Review of the Implementation of the Combined Code 2003

A Response to the Consultation by the Financial Reporting Council

(Comments requested by 14th October 2005)

From:

Patrick Gerard

Author of "Performance and Reward"

http://www.troubador.co.uk/book_info.asp?bookid=274

Contents:

Introduction	page	2
1- Comparative pay positioning	page	4
2- Conflicts of interests in the setting of executive pay	page	11
3 -Representation of the ownership interest	page	18
4- Alignment of incentives	page	22
5 -Executive pay as a leadership message	page	25
6 -Company directors as agents of the shareholders	page	32
Conclusions	page	36
Reference material and further reading	page	38
Notes on the text	page	41

Introduction

On 14th July 2005 the Financial Reporting Council (FRC) issued a call for evidence as part of its review of progress in implementing the 2003 version of the Combined Code on Corporate Governance.

This document is a response to the request for comments on the effectiveness of implementation. It identifies six areas where the Combined Code is not having its intended effect of improving the quality of corporate governance in UK listed companies. In each of these areas the problems are explained in detail and some changes to the Combined Code are suggested.

Much of the material in this submission has been developed as part of a book that I have been researching on executive pay. During the research it became clear that the current version of the Combined Code has had only limited success in resolving problems in the way that directors' remuneration is organised. In fact there are some problems, such as comparative pay positioning, that arise directly from the current guidance in the Code. In these cases urgent amendments to the Combined Code are needed.

Lying behind many of the six identified problems is a lack of clarity on the high level objectives of corporate governance. The FRC aims to promote high standards of corporate governance, but it is not clear what this means. On what basis should we decide whether a particular practice represents "high" or "low" standards of corporate governance? If the FRC could define a simple high level statement on what good corporate governance seeks to achieve then assessment of the success or otherwise of the Combined Code implementation could take place on a much firmer footing. This issue is discussed in the conclusions section of this document.

The FRC has made it clear that amendments to the code will only be considered if there is a strong consensus that they are needed. The desire to achieve consensus is admirable, but it is much more important that the FRC seeks to meet its top level objectives and to be consistent with its regulatory philosophy: "We will use our influence and powers to promote a regulatory regime in which high standards of corporate governance are seen to contribute to competitiveness, wealth creation and general prosperity"[1]. There is a significant risk that the consensus approach leads to a Combined Code which is not based on principles and clarity in standard setting and rule making[2], but instead comes to represent the balance of power between the various vested interest groups. In particular, the current version of the Combined Code focuses much more on the requirements of directors and institutional investors than it does on the requirements of end-investors who buy into pension schemes and investment products. End-investors are the underlying owners of most plc equity, but their interests often have a much longer term focus than the interests of the institutional investors who represent them. The Combined Code needs to do more to protect the long term interests of end-investors.

I would like to express my best wishes to the FRC as it seeks to improve the Combined Code's implementation. I am sure that this sometimes feels like a thankless task, but it remains a task of the utmost importance to the economic life of our nation. I hope the council will be thorough in its assessment of the issues and courageous in implementing solutions.

Patrick Gerard
4th October 2005

1 - Comparative pay positioning

Summary

The supporting principle of clause B1 of the combined code states that, "The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance."

It is clear from remuneration reports that this comparative approach is the most influential factor in determining the overall level of executive pay in the UK. Unfortunately, however, the approach is also combined with an almost universal desire on the part of remuneration committees to pay at median level or above. This has had a disastrous racketing effect which was already a concern at the time of the Greenbury report of 1995[3] and is still a huge problem today.

There are enormous problems with this approach

- The effect of an upward ratchet in executive pay
- The level of executive pay in a company is set to reflect the situation of other companies rather than seeking to meet the needs and aspirations of the company in question
- A situation has developed in which an artificially high level of executive pay is justified solely on relative consideration with no reference to what is actually desirable. As a German chief executive put it, "I know I am overpaid, but according to the benchmarks, I am not overpaid enough".[4]

In addition to these problems it is also important to note that the usual justifications for comparative pay positioning, whilst pragmatic for remuneration consultants and remuneration committees, are very weak when examined from the point of view of the shareholder.

The Combined Code should not advocate comparative pay positioning, as it currently does in B.1. Instead remuneration committees should be encouraged to identify ways of determining the right overall level of pay that are specific to that company. In section 5 "Executive pay as a Leadership Message" one way of doing this is suggested.

