

SUBMISSION NO. 3 TO THE FINANCIAL REPORTING COUNCIL'S REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE - FINAL REPORT AND RESPONSE TO CONSULTATION ON REVISED CODE

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I. INTRODUCTION

This follows my prior Submissions to the First and Second Consultations, and should be read in consultation with them, since I see no reason to revise them, nor to repeat them in detail here. I am broadly supportive of the main thrust and principal content of the revised (and renamed) UK Corporate Governance Code, especially the new Section headed "Comply or Explain", though I believe that it deals rather too gently with the much milder requirements of the AIC Corporate Governance Code. I also support the extension of its scope to cover foreign incorporated companies with a Premium Listing.

I note that the Walker Report has been delicately sidelined, with only the parts relevant to all companies being retained for this revision, a diplomatic approach which I support, in view of the manifest deficiencies of that Report. I also support the diversion of the section relating to institutional investors into a separate Stewardship Code, and wish here only to plead that as part of this Institutions should be very strongly urged to send representatives to AGMs, which at present they seldom bother to do; this only serves to reinforce the conclusion that they have privileged access to the board, and do not care about the issues which exercise other (i.e. private/individual) shareholders.

I have a number of detailed comments on specific points in the proposed new Code, with in some cases suggested modifications to the wording, which are noted in the next section by paragraph number; these are not in my judgement so significant or important as the two major omissions to which I drew attention in my Submission No. 2. I refer to the issues concerning private (individual) shareholders and the sourcing of NEDs from outside the ranks of current and former EDs, which I deal with more fully later: they are hinted at in this revised version of the Code, but I firmly believe that this is quite insufficient, and they deserve explicit treatment. I find this failure to confront the issues disappointing, and earnestly hope that it can be corrected in the final version.

II. SPECIFIC COMMENTS ON PROPOSED TEXT OF CODE

These comments follow the headings and numbering pattern of the proposed text, and in most cases suggest alternative wording.

* Comply or Explain:

4. A recurrent issue throughout the Code is the assumption that the only shareholders which matter are institutions, which I do not accept: in §4, line 7, therefore, delete “Institutional” and insert “All”.

A.1. The role of the board - Supporting Principle 1:

In Line 1, the word “entrepreneurial” is inappropriate, and should be deleted: with very rare exceptions (e.g. Richard Branson) the Chief Executives of large companies are not, and never have been, entrepreneurs, and this is even more true of the board as a whole. Their approach to business, as employees or NEDs, is entirely different from those whose entire net worth is seriously at risk.

A.1.2. I am concerned that the substitution of the phrase “board committees” for the former “nomination, audit and remuneration committees” may appear to give implicit permission not to appoint one or more of these. The reason for the change is presumably to allow for the appointment of risk committees in financial and any other companies (e.g. pharmaceutical) where these may be thought necessary, but this could be achieved by combining the two versions, as follows: “nomination, audit, remuneration and any other board committees”.

A.3. Supporting Principle 2:

I would insert the words “and unbiased” after “clear” (see comments on B.5 below).

B.1. Main Principle:

I would add after “balance” the words “and range”, for reasons given below.

B.1.1, bullet-point 4: as previously, I feel strongly that, because cronyism may be an issue, the words “or personal” should be added after “family”.

B.2. Supporting Principle 1:

This hints that the talent pool has inappropriately been restricted, but does not make explicit the nature of the restriction; I believe that this should be spelt out in B.2.2.

B.2.2. Few boards now include those of a professional/advisory background with wide experience of dealing with boards, and I would add at the end “Careful consideration should be given to ensuring both that membership is not confined to those who have previously served on other boards, and to whether there may be a retired ED of the company, judged to be sufficiently independent-minded, who could add value to the board.” He/she would not of course be formally

independent, but would have a level of knowledge of the company and its business that outsiders could never match. I attach particular importance to the first point, since I believe that it needs to be made quite clear what the rather coy expressions "...appropriate balance of skills, experience [etc.]" and "....criteria that do not inappropriately restrict the talent pool..." actually mean.

