capability and to monitor and manage environmental, social and governance (“ESG”) risks.

RI requires the integration of ESG considerations into investment policy. For this purpose, investment policy includes engagement with investee companies i.e. shareholder activism through dialogue, reinforced by the potential exercise of shareholder powers.

FairPensions believes that RI practices help to safeguard investments and to promote better corporate governance, as well as securing other environmental and social benefits.

FairPensions is supported by a number of leading charities and trade unions, including ActionAid, CAFOD, Community, CWU., ECCR, EIRIS, GMB, NUJ, Oxfam, Traidcraft, Unison, Unite and WWF. We are also supported by almost 5,000 individuals.

Further information about FairPensions and about our approach to RI can be found on our website.<sup>57</sup>

### **2. Executive Summary**

#### **General Comments**

***(1) This submission focusses on suggested changes to the Combined Code designed to encourage corporate responsibility on the part of companies and responsible investment on the part of institutional shareholders. These changes would also improve governance standards in general.***

***(2) The current financial crisis has revealed severe shortcomings amongst company boards and institutional shareholders alike. The starting point of any review of the Code should therefore be a recognition of these failures and a readiness to consider any changes which might help prevent such mistakes recurring.***

***(3) It is important that the question of governance be dealt with in a consistent manner across the entire investment chain, from the boards of investee companies, through the fund managers and their institutional clients and on to the “ultimate owners”, the beneficiaries of pension schemes and other individuals who have entrusted their savings to the market.***

***(4) Under such an integrated approach, the overriding objective should be to align the interests of the various participants with the long-term interests of the company and of its ultimate owners. This requires in particular (i) the elimination of any structural conflicts of interest and (ii) the greatest possible transparency at every level, so that the performance***

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<sup>56</sup> Registered charity number 1117244

<sup>57</sup> [www.fairpensions.org](http://www.fairpensions.org)

*of all parties can be monitored and, where necessary, improved.*

### **Specific Suggestions**

#### **Section 1 of the Code: Companies**

*(5) The provisions of the Code relating to independent non-executive directors should be amended so as to tighten the criteria for independence and so as to strengthen their position relative to the executive directors*

*(6) The provisions relating to multiple directorships should be tightened.*

*(7) The Code should contain further guidelines in respect of the level of expertise on the board*

*(8) There should be specific targets in the Code to encourage more diversity amongst directors.*

*(9) The Code should contain further provisions to equip non-executive directors with adequate resources; institutional shareholders could be encouraged to provide such resources.*

*(10) The Code should recommend that all directors submit to annual re-election.*

*(11) There should be changes to the guidelines on remuneration so as (i) to increase the influence of shareholders and the accountability of the remuneration committee and (ii) to reward long-term and responsible practices.*

*(12) Consideration should be given to prohibiting auditors from carrying out non-audit work. There should be an advisory shareholder vote on the report of the audit committee*

*(13) The provisions relating to the board's relations with shareholders should recommend a more structured process for dialogue and give greater emphasis to the role of the independent non-executive directors.*

#### **Section 2 of the Code: Institutional Shareholders**

*(14) This section of the Code should be expanded so as to be of comparable length and detail to Section 1, in recognition of its importance in the overall promotion of corporate governance.*

*(15) Important areas to be covered include (i) changing the prevalent culture of short-termism in relation to investment performance (ii) promoting active share ownership, including coordination between shareholders and (iii) promoting transparency in relation to investment and engagement activities, including that between pension scheme trustees and their beneficiaries and that between fund managers and their trustee clients.*

*(16) In view of the imminent publication of the ISC's review of the financial crisis, we look forward to having an opportunity to comment separately on the review, especially in relation to any revisions to the ISC statement of principles, to which the Code currently refers.*

### **3. General Comments**

#### **3.1 Scope of this Submission**

Most of FairPensions' research and campaigning has focussed on the role of pension schemes as institutional investors. (For this purpose, we include not only trust-based occupational schemes but also the providers of contractual personal pension arrangements, such as insurance companies.) We therefore particularly welcome the FRC's request for views on the content and effectiveness of Section 2 of the Code relating to institutional shareholders, especially as this currently consists of a mere two pages, whereas Section 1, relating to companies, runs to sixteen pages, a disparity which we hope is now to be corrected.

