nestoradvisors

Chris Hodge
Corporate Governance Unit
Financial Reporting Council
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29 May 2009

Re: Review of the effectiveness of the Combined Code – Call for evidence

Dear Mr Hodge,

In response to the Financial Reporting Council's March 2009 Call for evidence, we submit for your consideration the following comments and recommendations regarding the following areas of the Combined Code (the 'Code'): the level and make-up of executive remuneration, remuneration committee responsibility, remuneration disclosures, dialogue with institutional shareholders, and board performance evaluations. These comments are based on our experience with clients in the UK, Continental Europe and emerging markets, as well as our research on the governance practices of large US and European banks.

Our research suggest that, given the unique systemic attributes of the financial sector, some accepted corporate governance norms may not apply well to the financial sector and, therefore, the Walker Review should lead to a separate 'comply-or-explain' code for the sector. Hence, the comments herein are meant to apply to the Code for all sectors.

Our work in the UK and beyond informs us that the governance framework supported by the Code is generally effective and has not only contributed to higher standards of governance in the UK but also served as a template for reform around the globe. The failings of banks do not justify a fundamental reworking of the UK corporate governance system. The current crisis of confidence, however, does provide an opportunity to strengthen the system in light of recent experience. The following comments and recommendations should be considered in this light.

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The level and make-up of executive remuneration

Recommendation

The Code should encourage companies to set remuneration in a manner that encourages long-term orientation and is not divorced from risk. To this effect, the main principle under B.1 should include a reference to long-term corporate performance and the Code provisions should require companies to disclose in their remuneration reports how the remuneration of executive directors and other senior executives is structured to promote long-term performance and minimise key enterprise risks.

Rationale

Our research on the governance practices of leading US and European banks prior to and during the credit crisis found little evidence to support claims that bank failings occurred because senior executives had insufficient equity incentives. Indeed, many of the banks that suffered the worst losses were helmed by chief executives with a great deal of 'skin in the game'. In contrast, a significant contributor to the failings may have been that the judgement of senior managers and board members was clouded by an excessive focus on return on equity and a concomitant failure to disaggregate the factors responsible for an increase in returns. This may have been further compounded by predominantly tying executive compensation to earnings and earnings-based metrics such as return on equity and economic profit, where economic profit calculations were based on a cost of capital that did not reflect the higher risk of greater leverage. (See Bank Boards and the Financial Crisis: A corporate governance study of the 25 largest European Banks by Nestor Advisors, 2009.)

A number of the more sensible proposals circulating regarding the remuneration of executives of banks (take, for example, the Financial Services Authority's Draft Code of Practice on Remuneration Policies) are appropriate for banks because of their systemic link to overall economic health is far greater than other industries in our diversified Western economies. Such regulation is not appropriate for companies outside of the financial sector. Thus, the Code should discourage decision-makers from having an excessive focus on short-term earnings, encourage their long-term orientation, and encourage their assessment of risk-taking activities when evaluating individual performance.

Remuneration committee responsibility

Recommendation

The Code should include a principle assigning to the remuneration committee responsibility to oversee a company's policy towards remunerating executives, rather than just those managers who are one level below the board. The policy would not establish the quantum of individual compensation but would outline the company's approach to remunerating and providing incentives for all key executives. The Code's provisions should translate this principle into an obligation for companies to disclose in their annual report how the remuneration committee discharges this new role.

Rationale

Another lesson of bank board failures relates to boards' narrow view into companies' utilisation and remuneration of human resources. While the setting—or even the review—of individual remuneration below the top management ought not be the role of a board, utilisation and remuneration of human resources is a core strategic function and so should be. Hence, boards should regularly reflect on the company's policy towards compensating executives including, but not limited to, those one level below the board. This review can be a key instrument in a board's toolkit and so should be included in the board's calendar.

Remuneration disclosures

Recommendation

In order to enhance transparency that enables better oversight of significant decisions, the Code should require companies to disclose annually the remuneration arrangements of executive directors as well as the top five earners within a company—regardless of whether they are executive directors.

Rationale

Current disclosures required by the Code and Directors' Remuneration Report 2002 do not provide an adequate picture of remuneration arrangements within a company when high earners are not members of their board, particularly when—as is the case with banks—high earners are also significant risk originators. In addition, the current arrangements provide an incentive for executives to avoid board appointments so as to circumvent remuneration disclosures. A broader disclosure policy, as recommended above, should provide shareholders as well as regulators with a better view into how a company allocates significant resources, and rewards poor and/or strong performers.[1]

Dialogue with institutional shareholders

Recommendation

The Code's provisions with respect to dialogue with institutional shareholders should be strengthened and streamlined in a manner that increases transparency, encourages engagement, and focuses shareholders on the task they are best equipped to perform, namely ensuring the quality and effectiveness of the board. To this effect,

(a) the Code's main principle D.1 should require a 'structured' dialogue with institutional shareholders;

(b) the Code's supporting principle in D.1 should emphasise that the entire board—rather than just the chair and senior independent director—should participate in the structured meetings with major shareholders (defined, for example, as the five shareholders with the largest positions in the company for over the prior two years);

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1 *A similar policy is already in place in the US, where the SEC requires disclosure of the remuneration of (a) the chief executive, the chief financial officer, as well as the three other most highly compensated executives; and (b) up to three other employees whose remuneration exceeds that of any of the executives listed in '(a)'.*

(c) the Code's provisions should require the board to meet with the major shareholders at least once per year in addition to the annual general meeting;

(d) the Code's provisions should require these meetings to review the board's work and shareholders' governance concerns; and

(e) the Code's provisions should require these meetings be open to observation by all interested parties.

