TOWERS PERRIN

FINANCIAL REPORTING COUNCIL

REVIEW OF THE EFFECTIVENESS OF THE COMBINED CODE

RESPONSE TO CALL FOR EVIDENCE

INTRODUCTION

1 This paper contains Towers Perrin's response to the Financial Reporting Council's ((FRC) consultative document *Review of the Effectiveness of the Combined Code Call for Evidence*. Our response is primarily based on the operation of the Code when viewed through the lens of the operation of remuneration committees.

2 Towers Perrin has been active in executive compensation for 40 years and has the largest team specialising in the field in the UK. More particularly, the following evidence is based on the observations and experience of eight Principals of the firm who, between them, have some 170 years' experience of advising remuneration committees. The great majority of this experience has been gained working with FTSE 100 companies.

3 In addition, we have taken into account the views of the Commission of the European Communities expressed in its Recommendation C(2009) 3177 *as regards the remuneration of directors of listed companies* (Brussels 30.4.2009).

4 Accordingly, this response is organised as follows:

- the operation of remuneration committees;
- comply or explain;
- Annex 1 – issues raised by the EU Commission's Recommendation, and
- Annex 2 – matters relating to remuneration committee consultants.

Where appropriate (paragraphs 8, 12, 17, 31, 37 and Annex 2), we make suggestions for modification of the Code although we do advocate caution when making regulatory changes which may have unintended consequences.

THE OPERATION OF REMUNERATION COMMITTEES

Generally

5 The first and most important point to note is that, in our experience, the majority of remuneration committees operate satisfactorily:

- relationships between the parties are constructive and their respective roles are clear;
- the quality of both internal and external support is satisfactory and decisions are made after due consideration in a timely manner, and
- relations with institutional shareholders are properly managed.

6 It follows that most of this response is concerned with the position when the operation of the remuneration committee is, in some way, less than satisfactory, since these are the circumstances from which lessons can be learnt. We would not wish to create the impression that unsatisfactory practice is also majority practice.

Effectiveness of the board

7 Our primary observation would be that an effective board usually has an effective remuneration committee. Our experience is that the remuneration committee can be a barometer of board relationships. Tensions generally emerge through, *inter alia*, untimely and inadequate information, poor process and infrequent or poorly conducted meetings.

8 The Code already covers these matters so it is difficult to see where it could be further strengthened to correct for this circumstance, except to emphasise the importance of Section A6. This might be done by specifying that board reviews should be carried out by external agents [every third year] who would report directly to shareholders and also by emphasising the reporting requirements.

Board relationships

9 In the context of the remuneration committee, the critical relationships are those between the chairman of the company, the chief executive (CEO) and the chairman of the committee. In our observation, a dysfunctional relationship between any two of these three individuals may have a more or less detrimental effect on the operation of the committee. Particular dangers are:

- a forceful CEO who might disrupt the process, control the information flow or influence decision making beyond the normal advisory role;
- a forceful chairman who might assume the roles of either (or both) the CEO and committee chairman or a passive or uninterested chairman who ignores the process and its outcomes, and
- a committee chairman who might attempt to micro manage the process, the proposals and the decisions.

10 The first point is of particular importance because:

- for as long as the non-executive directors have confidence in the CEO and the executive team, there is a natural bias in the system towards approving the executive's proposals, and
- however the process might be improved, very few individuals welcome difficult conversations and someone in the organisation has to be capable of delivering a negative message to the CEO.

11 It is also critical that the committee feels able to trust the advice and support from the executive (particularly the HR function) since this also has a significant effect on the efficiency of the process. See below – paragraph 13 *et seq.*

12 We would therefore suggest the following points for inclusion in a revised Code.

- B.2.1 While we are indifferent to the question of whether the chairman should be a member of the committee, because of the sensitive nature of the matters under consideration, we are quite clear that he or she should be present for all its substantive deliberations. Therefore we would expand the scope of this provision to mandate that the chairman should attend all the committee's discussions (subject to the usual exception when his or her arrangements are under discussion) unless they are of a routine or administrative nature.

B.2.2 It may be a helpful process change if, having received advice from internal and external sources, committees were to deliberate and decide *in camera* with only the secretary and (if the committee wish it) their own external advisers present.

Quality of support

Internal advice

13 We comment firstly on three aspects of *internal* relationships with the committee which can affect its operation:

- conflict of interest;
- quality and timeliness of supporting papers, and
- relationships with external advisers.