None the less, we wish to comment also on such of the provisions of Section 1 of the Code as we think have a bearing on RI. We would emphasise that, in our view, the suggestions that we make below would also improve corporate governance not just in relation to RI but also more generally, since all the proposed changes are designed to promote the long-term interests of the company.

In compiling this submission we have had regard to various recent public analyses and suggestions in relation to the current financial and economic crisis and in particular to the indications of Government thinking afforded by some recent speeches of Lord Myners.

### 3.2 A Presumption for Change

Although it is acknowledged that the review of the Code has been occasioned by the banking crisis and the resulting recession, paragraph 6 of the Consultation Paper states that *“there is no assumption that the Combined Code is fundamentally flawed, or that a different regulatory framework for corporate governance could have prevented some of the current problems”*.

We would, however, suggest that the review should start with the presumption that significant changes are likely to be needed. The Code covers the respective roles of company boards and institutional shareholders in corporate governance and it is widely recognized that in both cases there have been severe failures that have contributed to the present problems. For example, the most recent Treasury Select Committee report on the banking crisis found that :

*“The current financial crisis has exposed serious flaws and shortcomings in the system of non-executive oversight of bank executives and senior management in the banking sector.”<sup>58</sup>*

and that:

*“Institutional investors have failed in one of their core tasks, namely the effective scrutiny and monitoring of the decisions of boards and executive management in the banking sector, and hold them accountable for their performance.”<sup>59</sup>*

We would also refer here to the recent remarks of Lord Myners that:

*“In the past year and a half , shortcomings in a number of areas have become clear:*

*Failures in the boards of our banks – whether through incompetence or poor practice.*

*Failures in companies' understanding and oversight of risk management.*

*Failures to exercise effective control over remuneration policies, so as to prevent excessive risk taking or activities inconsistent with corporate well-being.*

*And failures by institutional investors to adequately scrutinise and monitor the decisions of boards*

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<sup>58</sup> *Banking Crisis: reforming corporate governance and pay in the City* 15 May 2009, page 107, paragraph 24

<sup>59</sup> *ibid* page 108, paragraph 29

*and executive management and hold them accountable for their performance.*<sup>60</sup>

As to whether a better corporate governance framework could have prevented some of the current problems, we would again quote Lord Myners:

*“The OECD has stated – and I agree with them – that while corporate governance deficiencies were not the sole or direct cause of the financial crisis, they undoubtedly facilitated, or did not prevent, practices that resulted in misjudgement, poor performance and failure to anticipate risk.”*<sup>61</sup>

It could be argued that these corporate governance problems were not attributable to shortcomings in the Code but to non-compliance with its guidelines, or, as Lord Myners expressed it (in the context of the duties of institutional investors):

*“I don't believe that the recent major corporate failures we have seen are representative of a problem with our principles of corporate governance - which are respected internationally. Rather, they are a result, frankly, of failures to do what is required by the principles in a professional way that acknowledges the responsibility of investors to their clients and beneficiaries.”*<sup>62</sup>

Even this reading of events, however, points to the need for a more effective mechanism to enforce the principles of the Code. If that mechanism were to be a strengthened version of “*comply or explain*”, this would imply more specific guidelines in the Code, against which compliance (or non-compliance) could more easily be demonstrated. The alternative approach, based on more mandatory regulation, would likewise require more detailed provisions.