Historical Background

The 1995 Greenbury code of best practise included recommendation C2. "Remuneration committees should judge where to position their company relative to other companies. They should be aware what other comparable companies are paying and should take account of relative performance"[5]

To comply with recommendation C2 a remuneration committee needed to compile a large amount of detailed information about the pay and performance of other comparable companies. The required data about what other companies were paying was just becoming available because Greenbury also recommended increased disclosure of executive pay. Remuneration committees therefore started to make much greater use of remuneration consultancies which were well place to gather all the necessary data and to advise remuneration committees on what can be deduced from it.

The effect of comparative positioning of pay levels

However, right from the beginning there were concerns about recommendation C2. The Greenbury report itself includes several cautions about the practice of positioning pay relative to other companies. It states, "Companies should not pay above average regardless of performance. They should also beware of basing remuneration levels on a skewed comparator group so as to justify higher remuneration levels. If companies generally pursue such policies, the effect will simply be to ratchet up the general level of executive remuneration. Remuneration committees' annual reports should disclose and justify any deliberate policy of paying above average."[6]

These warnings appear to have turned into self fulfilling prophecies! Companies paying below average found that they could move up to average levels very easily and quickly by paying more, whereas companies that were above average did not generally want to move downwards so also paid more. Almost all companies aimed to pitch pay at median levels or above. Many companies aimed to pitch pay at top quartile levels. This ensured that the average level always moved upwards. Similarly the choice of comparator group, and the choice of which components of executive remuneration to include in the benchmark, gave companies plenty of scope to demonstrate that they needed to move pay upwards to achieve average position. The result was indeed a powerful upward ratchet on the general level of executive remuneration.

This quickly became a matter of concern. When the Hampel Committee produced its report in January 1998 it urged caution about the use of comparative pay surveys in setting executive pay because it suggested that few remuneration committees would want to recommend lower than average salaries.[7] When the first version of the Combined Code was finalised in June 1998, it included the original wording of recommendation C2 from Greenbury, but added to it, "But they [remuneration committees] should use such comparisons with caution, in view of the risk that they can result in an upward ratchet in remuneration levels with no corresponding improvement in performance."[8]

Executive pay continued to ratchet upwards quite rapidly after 1998, and even continued to ratchet upwards though the bear stock market from January 2000 to March 2003. From the policies described in remuneration reports it is clear that benchmarking performed for comparative pay positioning is usually the main reason why increases in executive remuneration are deemed necessary. Despite the endless upward ratchet the principle of comparative pay was included in the revised version of the Combined Code finalised in July 2003. This requires that, "The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance."[9]

The origins of comparative pay positioning

Most shareholders invest across all UK equities, usually as part of a pension scheme or investment product. To such shareholders comparative pay positioning, as currently practised, makes no sense at all. It forces executive pay relentlessly upwards irrespective of performance considerations. So why is comparative pay positioning considered a good thing? Why was it ever included in the Combined Code as good practice? It is very clear why executives like it but from a shareholder perspective the logic is far less clear. Should remuneration committees support it?

The mainstream interest in comparative pay positioning arose with the widespread public outrage at substantial increases in pay awarded to the directors of newly privatised utilities in the late 1980's and early 1990's. The Greenbury committee was concerned that the companies in question were paying more than was required to recruit, retain and motivate quality managers. It affirmed that companies should "take a rounded view of the markets in which they operate and the marketability of their Directors"[10] when setting executive pay.

Shareholders were certainly prepared to support this comparative reasoning when it was very clear that certain directors were being paid too much. However this rather obvious "sense check" is very different from the approach to comparative pay positioning that we see today. Pay positioning today has become a science. The consultants produce very detailed reports that systematically consider each different element of the reward package and the total reward position. The result is a pool of data and information that is both extensive and deep. Depending on how the data is selected and presented, a wide range of possible conclusions on executive pay can be justified.

The fact that statistics like these can be used to prove anything is most clearly seen in the performance graphs that companies are required to include in their remuneration reports. If the performance graph genuinely plotted performance against a realistic comparative benchmark then we would expect to see about half of all companies under performing against their benchmark and about half over performing against their benchmark. Remarkably however almost all companies manage to produce figures that show that they outperform their benchmark!

<u>Analysis of the justification for comparative positioning on pay</u>

The big argument used by remuneration consultants to justify comparative pay positioning to shareholders is that if a company falls seriously out of line with industry practise then its reward package may fail to recruit, motivate and retain executives of the required calibre. This is a powerful argument that has been used very effectively, but on close examination the argument does not stand up from a shareholder perspective.