14 Much institutional and media commentary is concerned with potential conflicts of interest affecting external advisers. None that we have seen is concerned with internal advisers (other than the CEO) facing the same problem. Yet, in our experience, the latter is the greater danger. The position of HR Director (or, perhaps, the head of reward reporting to the HR Director) can be particularly vulnerable because of the potential for job or career threatening actions by the CEO. The HR Director can play a number of roles (normally implicitly) in relation to the committee (e.g. respected internal adviser or technical expert) but there is a risk that the HR Director may also be expected to persuade the committee to follow the CEO's wishes.

15 The nature of any conflict is rarely, if ever, overt but it can lead to many forms of dysfunctional behaviour, for example:

- the committee's agenda or the content of papers is overly influenced by the CEO (or Chairman);
- inadequate papers are delivered late;
- self-selection of external data;
- poor or superficial supporting financial data;
- biased or disingenuous arguments in support of proposals;
- inadequate time allowed for discussion (so that the committee feel "bounced" into a decision).

The effect can be to create a damaging level of mistrust between the committee and its internal advisers.

16 One of the most critical factors in the successful operation of a remuneration committee is the provision of good quality, professional and timely supporting papers, which present both relevant context and the supporting arguments in full and allow the committee time to absorb the arguments and fulfil their obligation to provide constructive challenge Some of the characteristics of poor papers are noted in paragraph 15.

17 We suggest that the Code Provisions in A.5 might be extended to specify that papers must be clear about the use of *externally* sourced information and where that information is presented as an extract, summary or amendment of another document.

18 The way in which the company uses external adviser(s) ca*n,* also be less than satisfactory:

- where the adviser is kept at arms length from top management or the committee itself (*e.g.* by not being invited to meetings);
- if the advisers' reports are used simply to inform or support internal papers (thus allowing "cherry picking" of data or advice), or
- when the advisers are given inadequate time to review and comment on internal proposals even though they may have been some time in the gestation.

It is important to note that the first two of these observations can also be characteristic of a well staffed and highly competent HR function which simply needs only factual and second opinion support.

External advice

19 This is clearly one of the more sensitive aspects of the Code's operation. One of the chief concerns is the security of the adviser's independence and freedom from conflict of interest. The Code (Section B.2, Supporting Principle) already provides that the committee should appoint its own advisers.

20 We note that the EU Recommendation goes beyond this by recommending that, where the committee uses external consultants as advisers, the consultant "does not at the same time advise the human resources department or executive or managing directors of the company concerned"; effectively requiring separation of advisers.

21 This potentially presents a serious practical issue since the experience and knowledge of the business gained by working with management is extremely valuable to the process of providing sound advice. If separation of advisers were also to mean that the committee's advisers had limited access to the executive or the business, there is no question that the quality of both the advice and the process would be impaired.

22 For the reasons set out below, Towers Perrin's position on the separation of remuneration committee advisers has always been and remains that it is wrong in principle and unsound in practice. However, we accept that there could be greater clarity on the role and responsibilities of external advisers to the committee to ensure no perception of a conflict of interest (see paragraphs 30 and 31).

23 Under the UK's unitary board system all directors have the same individual and collective responsibility to the company's stakeholders. They are a single entity and the remuneration committee is simply a sub-set of the board to which it must account for the exercise of its delegated authorities.

24 The legal structure therefore calls for advisers to the board as a whole. There is no need for separation unless there is internal tension. And it is our experience that only a handful of companies have felt the need to operate with separate remuneration committee advisers as a matter of principle.

25 Operationally, in our view, advice is sound or unsound in relation to the business and its presenting issues. The source of the instruction (management or committee) is immaterial.

26 Finally, it is very difficult to make separate advisers work without time consuming management by the company. And our experience of a system where there are two separate advisers is that the company's costs would be more than doubled and there can be an unfortunate tendency to focus on differences in the advisers' data or advice rather than on the substantive issue under consideration.

27 This brings us to the question of the independence of the adviser itself.

- There is a widely held perception that the existence of a wider relationship between an adviser to a committee and that company's management puts the adviser in a position of conflict. The reality is that any distortion of advice (which must thereby become unsound) in a misguided attempt to support a wider relationship would certainly cost the adviser the committee appointment and would at least endanger the wider relationship.
- The other aspect of independence is purely financial. For Towers Perrin the loss of a major client would certainly be an embarrassment and might well have implications for our market reputation (which is the true cost of such a loss) but it would not be financially significant. The same would not necessarily be true of individuals or boutique firms who might superficially appear to be more independent in that they only advise on executive pay.

28 It follows from this analysis that we would not *prescribe* that remuneration committee advisers must work only for the committee. The EU Recommendation only requires that Member States ensure that "listed companies…have regard to" the Recommendation. This seems to us to fall within the principle of "comply or explain". While it is open to the FRC to incorporate this type of provision into the Supporting Principle for Section B2 of the Code, we think the better view is to deal with the issue by exception as is the case for auditors (see Annex 2, which covers the role of consultants).