Although there are some features of banking, and especially investment banking, that distinguish it from other sectors (e.g. a more prevalent bonus culture and the esoteric complexity of some of the activities that led to the crisis), there can be little doubt that the governance failings that have been exposed have more general relevance. As Lord Myners put it, in referring to Sir David Walker's review on bank governance:

*“It is of course fair to assume that the recommendations in Sir David's review... will have wider resonance in the field of corporate governance. This is particularly the case in respect of the work he will be doing on the role of institutional shareholders.”*

We are therefore pleased that the Government has now extended Sir David's terms of reference so that his review can also identify where its recommendations are applicable to other financial institutions.

### 3.3 The Need for an Integrated Approach to Governance

It is important that the question of governance be dealt with in a consistent manner throughout the investment chain, from the boards of investee companies, through the fund managers and their institutional clients and on to the “ultimate owners”, who will often be the beneficiaries of pension schemes or other individuals who have entrusted their savings to the market.

Under such an integrated regime, the overriding objective should be to align the interests of the various participants with the long-term interests of the company and of its ultimate owners. This requires in particular (i) the elimination of any structural conflicts of interest at each level and (ii) the greatest possible transparency between all parties, so that the performance of all actors can be monitored and, where necessary, improved. The specific suggestions for changes to the Code that are made below are mainly intended to give effect to these two imperatives.

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<sup>60</sup> Speech to the NAPF Annual Investment conference, 12 March 2009, paragraph 9, [http://hm-treasury.gov.uk/speech\\_fsst\\_120309.htm](http://hm-treasury.gov.uk/speech_fsst_120309.htm)

<sup>61</sup> *ibid*, paragraph 10

<sup>62</sup> *ibid*, paragraph 22

We believe that this unified approach requires that, in the exercise of their powers as shareholders, institutional investors should be guided by “*stakeholder*” fiduciary principles similar to the duties of company directors that are set out in section 172 of the Companies Act 2006, that is, to have regard (amongst other matters) to:

- “(a) *the likely consequences of any decision in the long term,*
- (b) the interests of the company's employees,*
- (c) the need to foster the company's business relationships with suppliers, customers and others,*
- (d) the impact of the company's operations on the community and the environment,*
- (e) the desirability of the company maintaining a reputation for high standards of business conduct, and*
- (f) the need to act fairly as between members of the company”.*

Moreover, in relation to the directors' overriding statutory duty “*to promote the success of the company for the benefit of the members as a whole*”, the Government's expectation that “*for a commercial company, success will normally mean **long-term** increase in value*”<sup>63</sup> (emphasis added) should also be read across to institutional investors.

In due course, we should like to see this definition of institutional investors' duties enshrined in legislation but in the meantime we see no reason why it should not be reflected in guidelines such as the Code: as it can be justified on the grounds of enlightened shareholder value, there should be no conflict with established legal principles either in the case of trust-based pension schemes or of insurance companies and other contractual providers. As the original Myners review put it:

*“The most powerful argument for intervention in a company is financial self-interest, adding value for clients through improved corporate performance leading to improved investment performance. One would expect that for institutional investors with long-term liabilities, such an approach to investing would appeal”.*<sup>64</sup>

Indeed, the case for long-termism is even more compelling in relation to pensions schemes and similar investors than in relation to individual companies. This is not only because of their long-term liabilities, referred to in the above quotation, but also because, being typically “*universal owners*” with interests across the entire investment spectrum, they have even less to gain, and even more to lose, from short-term, unsustainable business models. Such models may derive much of their profits from the off-loading of externalities onto other sectors in which the schemes are also invested. They may further cause more general economic or environmental harm, to the long-term detriment of scheme beneficiaries. The widespread destruction of value in pension fund assets brought about by the reckless destabilisation of the financial system is a salutary example of this vulnerability.

#### 4. Specific Suggestions

In this part of the submission, we wish to make some specific suggestions for changes to the Code in order to give effect to the principles outlined above. For this purpose, we shall broadly follow the order in which the subjects in question appear in the Code and shall generally adopt the

<sup>63</sup> Lord Goldsmith, Lords Grand Committee, 6 February 2006, *Hansard* column 255

<sup>64</sup> *Institutional Investment in the United Kingdom; a Review*, Paul Myners, March 2001, Chapter 5, paragraph 5.76

headings and numeration of the Code.

