Local Authority Pension Fund Forum

Additional comments from the Local Authority Pension Fund Forum to the FRC Review of the effectiveness of the Combined Code

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Background

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991 as a voluntary association of 49 local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum's members currently have combined assets of over £80 billion.

The Forum has already made a submission to the FRC's previous review of the Code, but felt that given the ongoing debate in respect of governance that further additional comments might be helpful. We have provided comments only in those areas where we have a particular view.

Comments

• *Whether it would be helpful to provide further guidance on the time commitment expected of the chairman, senior independent director and / or non-executive directors.*

LAPFF believes that a focus is required on the time that directors have available to perform their role, and this must logically raise a question about individuals with multiple directorships. We note that the Walker Review sets out a minimum expected time commitment of 30 to 36 days in a major bank board. It would seem sensible for the FRC to consider whether this should be applied to major companies (i.e. FTSE100) more generally. The same point could be made about Walker's suggestion that a BOFI chair should consider devoting at least two thirds of their time to this role.

• *Whether all the independence criteria identified in the Code remain relevant;*
• *Whether the independence criteria and the way they have been applied by boards of companies and investors have unnecessarily restricted the pool of potential non-executive directors, and in particular whether the so-called "nine year rule" has resulted in a loss of continuity and valuable experience.*
• *Whether the recommendation that the boards of FTSE 350 companies should comprise at least 50% independent non-executive directors has resulted in fewer executive directors sitting on boards and/or boards becoming larger.*

The Forum believes there is no pressing need to revisit independence criteria as they are currently set out, unless viable alternatives can be put forward. Similarly, we do not believe a shift away from the requirement for 50% independent non-executive director representation on the board is warranted. LAPFF believes a primary risk arising from the recruitment of non-independent NEDs out of proportion to current practice is that critical diversity may be lost on the board.

There is a risk that boards will self select for those who “fit” well with other members, with associated risks of producing the group think that investors wish to discourage. If the board is comprised of members who largely share the same skill set, experience and perspective, its collective intelligence will likely falter. We therefore believe there must be an emphasis on the board’s requirement to ensure *and evidence* that an appropriate diversity of skill set, experience and perspective is present.

• *Whether more guidance is needed, in the Code or elsewhere, on succession planning and the need to ensure that board composition is aligned with the present and future needs of the business.*

As we have seen in our engagement with Marks & Spencer over the past two years, poorly-handled succession-planning can become a major problem for shareholders. This is especially the case where, as at M&S, the outgoing chief executive is determined to play a significant role in choosing their own successor to the exclusion of others. Therefore it would be useful if the Code were refined to address this.

• *Annual re-election of the company chairman.*
• *Annual re-election of the chairs of the main board committees.*
• *Annual re-election of all directors.*

The financial crisis has clearly demonstrated that core governance concerns can emerge rapidly. Whilst investors will generally want to be supportive of management, on occasion this will result in the desire to oppose the re-election of a given director. At present it is not always possible to do this, because the typical term of appointment is three years (though we note that a number of FTSE100 companies have annual elections already).

The Forum therefore believes that it is time to consider annual elections for all directors. In practice we do not think this will pose practical problems for companies, and they will not face a challenge unless there are genuine shareholder concerns. But it seems reasonable that the voting right should be there, as it is to vote on remuneration policy every year.

• *Binding or advisory votes on specific issues, or on the corporate governance statement as a whole.*

The Forum believes that the FRC could consider the possibility of requiring companies to prepare a risk report as part of their audit committee report to shareholders, and that the audit committee report should be subject to an annual shareholder vote. In addition to encouraging reporting by non-financial companies, it would also encourage investors and their advisers to properly consider the risk disclosures made by companies before approving them.

• *Whether the Code should be amended to recommend that board evaluations should be externally facilitated at least every two or three years for some or all companies.*
• *Whether the recommendation that the effectiveness of all the main board committees should be evaluated every year should be relaxed in some way, for example to recommend a rolling cycle of committee reviews.*
• *How disclosures in the annual report might be made more informative, either in relation to the process that was followed and/ or the outcomes of the effectiveness review.*

LAPFF supports the Walker Review's recommendation that the board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year, and that a statement on this evaluation should be a separate section of the annual report. It also supports the recommendation that 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.

Relevant disclosure in this regard is likely to be found in:
• the behaviours that the board evaluation is designed to measure and encourage,
• the board's learning from the evaluation,
• the action points arising from the evaluation process, and
• performance against prior action points.

Outside agencies can appraise the board's composition, including its mix of skills and experience. Yet the Review consistently (and correctly in our opinion) observes that board composition is a poor predictor of board performance. Our view is: only when shareholders get better disclosure on past board performance will they be in a position to predict future board performance.

Currently the critical dynamics created by the board's composition and the nature of the board's functioning as a high performance team is not evident from disclosure. We believe this puts an onus on the board to evidence how it functions as a team, particularly in regard to the quality of any challenge process to decisions on major risk and strategic issues. The most likely place for such disclosure is in the board's annual evaluation statement.

• *Whether any other changes to the Code, or additional guidance, are required to reflect developments in best practice [on remuneration].*
• *Whether shareholders should be given a more direct role in setting remuneration and, if so, how this might be achieved.*

As stressed in our previous submission, we believe the need to be sensitive to pay and employment conditions elsewhere in the group could be made into a new main principle, with a supporting principle providing guidance on how companies might meet it. We also believe the issue of directors' pension entitlements deserves further attention. The Code could be amended to encourage disclosure of details such as accrual and contribution rates, normal retirement age and payments in lieu of pension provision.

LAPFF believes that non-financial performance measures should form a significant part of the performance assessment process, and that poor management of non-financial areas such as risk management, can be detrimental to performance. We believe companies should take account of non-financial measures in their long-term incentives as well as bonuses, because poor management of non-financial areas can also be detrimental to sustained long-term performance. We believe that such measures could be used to align the interests of owners and managers. Therefore we believe that the Code should make reference to the use of non-financial factors in remuneration policy.

• *The framework proposed by Sir David Walker, and the appropriate role for the FRC.*

We are broadly supportive of the Walker Review's recommendations in this area, and by extension the role foreseen for the FRC. We believe that the section of the Code relating to the role of shareholders should be removed and used to form the basis of a new set of Principles of Stewardship.