Firstly the augment does not work for investors who invest in a wide range of UK equities, as almost all investors do either directly or indirectly. Increasing executive pay to keep up with the market only forces the same problem onto other companies, who the investor also has shares in. If the other companies respond in the same way then executive pay ratchets upwards across the board without shareholders seeing any benefit at all.

Secondly the argument depends on a very competitive and liquid market in executive talent. The market is certainly not competitive and liquid in this way, and personally I doubt whether it ever could be or should be. However if we believe that comparative pay positioning is really market based then we have to acknowledge that there are many problems with the market. On this basis I have written to the Office of Fair Trading asking them to conduct a Market Study on executive pay.

Thirdly the "falling out of line" has to become very significant before it becomes noticeable and starts to have an effect. The very detailed surveys produced by the consultancies pick up discrepancies that are far more subtle than executives themselves could ever hope to notice, never mind act upon. The complexities of reward packages today mean that, without expert help, it is very difficult to compare overall levels of executive pay in different organisations.

Fourthly the argument assumes that pay is the all important factor in recruiting, motivating and retaining executives. In fact it is far from the most important factor. When Gerard Roche, the head hunter, was asked how he persuades the people he finds to change company he replied "Oddly enough, it's not compensation. How much they earn is important, but it is not their main reason for moving. They can only eat two eggs a day, drive one car at a time. What they really want is, number one, to run their own show. After that they want to be sure that they will enjoy working with their new colleagues, that the job is in an industry that they like and in a part of the world they would be happy to live in. Compensation could not get Jim Kilts to go to Coke."[11] These other factors beyond remuneration actually have far more impact on an executive's quality of life than pay does, but they have become seriously overlooked because of excessive interest in pay.

Fifthly even if a company is demonstrably paying market rates, or even top quartile rates, this does not necessarily protect it from a competitor who wants to poach executive talent. For very senior executives the competitor can always offer more money, although in practice the quality of the role offered may well be a more decisive factor than the money.

Shareholder problems with comparative pay positioning

In addition, from a shareholder perspective, there are serious disadvantages with using comparative pay positioning for senior executives.

Firstly there is the upward ratchet problem, caused by the average company seeking to remunerate its executives in an above average way. This ensures that average remuneration either steps or nudges upwards in real terms each year.

Secondly comparative pay positioning reflects what other companies are paying rather than the needs and aspirations of the company in question. Can the company afford it? Is it in the best interests of the company? If executive pay goes up, does pay increase for those people just below executive level? How far do the effects of executive pay cascade down the organisation? Is the company still competitive on this basis? Will other people in the organisation resent the higher executive pay? How does the executive pay fit with the culture and values of the company? Does the level of executive pay make the leadership of the company more or less credible? Are executives reaping rewards for sacrifices made by others? What does the executive pay say about the company's commitment to shareholder value? These more internal company considerations are extremely important. They are part of what makes each company unique and ensures a healthy diversity in our economy. Unfortunately these very important considerations are seldom discussed in remuneration reports. It would appear that remuneration committees are usually more influenced by the need to keep executive pay in line with the market.

Thirdly comparative pay positioning is concerned solely with relative considerations and has no points of reference in more absolute considerations. If the overall level of executive pay in industry and commerce rose to such a high level that companies could not flourish and the stock market could only stagnate, then this problem would never be identified by comparative pay positioning. Is it possible that we reached this point a few years ago and still have not realised it?

Conclusion

Comparative pay positioning as currently practiced is extremely unhelpful from a shareholder perspective. The wording of supporting principle of B.1 should therefore be changed. The text, "The remuneration committee should judge…improvement in performance" should be replaced by, "The remuneration committee should state in the remuneration report the factors that it considers to be of most importance in determining the overall level of executive pay within the company."

2 - Conflicts of interests in the setting of executive pay

Summary

Main principle B.2 includes the requirement that, “No director should be involved in deciding his or her own remuneration.” The supporting principle adds, “The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.”

This part of the combined code seeks to eliminate conflicts of interest in the setting of executive pay. This is a worthy goal but the current wording is not realistic because it ignores some fundamental problems.

- The principle of collective responsibility within a unitary board structure makes it impossible to properly avoid conflicts of interest.
- It is quite impossible to set appropriate and efficient remuneration without effective communication with the key people involved, even though they have a clear vested interest. This is partially recognised in the first part of the supporting principle.
- Remuneration consultants are often far from independent. Their businesses are completely tied up with the executive pay market in the UK and they can have their own interests and agendas to peruse within that market. These agendas invariably work against the shareholder interest.