## Section 1 Companies

### A. Directors

#### A.3 Board balance and independence

In view of the concerns expressed about the perceived failings of non-executive directors (“NEDs”) and particularly independent NEDs, we suggest that the board as a whole should no longer identify which NEDs it considers to be independent (A.3.1). We believe that it is wrong in principle for executive directors to participate in this decision, given that the independent NEDs will have the prime role in overseeing the executive directors, in determining their remuneration and, where necessary, in removing them.

Instead, the identification of independent NEDs could be determined exclusively by the existing independent NEDs (together, perhaps, with the chairman, if he or she was considered independent on appointment as chairman). In that case, however, there would need to be additional safeguards (which we believe there is a case for adopting in any event):

Firstly, if any of the relationships or circumstances listed in paragraph A.3.1 of the Code apply to an NED, specific shareholder approval of the NED’s independent status should be sought in advance.

Secondly, there should be an absolute prohibition on any NED being regarded as independent if any other director of the company is also a co-director of the NED in another company and that co-director has any role in determining the NED’s remuneration in that company (i.e. whether as a member of the other company’s remuneration committee or as a member of its board). Thirdly, the shareholders should determine the remuneration of the NEDs, even where this is not required by the Articles of Association. (We think that the Code should recommend this - paragraph B.2.3 refers).

If these changes were adopted, then, as a transitional measure, existing independent NEDs could retain their status, subject to shareholder approval.

The issue of board balance and independence is closely linked with the policy relating to appointments to the board, which is considered in the next section.

#### A.4 Appointments to the Board

Here again, we suggest that there should be changes in relation to NEDs.

The Treasury Select Committee report referred to above identified three main problems affecting NEDs in the banking sector:

*“the lack of time many non-executives commit to their role, with many combining a senior full-time position with multiple non-executive directorships; in many cases, a lack of expertise; and a lack of diversity”.*<sup>65</sup>

In relation to multiple directorships, we suggest that the Code be strengthened in the following ways:

Firstly, the only quantitative restriction currently in the Code is the provision in paragraph A.4.5 that

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<sup>65</sup> Page 107, paragraph 24



the board should not agree to a “full time executive director” taking on more than one non-executive directorship in a FTSE 100 company nor the chairmanship of such a company. We suggest that “full time executive director” should mean what it says and that holding such an office should normally preclude other paid employment, including any non-executive directorship in any listed company. This would seem to be in the interests of both the companies in question. Any exception to this rule should require shareholder approval in both companies.

Secondly, in respect of plural non-executive directorships, we suggest that the Code set out specific limits that should normally be considered appropriate. These limits could be a function of the aggregate of the expected time commitments that paragraph A.4.4 of the Code already requires to be set out in an NED's terms and conditions of appointment and of the time commitments of any other employments. Again, any proposed breach of the specified limits should require shareholder approval in all the companies concerned.

With regard to the problem of a lack of expertise, the Code could require the board to identify the precise expertise, whether particular professional qualifications or relevant business experience, that they considered it requisite for the board to possess and for the annual report to show the extent to which the actual composition of the board complied with these targets and to explain the steps being taken to rectify any shortcomings.

Lack of diversity seems likely to be a key factor in the failure of NEDs to ask searching questions of their executive colleagues. The Code's Main Principle governing board balance and independence (A.3) states that the balance between executive and non-executive directors should be “such that no individual or small group of individuals can dominate the board's decision taking” It is, however, not enough to guard against the dominance of a single person or group; it is equally important to prevent the dominance of a single mode of thinking. As the Treasury Committee report observed:

*“We... received evidence that the pool from which non-executive directors in the banking sector were recruited was far too narrow. Lord Myners was of this view, arguing that if boards consisted of people who read the same newspapers, went to the same universities and schools and have the same prejudices and views to sit (sic) round a board table you do not get diversity of view and input.”<sup>66</sup>*