29 There is another aspect to the role of committee advisers. While there are appropriate disclosures naming advisers and their relationships to the business, there are no provisions which deal with the extent to which advice was given or taken. It is possible to provide material assistance to a committee:

- without attending a committee meeting;
- while having no opportunity to influence decisions, or
- when all advice is ignored.

There are also matters about which remuneration committees may not seek advice or provide the opportunity for the advisers to comment. We think that it may not be generally appreciated that, even where advisers are formally appointed by the committee, they may not see all committee papers and may only attend committee meetings when the committee (or the internal advisers) consider it appropriate (e.g. when a new plan is being discussed or implemented).

No one is obliged to take our advice (which is just as it should be!) but we have no recourse should failure to take our advice lead to reputational damage.

30 Therefore if the Code is to be amended to include the EU's Recommendation then we think that it should be supplemented with a new Schedule to the Code dealing with some specifics relating to remuneration committee advisers. We discuss this in Annex 2.

Code developments

31 Having regard to this analysis, we suggest the following points for inclusion in a revised Code.

- We have already made suggestions (*ibid* paragraph 12) for the participation of the chairman in the committee's activities and the decision making process.
- In B.2.1 as an aid to clarifying the role of any remuneration consultant, we would add a reference to any consultant's terms of reference being made available.
- In B.2.1 to clarify the question of a remuneration consultant's independence we suggest moving the reference to the remuneration consultant's connection with the company to a new Provision B.2.5 (see below).
- We would suggest the creation of a new Provision B.2.5 to deal with the independence of remuneration consultants (see also Annex 2 about their role):
  - repeating the terms of Provision C.3.7 relating to auditors thus; "the Directors' Remuneration Report should explain to shareholders how, if the consultant has another connection with the company, the consultant's objectivity and independence is safeguarded";
  - containing a statement about the consultant's other connection (currently in B.2.1), and
  - containing a statement that the aggregate fees paid to the consultant for all work carried for any part of the client's organisation does not exceed, say, 5% or 10% of the consulting firm's total revenue or, if it does, what percentage of the consultant's revenue fees from that client do represent.

The role of institutions

32 As in the case of the operation of remuneration committees, we start with the general observation that, with few exceptions, institutional participation in the process is constructive and has become increasingly so over time. Provided companies maintain reasonably open and timely communications, our experience is that most shareholders are supportive of pay proposals which are the conclusion of a properly reasoned business case. That said, we think that the encouragements given at the end of the last review of the Code (for companies to explain better and shareholders to listen more) still remain valid.

33 In practice (although not necessarily in terms of the Code) there are aspects of the process which are still sometimes less than satisfactory:

- the liaison between the corporate governance and fund management functions of the same institution can still be inadequate, leading to the institution giving mixed messages externally;
- under the pressure of current economic conditions some institutions and at least one voting advisory service are "second guessing" *operational* decisions which have been made by management;
- while single institutional shareholders are almost always reasonable in consultation, groups of institutions can concentrate on governance concerns to the exclusion of business circumstances, and
- there is a widespread practice among investors and their representatives of identifying a change in governance requirements and immediately labelling the change as "best practice"; this is unhelpful.

34 The only suggestion we would make for developing the Code is an addition to Supporting Principle E2 stipulating that, in relation to Section B of the Code, shareholders should be concerned with the application of corporate governance principles and not with the company's operational decisions.

COMPLY OR EXPLAIN

35 While we are inclined to extend to the principle of "comply or explain" Churchill's famous dictum about democracy[1], we are wholehearted supporters of this approach. We have no doubt that a rules-based approach would be incomplete, difficult to interpret and would lead to an unhelpful atmosphere of loop-holing.

36 Our only observation is that "comply or explain" seems to work best for those with the resources which enable them to employ its flexibility (FTSE 100 companies perhaps). Otherwise we wonder if the principle sometimes degenerates to "comply or comply". In what might be described as the operational aspects of the Code, some allowance is already made for this (e.g. the number of non-executive directors required to serve on board committees in small companies). This problem (if it is a problem) may be intractable but may be worth considering in the wider application of the Code. (Incidentally, the observation applies also to the major institutional shareholders which may well be consulted about governance matters when other shareholders are not.)

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Note 1: "Democracy is the worst form of government, except for all those other forms that have been tried from time to time." House of Commons, Nov. 11, 1947

ANNEX 1

EU Recommendation C(2009) 3177 *as regards the remuneration of directors of listed companies* (Brussels 30.4.2009)

The EU's Recommendation corresponds to its previous Recommendations made in 2004 and 2005 and extends them. In general, the provisions of the Recommendation are consistent with the terms of the Code or the Listing Rules. There are parts of the Recommendation which differ in emphasis from or are more specific than the current Code provisions but we have nevertheless regarded the Code as covering these topics.