B.4. Supporting Principle 2:

I strongly support this: it was previously often the case that contacts between NEDs and operational managers (never mind staff!) were not encouraged and frequently did not occur, with the result that the NEDs had no real exposure to what actually happened in the business, and in consequence a very limited understanding of what drove it.

B.5. Supporting Principle 1:

This seems to me to be weak and incomplete, and I propose adding at the end "whether from internal or external sources". The point is that the ability/licence to seek independent professional advice, originally recommended by Cadbury (§4.18), is seldom utilized, with the admittedly important exceptions of the audit and remuneration committees. I would myself go further, and strongly encourage larger companies (say FTSE100) to follow the lone example of BP, and set up a small unit under the company secretary dedicated to providing NEDs with whatever analytical assistance/resources they require: the point is that they will generally be busy people, without in many cases (to put it delicately) recent experience of doing their own analytical work and sometimes time-consuming research. It cannot unfortunately be assumed that the information provided through management channels is entirely unbiased.

B.5.1. Add at the end of the first sentence "and that they are encouraged to seek it."

B.7. I very strongly oppose the idea of annual re-election for any NEDs, including the Chairman. If annual election were to become a formality, then it would be pointless, but if not its consequences would be very undesirable: it would inevitably create a certain sense of insecurity, which might weaken the vigour with which they pursued the "constructive challenges" they are now explicitly required to make. I see no convincing argument to change the normal present practice of rolling 3-year terms, with annual re-election coming in only after 9 years' service: this security of tenure contributes to independence of mind and judgement, a vital benefit which should not be lightly cast aside. There does of course need to be a provision for dealing with the rare cases of misconduct, in which event it should be possible for the offender to be removed by a two-thirds majority of directors, or of loss of confidence by a substantial proportion of shareholders, in which case they should *in extremis* call an EGM to vote on the proposed removal of the NED in question.

C.1.2. This is potentially an excellent addition to the Code, and one can only hope that companies will take it seriously, and not simply provide a boilerplate marketing brochure.

C.2.2. It is not clear from this whether companies are to be encouraged to provide information to shareholders on the results of the board's annual review of risk management and internal controls (other than that required by the FSA), and I appreciate that this point may be covered in the FRC's forthcoming review of the Turnbull Guidance; if a more detailed report is eventually required of companies, it might be preferable, in view of its likely complexity and specialist interest, to provide it on the website rather than in the Annual Report (just as may be proposed - after consultation - for disclosures in the corporate governance statement).

D. Remuneration:

Most of my comments on this issue are reserved for Schedule A, but a few belong here.

D.1.3. The objection to the awarding of share options to NEDs should be even stronger, and in my opinion they should be banned. As I have noted previously, the remuneration of NEDs should ideally, to the extent possible, be in restricted shares, with as here a holding requirement of at least one year, and preferably 2-3 years, after the NED leaves the board. Add at the end "The preferred method of remuneration for NEDs is mainly in shares, which should be held for a significant period after the NED leaves the board."

D.1.4. It is disturbing that this clear statement, retained from the previous Code, in no way deterred the Remuneration Committee of RBS from awarding Sir Fred Goodwin a grotesquely inappropriate pension on his (very) early retirement. It may be worth consideration whether the FRC should, on the occasion of a flagrant breach such as this, be prepared to name and shame the perpetrators - in this case the remuneration committee of the board of RBS.

D.2. Supporting Principle 2:

It is not at all clear what this means, and it seems to me undesirable that the chairman or the remuneration committee should initiate such contacts: it is surely up to the shareholders to make representations if they feel it necessary. Furthermore, this is yet another instance of the distinction frequently made in practice (and here endorsed) between favoured large institutions and other (especially private) shareholders in terms of privileged access to information, in plain contradiction to the explicit statement in Note 26: "Nothing in these principles or provisions should be taken to override the general requirements of law to treat shareholders *equally* [my italics] in access to information".

D.2.2. It is clearly desirable to retain this clause, not least because of the tendency for the remuneration (whether base salary, annual bonus or long-term incentive) of senior management just below the board to push up that of EDs, perhaps most obviously in the financial sector.

