



# **Review of the effectiveness of the Combined Code**

**PIRC's response to the FRC review of progress**

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## **Introduction**

We welcome the opportunity to respond to the consultation on the review of progress. Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £1.5 trillion and include some of the largest pension funds, investment management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareholder initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

## **Director accountability and time commitments**

PIRC considers that a greater level of accountability to shareholders is required of boards. As the financial crisis has demonstrated, governance concerns can develop rapidly, and shareholders need to be able to respond. On occasion this will mean that shareholders wish to oppose the re-election of an existing board member because of concerns about performance. Yet as the system currently stands, with directors typically elected on three-year terms, this is sometimes not possible within a reasonable timeframe. There have been occasions in recent history to our knowledge where directors involved with failing companies have not been able to be held to account because this.

It has been argued that investors could work behind the scenes to encourage the removal of a board director, or even call an EGM. It is clear that the former option is sometimes taken and sometimes effective. But in our experience it cannot be relied upon, and in any case such a course of action is likely to be more effective if the prospect of a vote against backs up such pressure. In addition we do have some concerns about the accountability of institutional investors themselves if their engagement is solely carried out in this way. We do not consider the suggestion that investors can call an EGM to be a credible alternative, since it requires a high ownership threshold to initiate, and in our experience asset managers are not inclined to undertake such radical action.

In addition we do not believe that some of the halfway houses suggested, such as annual election of chairs, or chairs of committees, would be effective. For example, the idea of making remuneration committee chairs face annual re-election (rather than the whole committee) would surely reverse the direction of travel since the introduction of an advisory vote on remuneration, which has been to de-personalise voting decisions on remuneration issues. Given our support for annual elections, this is clearly not to argue that shareholders should not seek accountability from directors

by opposing their re-election. But rather, by making only the committee chair face an annual vote it could result in an undue focus on one individual.

In light of the above, we strongly urge the FRC to consider a move towards annual elections as best practice. The table below lists the companies that have instituted annual elections, and we are aware of others considering doing so. We do not believe that proving this level of accountability to shareholders has made these companies any more short-term in their thinking, as some contend this reform would entail.

BP PLC  
CAMELLIA PLC  
COLT TELECOM GROUP SA  
INFORMA PLC  
PEARSON PLC  
VODAFONE GROUP PLC  
FUTURE PLC  
UNILEVER PLC  
CARNIVAL CORPORATION PLC  
ASTRAZENECA PLC  
VENTURE PRODUCTION PLC  
YELL GROUP PLC  
QINETIQ GROUP PLC  
GOLDENPORT HOLDINGS INC  
THOMSON REUTERS PLC  
FRESNILLO PLC  
NORTHUMBRIA WATER

We also believe that there should be a greater focus on the time commitment required from both executive and non-executive directors. We recognise that the Walker Review has made some suggestions here, but we would go further. Specifically we believe that executive directors should be limited to one external non-executive directorship, a rule we think should also apply to FTSE350 chairs. It is vital that directors recognise that their position is one of significant responsibilities and as such requires a proper allocation of their time.

We believe that a strict limit of the type outlined, promoted by the Code, would ensure that directors do take the time commitment issue seriously. In addition, by putting a limit on the number of directorships that an individual can hold, we believe that this would encourage companies to draw on a wider pool of talent, rather than simply the boards of other companies. We set out some further thoughts below about why this is beneficial.

## **Director competence and independence**

Understandably, in the wake of the crisis there has been a greater focus on the competence of board members. In particular there have been questions about whether non-executives have sufficient industry knowledge to perform the 'challenge'

function effectively. There is a clear implication in the Walker Review and some responses to it that perhaps more of a focus on relevant experience, and less on independence, might be preferable, at least for financial services companies.

PIRC believes that it is right that there scrutiny of the competence of directors, and indeed are working to develop some metrics in this area. But we do not believe that competence should or need come at the expense of independence. Indeed we would caution against encouraging a view amongst companies that they are 'playing it safe' by appointing directors from within their own industry.

