AVIVA INVESTORS' RESPONSE TO FRC'S CONSULTATION ON SUCCESSION PLANNING

1 February 2016

Aviva Investors is a global asset manager with £265bn (September 2015) under management in equities, fixed interest, property and multi asset. As a subsidiary of Aviva Plc, an insurance company, we are naturally long term investors. When we buy into companies we tend to remain shareholders for many years so it is in our interest to know that the people who are running our businesses are also thinking long term, and more to the point, that they are thinking about the people who can take over the reins when it is time for them to step down. Directors come and go but good succession planning means that we can remain confident that the company's strategy remains on track and we can remain long term shareholders. The way companies manage their succession planning often contributes to market perception on the quality of the board and management. Therefore, it is in companies' interests to get succession planning right.

We have for many years said that good succession planning is critical for the long term security and progress of companies and Nomination Committees have a major role in ensuring companies have effective boards that make the best decisions for their companies but, to date, we have been disappointed on the quality of succession planning at many companies.

The importance of culture

The 'tone from the top' in establishing a strong and positive culture is an important component to continuing success for companies. Therefore, it is important that individuals brought on to boards have the right personalities and approach to deal not only with the financial and operational issues but also with leadership skills that include developing the culture of the business, setting the standards and values, being aware of reputational risks arising from poor behaviour in dealing with shareholders, employees, customers, suppliers, communities and the environment.

Raising the profile/status of the nomination committee

If we believe that the quality of the board, diversity, skills and experience are the most important influencing factors on the future of the firm, then the Nomination Committee is arguably the most important board committee. However, it has had the least attention paid to it. The lack of confidence investors have on board nominations has led to various discussions in recent years on how shareholders can take back the responsibility of appointing directors hence the discussions on the Swedish Nomination Model. We don't believe we need to go that far but change needs to be made to provide investors with more confidence that the Nomination Committee is on top of their job and continuing attention and monitoring is given to the ability of the board to function effectively.

In order to raise the status of Nomination Committees, disclosures in Annual Accounts and investor meetings should focus on the effectiveness of the board. The starting point of any governance discussion is around strategy and whether the right personalities, skills and experience are available on the board to give companies the best possible chance to succeed. The first board committee report in the Annual Report should be the Nomination Committee Report and the Chair of the Committee should say they are happy with the current structure of the board and that it is well equipped to meet the challenges of the future and is diverse enough to make good decisions. If you look at Annual Reports, the Nomination Committee report is often comparatively short and uninformative compared with remuneration and audit reports. This gives the impression that board composition and structure is a secondary issue.

In particular, we are concerned that boards are not dominated by any one individual and if it is, then it is the Chairman's role, together with the Senior Independent Director and the Nomination Committee to consider succession. We have had many occasions where, once an apparently successful CEO has left the company, investors discover things were not as good as they thought and the successor CEO has had to re-state the accounts, resulting in deteriorating share prices and loss of reputation. Investors should hold Chairmen and Nomination Committee Members accountable for such situations. If the chair is the problem then the Senior Independent Director should take on the responsibility of appraising the effectiveness of the board. Regular board evaluations, including externally facilitated ones, would be a good ongoing process .

Sifting out and personal conflicts

The consultation asks to what extent we agree with the assertion that those who challenge are sifted out during the recruitment process. We believe that it is likely to be true on some boards. Even where companies try to do the right thing we have experienced the removal of 'difficult' non executives – this may be sifting!

Probably the biggest barrier to good succession planning is the personal awkwardness of having to tackle the issue. This has not been mentioned in the consultation. For example, weak chairmen do not put in place succession arrangements for fear of upsetting the CEO. No succession planning is seen by us as an indicator of weak chairmanship. Therefore, any guidance that is produced should address how individual directors can overcome this situation objectively. As good practice, Chairmen should say to CEOs and other senior management, on their day of appointment, that the search for their successor starts on day one. This de-personalises the situation and is good risk management. Unilever is a good example of this.

Proper succession arrangements have a Plan B

It is good practice for Companies to have a 'Plan B'. Good succession arrangements need to cover the scenario of the first choice candidate not being available or not working out. In our experience, many companies fail to consider this and therefore are forced to appoint external candidates, which sometimes result in them paying much more than would otherwise be expected.