The Combined Code should acknowledge inherent conflicts of interest and should seek to ensure that these are properly managed through increasing accountability and trust in the setting of executive pay. This is examined further in section 5 “Executive pay as a leadership message”. The Combined Code should also seek to reduce the influence of remuneration consultants.

Unitary Board Structure

Main principle B.2 includes the requirement that, “No director should be involved in deciding his or her own remuneration.” The supporting principle adds, “The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest."

This language in B.2 is seriously unrealistic in the context of a unitary board. Under a unitary board structure the directors are collectively responsible for the success of the company.[12] Remuneration policy is defined by the remuneration committee, but all directors must ensure that it is objectively in the best interests of the company[13], and if it isn't then each director has a responsibility to take action. The presence of a remuneration committee relieves some directors of the immediate duties associated with remuneration policy, but it does not absolve them from ultimate responsibility and it does not eliminate the ultimate conflicts of interest. If the chairman or chief executive believe that remuneration policies are not in the best interests of the company then it is essential that they raise the matter and get it resolved. Conflicts of interest on directors' pay are inherent in unitary board structure and cannot be avoided.

Nobody favours the two tier board structure that would be needed to avoid conflicts of interest. It is therefore far more realistic to acknowledge that a unitary board envisages directors facing a conflict in the setting their own remuneration, and to focus attention on the proper management of this conflict. Where conflicts of interest occur, a company board needs to demonstrate to shareholders that the company is being managed for the shareholder benefit. This builds up the trust and confidence that shareholders have in the board. The way that directors are paid is a touchstone issue for this trust and confidence. Transparency helps to build trust. Accountability through an annual vote on remuneration policy helps to build up confidence. Restraint on executive pay is the most convincing way that directors can prove to shareholders that the company really is being managed for shareholders' benefit.

Shareholders need to trust directors. It is not enough for shareholders to trust directors in everything except the setting of their own pay, because this is actually a statement of mistrust. Once mistrust has entered the relationship there will be more and more calls for disclosure, accountability and conformance with guidelines but none of these things can actually cure the mistrust. In fact they can have the opposite effect because they effectively tell directors to please themselves so long as they stay within the guidelines.

Communication and the sharing of information

It is not only responsibility for success that directors must share in a unitary board structure. The directors must also share information. If information is not shared then directors cannot make objective decisions in a collective way. The current Combined Code's attempt to avoid conflicts of interest would, if really acted upon, seriously compromise the information flows necessary to set appropriate remuneration.

Consider, for example, a company who is hiring a new senior manager. In such a situation the remuneration package for the new manager is determined as part of a negotiation. This negotiation will also cover many other topics such as responsibilities, reporting lines, travel arrangements and office locations. These factors are at least as important as pay in any final deal. One outcome of the negotiation is a good understanding of what the important issues are in the recruitment, motivation and retention of that particular senior manager. In particular it will be known if the proposed level of remuneration is satisfactory, or whether it needs to be increased to secure the appointment. This information is obviously essential if an appropriate salary is to be set.

However, in the case of executive directors, it is very unclear how this essential information can properly be brought together. The Combined Code requires that, "No director should be involved in deciding his or her own remuneration."[14] Similarly it requires that, "Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to avoid conflicts of interest."[15] The Combined Code also envisages a separation of responsibilities between the Nomination Committee, who recommend board level appointments and the Remuneration Committee who set remuneration. All this separation is intended to avoid conflicts of interest, but it has the unintended consequence of preventing the information necessary for setting appropriate remuneration from all coming together in one place at one time. If all the necessary information does come together in one place then this is likely to be with an external head hunting agency and such agencies have incentives to inflate salaries.

The Combined Code's aspiration to avoid conflicts of interest is therefore unrealistic because it seeks to prevent the flow of necessary information.

<u>The role of remuneration consultancies</u>

Remuneration committees are made up of part time independent non-executive directors, who usually have very limited time available to devote to their duties.[16] It is also difficult for them to use company employees to work on executive remuneration issues because of concerns about conflicts of interest. This means that it is very common for almost all hands on work on the development, implementation and presentation of executive remuneration policies to be done by remuneration consultancies. This approach is strongly endorsed by the Combined Code which states, "The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest."[17]

This role of remuneration consultancies really took off with the inclusion of recommendation C2 in the Greenbury code of best practise in 1995. Collecting the large amount of data needed for comparative pay positioning was a natural task to outsource to a consultancy, and certainly one that a remuneration committee would struggle to do itself. Recommendation C2 appears to have been a massive scoop on the part of Towers Perrin, the remuneration consultancy who acted as professional advisors to the Greenbury study group. It guaranteed them, and many consultancies like them, a huge new market with excellent possibilities for further expansion.

