HANSON GREEN

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

*The views of Hanson Green*

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We are grateful for this opportunity to submit our views on the current functioning and effectiveness of the Combined Code.

By way of background, Hanson Green has specialised in placing high-calibre independent directors and chairmen on the boards of listed UK and international companies since 1989. We were one of the first firms to identify the need for professionally-appointed non-executive directors and we have been active pioneers in the corporate governance debate ever since.

In addition, our specialist boardroom consulting practice advises companies on board performance evaluation, director induction programmes, information audits and corporate governance reporting.

We believe our extensive experience and up-close perspective on UK boards makes us well placed to comment on the effectiveness of the Combined Code, especially in the light of the current financial crisis and recession.

## Overall comments

In general, we believe the code to be working well. It is clear that governance and risk management failed badly in the financial services sector, and we are pleased that a sector-specific review is under way in the form of Sir David Walker's enquiry.

In the rest of the economy, there are few signs of the UK governance regime suffering from systemic failure. It is important to bear in mind what good governance can and can't achieve. The Combined Code, or any governance regime, can never turn a bad company into a good one or protect absolutely against corporate failure. Such an ideal is impossible in the commercial world where risk-taking is a given.

The Combined Code does not, and should never seek to, provide a set of rules, compliance with which will ensure good governance and business success. Instead, it offers a sensible, practical guide that, properly applied by good chairmen and strong directors, helps foster the right environment of strategic thinking, challenge and oversight.

The Code's principles have been developed over nearly 20 years and many iterations. The 1992 Cadbury report introduced the 'comply or explain' best practice code, formalised the role of non-executive directors, and greatly strengthened the audit process.

Later codes, led by Sir Richard Greenbury and Sir Ronnald Hampel, focused on remuneration standards and board effectiveness respectively. Finally, Sir Derek Higgs' review of non-executive directorship, published in 2003, established sound guidance on director independence and board evaluation. Since then, the Code has been reviewed on a biannual basis.

The result is that any board that wishes to commit itself to good governance has a first rate template from which to work. Our view, therefore, is that the content of the Combined Code, subject to the changes outlined below in relation to the remuneration committee, remains relevant, fit for purpose, and of a high quality.

**Content of the code – the remuneration committee**

We are concerned that the role and work of the remuneration committee is the main area where the code is not working as effectively as it should. The system for rewarding executive directors was last subject to serious review nearly 15 years ago by Sir Richard Geenbury, then chairman of Marks & Spencer, and it is in this area that the Financial Reporting Council should focus its energies.

Companies fail – that is an inevitable aspect of our market system, and one which reasonable investors understand. Less understandable is the payment of lavish rewards for those who have led companies to failure, and it is the sight of such payouts that has (rightly) driven public anger and media headlines over the past year.

The review of the Combined Code should seek to put an end to rewards for failure once and for all, and to give boards and remuneration committees the necessary tools to achieve this.

In a survey of 400 directors we undertook in late 2008/early 2009 with remuneration consultants MM&K, we found that respondents broadly approved of the overall quantum of executive pay, and believed that the mix of fixed and variable pay was about right. But a majority said that the structure of incentives encourages short-termism, while 40% thought that executive pay was too complex, and 44% were concerned that there was an insufficiently strong link between pay and performance. (A copy of this research is enclosed).

In short, we still have not got executive remuneration right. Several steps need to be taken if we are to restore trust in the system.

First, companies and their advisers need to cut themselves free from the straightjacket of standardisation. Incentive schemes in particular often seem to be adopted on the basis of whether they will win a vote in favour from institutional investors, rather than whether they suit the company's individual circumstances.

Remuneration committees need to match rewards against the specific key performance indicators that are used by the board to manage and oversee the business. If the usual metrics are not relevant, remuneration committees should ditch them and select better ones. It should be the committee's job to determine the pay model that is appropriate to the company, given its sector, stage of development, strategic plans and the KPIs agreed by the full board.

It is incumbent on institutional investors to support companies when they try and break out of the box and move to more company-specific targets. Innovation and flexibility will only flourish when those who vote on pay plans spend the necessary time to understand and, as appropriate, support them.

Institutional investors have been quick to voice their anger over executive pay at the current annual meeting season – so far in 2009, blue chip UK companies such as Xstrata, BP, Pearson and Shell have all recorded high 'no' votes and abstentions on pay policy. Investors are right to be angry about the poor connection between pay and performance, but they have an important job to do in helping deliver a solution.

The overriding principle of incentive pay is to link rewards to genuine, sustainable value creation over the long term. The financial crisis has demonstrated that significant share price gains can be achieved that turn out to be built on sand – in such circumstances, executives can enjoy substantial rewards while shareholders eventually suffer catastrophic loss of value. We believe that the standard three-year time period for judging long-term performance is too short, and appropriate tools should be devised that commit executives to hold stock-related awards well beyond the time they leave the company.

Our specific recommendations to help improve best practice in this area are as follows:

- Clarify that incentive pay is an area where one size does not fit all, and both companies and investors must seek to champion innovation and individuality over standardisation

- It should be a Code principle that incentive awards should be closely linked to the specific key performance indicators used by the board to manage and direct the business

- Since the post-Enron reforms, a perception has developed that the audit committee has the status of *primus inter pares* among board committees. But the remuneration committee is of at least equal importance. A FTSE 100 company chairman has told us that he prefers the board's senior independent director to chair the remuneration committee, and while the committee chair should always be the best qualified person available, having the senior independent director chair this committee can send an important signal about the importance the board accords this committee.

- The code already warns about the danger of comparative data driving an upward ratchet in pay, but this supporting principle needs emphasis. Remuneration committees have only one job, which is to focus on rewards in their own business; what other companies are doing is only relevant as a 'sense check' and not a starting point

- Many bonuses and incentive schemes take base salary as the starting point, with performance rewards awarded as a multiple of salary. This not only has the effect of prompting an upward ratchet in terms of salary increases, but is entirely the wrong yardstick in the first place. Success-related pay is awarded for exceptional performance; it is not simply another form of pay that executives should expect as of right.

- Determine appropriate methodologies for clawing back incentive pay in cases where genuine long-term value was not created

- No remuneration terms should be agreed that alter basic facts, such as joining dates and years of service, in order to boost pensions or other awards

**Application of the Code**

In general, we believe the application of the Code works well. The 'comply or explain' offers vital flexibility, allowing companies to tailor their governance structure to their individual circumstances. But this flexibility is not simply an excuse for companies to cherry-pick the bits of the Code they like and ignore those they don't. Rather, it provides an opportunity for companies fully and clearly to explain the particular governance set-up that suits them, and why. We remain concerned that too many companies continue to choose boilerplate language over rich, textured disclosure that provides a genuine insight into the board and its functioning.