Rationale

The engagement of shareholders with companies is a critical component of the 'comply-or-explain' model and yet, there are serious and significant concerns that major shareholders are not fulfilling this function. There are two matters to consider with respect to shareholder engagement: firstly, what is the purpose and scope of shareholder engagement; and secondly, what means effectively promotes constructive shareholder engagement in light of the economic incentives of the investment industry.

The philosophy underpinning modern company law is quite clear on the purpose of the shareholders' governance function: simply, shareholders are to ensure that a company is run by an effective board. This calls for a scope that is narrowly targeted on judging a board's effectiveness and voting for board appointments and dismissals.

Regrettably, some commentators and even UK regulation[2] incorrectly broaden the scope and raise expectations as to what shareholders should or can achieve through engagement. While shareholders need to be informed as to how a board discharges its responsibilities, requiring shareholders to engage in a manner that encourages a board to defer its responsibilities to shareholders is counterproductive. The responsibility for key board functions such as strategy setting (and matters core to strategy such as defining a company's risk appetite and setting remuneration) should remain with the board. Shareholders should review a board's actions in these areas *ex post* and judge board effectiveness accordingly. The public nature of *ex ante* shareholder surveys of board decisions invites politicking by various special interest players that may not be in the company's long-term interest. Those surveys differ significantly from mandatory votes on transactions for which the law grants shareholders the last say so as to prevent abuse or gross mismanagement that may alter significantly and irrevocably the nature of the asset owned by the shareholders.

With the perspective that a shareholder's single governance function is to ensure that a company is run by an effective board, we consider now the means of shareholder engagement. The Code recognises the annual general meetings is a separate matter from dialogue with institutional shareholders, and underscores the importance of this dialogue. With this, we completely agree. The annual general meeting serves a separate function and so should remain intact. Similarly, earnings reports and investor presentations serve a third function and so should remain intact. Another venue is needed to allow dialogue into matters of governance with institutional shareholders.

The Code envisions one-to-one discussions between institutional shareholders and the company, with the latter represented by the chief executive, finance director, chair, or senior

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2 *See, for example, the shareholders' advisory vote on remuneration stipulated by The Directors' Remuneration Report Regulations 2002.*

independent director. Regrettably, these one-to-one discussions do not sufficiently enable shareholders to execute their responsibility. In order to judge the effectiveness of individual directors and a board as a group, institutional shareholders need to interact with, have meaningful exchanges with, and observe the entire board. Additionally, the economics of the investment industry and rent-seeking behaviours means that these one-on-one discussions happen far less than they otherwise would.

Structured, regular, multilateral meetings between an entire board and its major shareholders as proposed above would more effectively promote the Code's aim of a board and its institutional shareholders having a 'mutual understanding of objectives'. In addition, these meetings may allow for more senior representation of institutions than is currently the practice, and thereby add more weight to shareholder engagement. The meetings would provide shareholders with a venue to express transparently views that would be heard by not only the chair and entire board but also, as importantly, investor peers. To the extent that such activity is safeguarded from concert party rules, these meetings would allow coordinated engagement to improve board composition in a way that may better safeguard a company's assets and strengthen its long-term performance.

Since structured, coordinated engagement with major shareholders may create fair disclosure issues, particularly for companies that are also listed on US exchanges, the Code's provisions should recommend that companies provide all shareholders an opportunity to observe these discussions. Reserving the right to participate to the major shareholders would better bring to the fore the talents of professional shareholders, distinguish this meeting from the annual general meeting and may enhance the effectiveness of the annual general meeting.

Board performance evaluation

Recommendation

To ensure that board evaluations are meaningful and promote better board performance, the Code should further elaborate on principle A.6, which requires a board to 'undertake a formal and rigorous' evaluation. Specifically, the Code should recommend:

(a) a short, streamlined annual appraisal of individual director performance and board functioning; and

(b) every several years, an in-depth evaluation of a board's effectiveness, including a detailed assessment of the discharge of key responsibilities, information flows, and specific proposals to improve performance.

Rationale

Our experience is that a number of companies employ a fairly mechanical, survey-based approach, which may include individual director evaluations of varyingly levels of rigour. While this may aid the process of appointing directors, its standardisation and checklist approach impede considerable reflection. A step back and out-of-the box is important. A board evaluation should be seen as an additional instrument in a board's toolkit. As such, the presentation and discussion of the assessment's results should be incorporated into each board's annual calendar.

We agree strongly with maintaining the current scope of the Code's requirement regarding disclosures, namely the Code's focus on the process employed for rather than the outcome of board evaluations. Requiring the latter may provide incentives for boards to be less than candid in their evaluations.

Concluding remarks

We very much support actions to strengthen the Code. Such efforts should focus on enabling boards to discharge effectively their evolving duties, free from unnecessary compliance burden, while encouraging engagement with shareholders that constructively focuses on strengthening companies' long-term performance.

Yours sincerely,

[Sent electronically]

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