As one possible solution to this hitherto intractable problem, we agree with the suggestion in a recent *Financial Times* editorial that the FRC's review of the Code offers an opportunity to increase the proportion of women directors and that

*“there is a strong case for a voluntary time-limited quota. A declaration that at least 30 per cent of board members should be female, applied for the next 10 years would attest to serious intent. Using the “comply or explain” principle, companies with a lower proportion would have to explain if they proposed to fill a vacancy with a man. Chairmen of companies with all-male boards - a fifth of the FTSE 100 – should explain in the annual report why they think this is acceptable.”<sup>67</sup>*

Consideration should also be given to similar measures in relation to ethnic diversity.

#### A.5 Information and professional development

In order to help directors, and especially NEDs, to become both more diverse and more effective, there should be a strengthening of the Code's provisions relating to their induction and subsequent

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<sup>66</sup> Page 55, paragraph 150

<sup>67</sup> “How to build diversity in boards”, *Financial Times*, 18 May 2009

professional development and to the professional advice and secretarial support available to them. In particular, we agree with the Treasury Select Committee's report that

*"there is a strong case for non-executive directors ....to have dedicated support or a secretariat to help them to carry out their responsibilities effectively"*<sup>68</sup>

We were also pleased to note Lord Myners' recent remarks on the same subject:

*"I am keen that Sir David [Walker] should consider.....whether there is a case for Non-Executive Directors to have dedicated support and resources to help them carry out their responsibilities and commission reports independent of management. I feel there is, for example, potentially scope for expanding, in this respect, the role of the company secretary".*<sup>69</sup>

We also think that the Code should encourage institutional shareholders, especially where they are acting in coalition, to allocate resources to NEDs to help them discharge their responsibilities in the interests of the company and of its members as a whole.

#### A.7 Re-election

We believe that, in the interests of greater accountability to shareholders, the Code should provide that all directors should be subject to re-election annually.

#### B. Remuneration

We suggest that the provisions of the Code in relation to remuneration should be amended to reflect the following changes:

(1) A shareholders' advisory vote on directors' pay under section 439 of the Companies Act 2006 should be treated as binding. (We believe that in due course the Act should be amended to this effect.)

(2) The remuneration of senior management below board level which is recommended and monitored by the remuneration committee under paragraph B.2.2 of the Code should likewise be submitted to shareholders for approval, with the vote again being treated as binding.

(3) Disclosure of remuneration should be sufficiently detailed to allow shareholders to make an informed judgement. This principle should apply to pension arrangements and to any other benefits where the actual or potential cost to the company may not be apparent without full information.

(4) Where shareholders reject the remuneration report in respect of directors or senior management, the chairman of the remuneration committee should resign (as recently suggested by PIRC).

(5) As already suggested above, the remuneration of NEDs should in any case always be determined by shareholders, whether or not this is required by the Articles of Association.

(6) The existing provision in the Supporting Principle under B.1 (The Level and Make-up of Remuneration) that the remuneration committee should be *"sensitive to pay and employment conditions elsewhere in the group"* should be more fully reflected in the relevant provisions of the Code, which should require formal consultation with group employees or their representatives, as

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<sup>68</sup> Page 55, paragraph 153

<sup>69</sup> Speech to the Association of Investment Companies, 21 April 2009, paragraph 18. [http://www.hm-treasury.gov.uk/speech\\_fsst\\_210409.htm](http://www.hm-treasury.gov.uk/speech_fsst_210409.htm)

recently suggested by Lord Myners.<sup>70</sup>

(7) The remuneration committee should also establish formal consultation procedures with shareholders and their representatives.<sup>71</sup>

(8) The references in this section of the Code to the need for remuneration policy to be designed so as to align the interests of executive directors with those of shareholders should apply to senior management also.