Poor succession can result in pay arrangements that are not aligned with shareholder interests

We have found that poor succession planning can be evident in poor remuneration arrangements. We have seen numerous examples of companies increasing variable pay or making retention payments to existing directors or paying significant amounts for external appointments and in most cases this is because succession (particularly identifying and developing senior managers) hasn't been properly addressed. Under normal circumstances (bearing in mind there may be exceptional circumstances) a new executive should be appointed on a lower remuneration package than the executive they are replacing (particularly if the former executive had strong performance at the company), with their pay increasing over time, once they are proven.

Diversity

Good succession arrangements will also help to address the lack of general diversity, such as industry background, nationality, ethnicity, age and also of women in executive positions. Companies should explain what they are doing to ensure sufficient diversity and to improve the pipeline so more women are given the same opportunity as men for the top jobs. When recruiting for positions companies should ask their recruitment firms to include women in their shortlists.

Practical suggestions for nomination committees and non-executive directors:

In coming up with succession plans, the Chairman and/or Non-executive directors need to allocate more time to speaking with employees, especially senior managers. This does not replace formal processes but informal discussions may be just as useful as the formal conversations, training and development . More time spent walking around offices may help them to discover the next CEO, who at the time may be more than one tier below board.

Importantly, the effectiveness of Senior Managers should also be within scope of the Nomination Committee as it is from this cadre of executives that the future leaders may be chosen.

Nomination Committees should be confident that all key positions within the business have successors that can take over with the minimum of disruption under normal circumstances.

Where there is M&A activity or big shifts in strategy, the Nomination Committee should make special efforts to explain their thinking on whether anything needs to change, whether strategy is changing, whether the board has gaps in addressing the change in strategy or expansion in the size of the company. If change is required are they on top of the process?

Much of what investors will learn about the quality of the board and succession planning comes from adequate disclosure. The quality of reporting in this area can be greatly improved. For example:, companies should consider :

- Linking succession planning discussions to strategy
- Moving away from boilerplate reporting on Nominations Committee. The language should be relevant to the company's situation rather than repeating the UK Corporate Governance Code requirements.
- Describing the process of nominations and board succession so investors are clear there is a proper process.
- Discussing the reasons for changes made and, importantly, not made, so investors are reassured that the Nomination Committee is regularly reviewing the effectiveness of the board. Reasons could include introducing more independent challenge or diversity, improving the quality of conversations, or filling a gap in experience
- Stating why they believe the board is sufficiently diverse so 'Groupthink' is not an issue and all geographical areas covered by the business is represented, so too with age groups and gender.
- Explicitly stating whether they have or have not got succession arrangements in place for all members of the board and senior management. This should include the readiness of succession arrangements according to various executive levels and time scales e.g. if the changes needed to happen tomorrow, in six months, in a year etc. how does the company stand?
- Providing more meaningful biographies of individual directors, why they are on the board, what skills/experience they fill, how they are working together, what they are contributing.
- Providing information on the quality of the pipeline internally to fill these slots, including what is the company doing to improve the pipeline and, topical at the moment, the pool for female executive directors

- Describing how board evaluations are linked into succession planning. The intelligence learned from a useful board evaluation should feed into Nomination Committee work. Companies should give an overview of the evaluation exercise and key recommendations for improvement and what the company has done in response.
- Asking investors of their perception of the board and whether it looks optimal and if not why not.

What investors can do:

- Investors should raise board effectiveness and succession when they engage. They should make it clear to chairmen and other NEDs of the importance of succession planning and why it is in their interest and shareholders that a good plan is in place. Investors should also let boards know what is expected of them and what disclosures they would like to see.
- Where they are not happy with chairmen for not having put in place good succession processes or plans, investors should consider voting against their re-election.
- Investors could also consider voting against chair of the Nomination Committee and even its members.
- In very extreme cases actions such as submitting resolutions and calling EGMs may be considered but we would expect this to be a very rare occurrence.

What the FRC can do:

The Consultation says that there is little consistency in reporting. Perhaps the FRC could provide guidance on good reporting on succession planning.