D.2.3. I regard it as very undesirable indeed, for reasons that are surely obvious, to allow the Chief Executive to play any part whatsoever in determining the remuneration of NEDs: hence I would urge the FRC to delete everything after “responsibility”, and insert “to the chairman, or to a committee of which the chairman is a member”.

E.1 Supporting Principle 1:

I fail to understand the reason for changing the text from the previous wording, since that seemed to me to meet the case very satisfactorily, and this new wording would significantly weaken the requirement for NEDs to meet major shareholders and “understand their issues and concerns”. The previous wording should be reinstated. Furthermore, the reference to Supporting Principle A.2 must be a mistake - surely A.3 is meant?

E.2. It seems that the representations of UKSA to the last consultation have been accepted with regard to the “show of hands” at the AGM, and I agree with their other observations, but I do not believe that they go nearly far enough: private (individual) shareholders still constitute an important element of company ownership*, but are not, as in other countries, treated as though they did. I therefore repeat below my comments, from Submission No.1, on the AGM, which seem to have been entirely ignored hitherto:

“The basis of the AGM needs to be rethought, as it is virtually the only opportunity for private shareholders to make their views and concerns known. ‘It is hard to escape the conclusion that most chairmen and chief executives regard AGMs as a tiresome formality, or even charade, which they are obliged to go through once a year, and where their main priorities are to get their resolutions through as quickly and easily as possible, to avoid public relations blunders, and to deal expeditiously with any protests that occur’ (quote from my book - *Who will Guard the Guardians? Corporate Governance in the Millennium*). It is also worth giving much stronger encouragement to institutional shareholders to attend, which they seldom do at present unless there is a crisis.”

There are also very real issues, much wider than those relating solely to the AGM, about the representation of private shareholders, and I reproduce my comments from another Submission (No.2), which once again seem to have been ignored:

“The situation of private (individual) shareholders, whose interests are not even mentioned in this document: it is not just a question of ‘Grannies losing their

blouses' as a former Government Minister contemptuously dismissed them, but a moral issue: private shareholders provide a substantial part of the equity, and they are given little information - none at all if they hold their shares through an ISA, and are treated with weary disdain at AGMs if they are bold enough to put questions to the Board. This is simply not good enough, and if they were organized so that they had a collective voice and vote, as is the case in France, Germany and Sweden, they would have as much clout as any institution. The Report should encourage UKSA to set itself up as a real interest group, just like its counterparts in the European Continent, and should as a means to this end give private shareholders the opportunity to vote separately for an NED to represent their interests - which nobody does at present."

* The Walker Report states, "Individuals directly hold around 13% of UK equities", though regrettably (and characteristically) it does not provide any evidence for this claim; nevertheless, even if we assume that the true figure is only c.10%, this is still a far larger proportion than any institution normally holds - and those with 5% can still usually get the Board's attention.

Schedule A (I have numbered the paragraphs for ease of reference):

1. Performance measures or conditions for annual bonuses should be based primarily on the management objectives, including operational results, which individual EDs are required to achieve, although overall corporate performance might be required to reach a prescribed threshold before any bonus became payable. Total shareholder return (TSR) should **never** be the measure used for any incentive scheme, whether short- or long-term, since if it is there will inevitably be a temptation to manipulate the outcome, either directly or by the nature and timing of announcements. I propose the following changes to the wording:

* After "company" add "and based primarily on agreed management objectives, including operational results".

* After "part" insert "or full".

2. If the word "benefits" means "pension benefits" this would be a serious mistake, and contrary to the position advanced in §8 below; this sentence should therefore definitely be deleted. I am also doubtful about the value of the other sentences in this paragraph, which should probably also be deleted.

5. I support this paragraph, except for the final clause of the last sentence, beginning "and criteria....", since I do not know what it means; it should be clarified or deleted. In the previous sentence, the ugly word "metrics" should be replaced by "conditions", when it would become compatible with my proposals for §1 above. I also approve of the removal of any reference to TSR as a performance criterion, for the reasons given above.

7. I support the intention behind this, but it might be difficult to achieve in practice, unless there were imposed unusually long vesting periods, which would risk punishing the innocent as well as the guilty.

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