(9) The Code should explicitly state that the interests of executive directors and senior managers should be aligned with the **long-term** interests of the company and its shareholders. Whilst a comprehensive definition of “long-term” may be impracticable, some indications could be given as to what might constitute long-term interests for these purposes. Such indications should take into account the fact that, by the nature of their liabilities, many institutional shareholders have perspectives measured in decades rather than years. Against this background, and by way of example, the minimum vesting period of three years for a long-term incentive scheme, which is specified in paragraph 2 of Schedule A (Provisions on the design of performance related remuneration) seems much too short.

(10) Apart from specifying longer periods before the vesting of shares or the exercise of options, the Code should encourage other safeguards against perverse, short-term incentives. Such safeguards could include claw-back or forfeiture provisions.

(11) As a more fundamental change, the Code could also require remuneration committees to consider incentives that are directly linked to business models and management processes which have due regard to the company's long-term social and environmental impacts. The approach taken here could be consistent with any “key performance indicators” relating to environmental and other relevant matters that are included in any business review prepared in accordance with section 417 of the Companies Act 2006. There could also be taken into account the related concerns of shareholders, such as pension schemes that are required to include in their statements of investment principles their policies in relation to social, environmental and ethical considerations.

(12) To help counter what Lord Myners has called “*the insidious influence of executive benefit consultants*”,<sup>72</sup> any external benefit consultants whose advice is sought should report to the remuneration committee and / or the shareholders exclusively. They should have no other current or recent connection with the company.

### C. Accountability And Audit

In our view, the most important issue in this context is the potential for conflicts of interest where the company's auditors are also retained to carry out non-audit work. We have noted the review of this question in Treasury Select Committee's report,<sup>73</sup> including their conclusion that:

*“Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. .... This problem is exacerbated by the concentration of audit work in so few major firms. We*

<sup>70</sup> Speech to NAPF, 12 March 2009, paragraph 62

<sup>71</sup> *ibid*

<sup>72</sup> Speech to Investment Management Association, 19 May 2009, paragraph 35 [http://www.hm-treasury.gov.uk/speech\\_fsst\\_190509.htm](http://www.hm-treasury.gov.uk/speech_fsst_190509.htm)

<sup>73</sup> Pages 82-84, paragraphs 233 - 237

*strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.*<sup>74</sup>

We do not know whether the FRC intends to carry out the suggested consultation but at this stage our inclination would be to support such a prohibition.

The Code might also recommend the appointment of an independent adviser to the audit committee. As Lord Myners has suggested, the adviser's role could include engaging with external auditors, developing agendas, providing technical briefing and recommending when a second opinion should be obtained.<sup>75</sup>

We agree with the suggestion made by PIRC that consideration be given to introducing a statutory requirement for an advisory shareholder vote on the report of the audit committee. The Code could in any event recommend this.

#### D Relations With Shareholders

As will be apparent from some of the comments and suggestions made above, we think that this part of the Code should place greater emphasis on the role of the NEDs, and in particular the senior independent director, in the dialogue between the company and institutional shareholders. This dialogue should be placed on a more structured and proactive basis and should, for example, include the formal consultation procedures on remuneration already referred to.

#### Section 2 Institutional Shareholders

As we have already indicated, we hope that, following the current review, the Code will give an equivalent degree of guidance to institutional shareholders as it does to companies. It would clearly be inappropriate for us to attempt to detail here all the points that an expanded Section 2 of the Code might cover, as that would effectively amount to a full redraft. We shall therefore restrict our comments to what we consider to be the three most important areas which an expanded Section 2 should cover:

(1) **Short-termism** Although the need to change the culture of short-termism among institutional investors was one of the main themes of the Myners Review, eight years on it remains a problem, as Lord Myners has recently observed:

*“Short termism, as practised by pension funds, is self-defeating for those charged with delivering pensions over many decades in to the future, and yet it remains a predominant form of behaviour.*

*A focus on “shareholder value”, as measured by relative share price performance over quite short time periods lies at the heart of a number of behaviours which have delivered less than ideal outcomes, such as:*