In PIRC's view one of the contributory factors in the financial crisis was a tendency for 'group think' on the part of company boards. Therefore if post-crisis boards decide to prioritise board candidates from their own industry there is a danger of exacerbating this tendency. Legal scholar Cass Sunstein has recently written about the tendency of like-minded people to reinforce each other and reach more extreme views as a result.<sup>1</sup> He specifically highlights the need for boards to contain diverse points of view in order to address the reinforcement effect and its tendency to result in extreme opinions and decisions.

Arguably this leads to a question about the composition of remuneration committees in particular. For example, if there had been a representative of the RBS workforce on its remuneration committee perhaps it is less likely the group would have reached the decision it did in respect of Sir Fred Goodwin's pension. We believe that the FRC might wish to consider some further research in this area.

Turning to specific governance criteria, we do recognise the frustration that companies sometimes feel in respect of the criteria applied to non-executives such as the so-called '9-year rule'. Clearly such criteria represent a somewhat arbitrary assessment of independence, and there is room for more flexibility in interpretation.

Nonetheless investors need some yardstick against which to judge the level of independent representation on boards. We are therefore wary of the suggestion of a move away from such criteria without any suggestions from companies of credible – and measurable – alternatives. It is unfortunate that whilst companies often berate 'box-ticking', what they offer in the place of quantifiable standards often add up to little more than vague statements.

Similarly we see no need to row back from the current guidance that boards should comprise at least 50% independent non-executive directors. We are not convinced that this has led to a diminution of the quality of boards, and await the results of the research the FRC has itself on this question with interest.

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<sup>1</sup> *Going to Extremes*, Cass Sunstein, 2009  
PIRC Ltd October 2009

## **Remuneration**

In our view on remuneration there are three areas where the Code could be strengthened or where the FRC might consider whether further reform might be required.

First, as we have argued many times in the past, it is clear that most companies do very little to demonstrate that their remuneration committees are sensitive to pay and conditions across the group when setting policy. As we have seen from the public reaction to the rapid re-emergence of sizeable reward in the financial sector, this is a very contentious issue. We believe that if the FRC is serious about this element of the Code it should give further direction to companies.

We know from our conversations with companies that a number are behaving very responsibly in this area during the recession, but we feel that there is no guidance on what might be best practice. In addition it would be helpful in seeking to address this question to encourage companies to disclose certain basic metrics (ie median board pay as a multiple of median employee pay).

Secondly, we believe that the FRC should consider whether companies should be encouraged to disclose 'heads of terms' for directors, which would set out the broad contract policy. This could be the subject of a shareholder approval vote, which would provide authority for the policy for a set period. This would at least enable shareholders to directly challenge, and ultimately reject, contract policy that was not in their interests.

Finally, we consider that proper disclosure of directors' pension entitlements is long overdue. We believe that company should be encouraged, or preferably mandated, to disclose information such as accrual and contribution rates, normal retirement ages and payments in lieu of pension. They should also be instructed to provide an explanation of any differential treatment between directors and other employees. We are aware from discussions with other shareholders that they also believe that there should be greater disclosure in this area.

PIRC believes that there are some substantive issues here, and it may be that a further consultation specifically on remuneration is required.

## **The role of shareholders**

PIRC is very supportive of thrust of the section of the Walker Review dealing with shareholder engagement and communication. We support the recommendation that the section of the Code dealing with shareholders should be split out to form the basis of a new set of Principles of Stewardship. We also support the recommendation that the FRC be responsible for these principles, and have urged the Review not to give a role to the Institutional Shareholders Committee, we regard as inherently conflicted.

Finally, we are also supportive of the Review's recommendation that shareholders should disclose their voting records. Indeed we have argued that the FRC could provide a repository for an annual voting report to be filed by all shareholders that the Government decides ought to disclose.

PIRC would be happy to discuss the points we have made in our submission in more detail. Please contact:

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