In this Annex we refer only to those parts of the Recommendation which go beyond the Code or the Listing Rules.

As noted earlier (paragraph 28) the primary point to note is that Paragraph 1.2 of the Recommendation requires only that Members States "…ensure that listed companies, to which Recommendations 2004.913/EC and 2005/162/EC are applicable, *have regard to* this Recommendation" (our emphasis).

Therefore it seems to us that, with one exception, it would be open to incorporate the terms of the Recommendation into the Code on the principle of comply or explain.

The extensions would be as follows.

- Paragraph 3.2 states:

  "Award of variable components of remuneration should be subject to predetermined and measurable performance criteria.

  "Performance criteria should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long term value creation, such as compliance with applicable rules and procedures."

  This provision might usefully be incorporated in to Schedule A of the Code (paragraph 4)

- Paragraph 3.4 introduces the principle of "Clawback" which has not so far appeared in the Code. It might form the basis of a new Provision B.1.7

  "Contractual arrangements with executive or managing directors should include provisions that permit the company to reclaim variable components of remuneration that were awarded on the basis of data which subsequently proved to be manifestly misstated."

- Paragraph 4.1 requires that share awards should not vest for at least three years after their award. This provision is already present in paragraph 2 of Schedule A to the Code. But it is not consistent with the current Listing Rules definition of a Long Term Incentive, which relates to schemes requiring shareholder approval and refers to performance periods longer than one financial year

- Paragraph 4.3 requires, in effect, that companies ought to have shareholding guidelines and paragraph 5.2(f) that the guideline and how it operates must be disclosed. Both of these things are common practice in the UK but they are not part of the Code. These provisions might conveniently be added to Schedule A, paragraph 1.

- Paragraph 7.1 introduces in relation to the remuneration committee, a requirement that one of its members ought to have specialist knowledge of remuneration policy. This type of provision is already in the Code in relation to audit committee membership (Code Provision (C.3.1). A similar provision could be incorporated in to Provision B.2.1.

- Paragraph 9.2 expresses a clear view that remuneration consultants should be independent of the HR department; it states:

  "When using the services of a consultant with a view to obtaining information on market standards for remuneration systems, the remuneration committee should ensure that the consultant concerned does not at the same time advise the human resources department or executive or managing directors of the company concerned."

  It of course open to the FRC to incorporate this type of wording into the Supporting Principle for Section B2 of the Code. For the reasons given in paragraph 22 *et seq* we think the better view is to deal with the issue by exception as is the case for auditors (see paragraph 28)

ANNEX 2

The role of formally appointed remuneration committee consultants

We have already expressed our view that the employment of 'independent' remuneration committee advisers ought not to be prescribed. We have, rather, suggested Code changes which are intended to improve the process by strengthening the position of the adviser. For convenience we repeat them here.

- B.2.2 it may be a helpful process change if, having received advice from internal and external sources, committees were to deliberate and decide *in camera* with only the secretary and (if the committee wish it) their own external advisers present.

- We would suggest the creation of a new Provision B.2.5 to deal with the independence of remuneration consultants:
  - repeating the terms of Provision C.3.7 relating to auditors thus; "the Directors' Remuneration Report should explain to shareholders how, if the consultant has another connection with the company, the consultant's objectivity and independence is safeguarded";
  - containing a statement about the consultant's other connection (currently in B.2.1), and
  - containing a statement that the aggregate fees paid to the consultant for all work carried for any part of the client's organisation does not exceed, say, 5% or 10% of the consulting firm's total revenue or, if it does, what percentage of the consultant's revenue the fees from that client do represent.

In addition to these Code provisions, we suggest the addition of a Schedule (or an extension of the current Schedule A) which would mandate the following provisions dealing with the role of a consultant formally appointed as primary adviser to a remuneration committee.

- A requirement that the Directors' Remuneration Report (DRR) contains a statement of the primary responsibility of the consultant.

- A requirement that the DRR contains a statement about the direct access which the consultant has had to the committee or its chairman.

- A requirement that the DRR contains a statement about the extent to which the consultant has worked with or had access to executive management.

- A requirement that consultants be entitled;

  - to attend any meeting or discussion of the committee except where confidential matters relating to an individual (e.g. the performance of the CEO) is under discussion (this again is primarily directed at improving the quality of the consultant's advice), and
  - to receive all remuneration committee papers, including minutes, at the same time as (or before) they are circulated to committee members.

- A requirement that all written advice given by the consultants must be provided to the committee in its original form.