*the ascendancy of momentum investing which discourages contrarian thinking by all but a small minority;*

*a partiality to merger & acquisition activity which so often fails to deliver the outcomes promised;*

*the adoption of aggressive and inappropriate capital structures to fend off predatory activity by private equity and others ; and*

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<sup>74</sup> *ibid* paragraph 237

<sup>75</sup> Speech to NAPF, 12 March 2009, paragraph 57

*a failure to take account of the longer-term consequences of investment activity, including impact on the broader economy and society”<sup>76</sup>.*

The Code could give detailed guidance to all institutional investors on how to help bring about the requisite change in culture. We would suggest that particular attention be given to the relationship between professional fund managers and their clients, including pension funds, and to the terms of the mandates given to fund managers, so that, for example, performance measurement is recalibrated to encourage long-term perspectives.

(2) **Active share ownership** We welcome Lord Myners' revival of the suggestion, originally made in the Myners Review, that professional investors should have an express statutory responsibility to seek to enhance the quality of investment and governance to promote value creation, based on the United States' ERISA model.<sup>77</sup> We think that this would fit well with the kind of redefinition of fiduciary duty which we have already suggested above. Here again, we would suggest that the Code should specifically endorse such an approach in any event, since there would be no conflict with existing law.

We also agree with Lord Myners that particular emphasis should be placed on encouraging institutional investors to coordinate their efforts to improve corporate governance, so as to maximise their influence and more effectively counter the syndrome of the “ownerless corporation”.<sup>78</sup> The Code could usefully give support and guidance in this respect.

(3) **Transparency** In our view, lack of transparency throughout the investment chain remains one of the key problems to be addressed. Our own research in this area has consistently revealed serious failings, starting with inadequate disclosure by scheme trustees to their members and continuing through inadequate reporting of engagement activities by fund managers to their trustee clients.<sup>79</sup>

We believe that that the reserve powers under section 1277 of the Companies Act 2006 should be activated so as to require institutional investors to provide information about the exercise of voting rights and also that the disclosure regulations for occupational and personal pension schemes (which are currently under consultation) should be strengthened in these respects. Once again, however, we suggest that in any event the Code could provide encouragement and specific guidance on this issue.

Turning to the existing provisions of Section 2, we would normally wish to comment in some detail on the Supporting Principle under E.1, which provides that the Institutional Shareholders' Committee's “*The Responsibilities of Institutional Shareholders and Agents - Statement of Principles*” should be reflected in fund manager contracts. (This is not least because we think that there are significant shortcomings in the wording of the ISC statement, as well as in its application in practice.)

We note, however, that in early June the ISC is due to publish, in Lord Myners's words, “*its reflections on the financial crisis and its key conclusions in respect of shareholder responsibility and governance*”.<sup>80</sup> We have therefore concluded that there would be little point in commenting on

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<sup>76</sup> Speech to IMA, 19 May 2009, paragraphs 27 & 28

<sup>77</sup> Speech to NAPF, 12 March 2009, paragraph 57 & speech to IMA, 19 May 2009, paragraph 29

<sup>78</sup> Speech to NAPF, 12 March 2009, paragraphs 69 -72, & speech to IMA, 19 May 2009, paragraph 24

<sup>79</sup> See, for example, our reports *Responsible Pensions? UK Occupational Schemes' Responsible Investment Performance 2009* (April 2009) and *Investor Responsibility? UK Fund Managers' Performance and Accountability on “Extra-Financial” Risks* (November 2008). Both reports can be downloaded from our website [www.fairpensions.org](http://www.fairpensions.org)

<sup>80</sup> Speech to IMA, 19 May 2009, paragraphs 31 & 32

the current Statement of Principles (or on the related *Voting Disclosure Framework*). As the ISC's review will be issued after the closing date for this consultation, we trust that there will be an opportunity to comment on the outcome of the ISC review, whether in the course of the further consultation later this year that is envisaged in paragraph 8 of the Consultation Paper, or otherwise.