The large and important role of remuneration consultancies has made them extremely influential in executive pay matters ever since Greenbury. It has also ensured that a very large part of all expertise on executive remuneration resides inside the remuneration consultancies. A big proportion of all serious public comment on executive pay, be it in government consultations, books, newspaper articles or TV interviews, originates either directly or indirectly from remuneration consultancies. Remuneration committees need to be aware of the huge influence that the consultants therefore have.

The incentives on remuneration consultancies

Just like any other consultancy a remuneration consultancy's main business objective is to sell consultancy services. They get paid for the consultancy that they provide, and the more consultancy they can provide the more they get paid. In support of this objective the remuneration consultancies offer an ever increasing range of services.

Given that remuneration consultancies are so influential it is important that remuneration committees are aware of and understand the incentives to which the consultants are operating. In doing this I do not wish to suggest that remuneration consultancies operate with anything other than the greatest professionalism and integrity. However the fact remains that the remuneration consultancies that grow and develop and become most influential are the ones that sell the most consultancy services. They are in the business of selling consultancy services.

Given this, remuneration consultancies tend to welcome any developments in executive pay that will help them to sell more services. In practice most developments in executive pay will help consultants to offer more services. New regulations, new guidance from shareholders, new definitions of best practise and new research all help to move industry practice forward and all create opportunities to sell services.

There are some potential developments in industry practice that would work against the interests of the consultants. For example a move away from comparative pay positioning would seriously undermine the remuneration consultancy business. Any such proposal can expect to meet fierce opposition from the consultancies.

Remuneration consultancies stand to benefit from the growing complexity of executive remuneration packages. Complexity increases the dependency of remuneration committees on consultancies. They need someone to keep track of what is happening and to advise them. This increases the influence of the consultancies and creates new opportunities for them to sell services. In itself higher complexity generates additional work that the consultancies can charge for, increasing the size of their market. Complexity also makes it more difficult for non-specialists to provide the services required, improving the consultancies competitive position.

Remuneration consultancies often benefit from controversy and shareholder rows associated with executive pay. There is a good chance that a remuneration committee engaged in a row will hire a remuneration consultancy to develop its case and find a way forward. Perceptions about good practice are very likely to move on as a result of the controversy and it may lead to additional guidance or regulation in the longer term. All these things create opportunities for remuneration consultancies.

To keep executive remuneration practice moving along it is firmly in the interests of remuneration consultancies to recommend increases in executive pay. Justified proposals to increase executive pay are likely to lead to further work for consultancies. A new incentive scheme might be required to make the payments. Explanation and justification of the higher pay will be required, especially if shareholders are uncomfortable. The bigger executive remuneration becomes as a financial cost and as a business issue then the more work there is for remuneration consultancies.

At first sight the remuneration consultancies might be able to build their business just as effectively by recommending reductions in executive pay. However in practice this just does not work. It is far easier to sell the idea of higher executive pay to a remuneration committee than the idea of lower executive pay. Most remuneration committee members have been executive directors at other companies and they naturally identify with suggestions that good executives are a scarce commodity, under paid and under appreciated who really deserve more. In contrast it is extremely difficult to attract attention with a message about reducing executive pay. It is difficult enough for a remuneration committee to make a reduced payment under an annual bonus scheme. To actually reduce the expected value of remuneration is extremely difficult and could easily cause serious rifts at board level.

Awareness of the conflicts of interest

Remuneration committees therefore need to take notice of the fact that most of the incentives that are faced by remuneration consultancies as businesses actually work directly against the interests of their own shareholders. Shareholders want to see stable long term incentives in place whereas remuneration consultancies always want remuneration practice to move forward. Shareholders are suspicious of the upward ratchet arising from comparative pay positioning, but remuneration consultancies firmly support this practice. Shareholders want simple and transparent remuneration schemes.

Remuneration consultancies benefit from complexity. Shareholders want remuneration committees who they can trust, but consultancies benefit from rows and controversy. Shareholders want to see the average level of executive pay constrained or reduced whereas remuneration consultancies have a strong interest in seeing it rise.

Remuneration committees should consciously take these incentives into account when they accept advice from remuneration consultancies. They should seek to minimise the influence of the consultancies by avoiding conflict, reducing the complexity of executive pay and increasing its transparency. They should seek stable long term incentives and resist unnecessary developments in industry practice.

Conclusion

The wording of B.2 "No director should be involved in deciding his or her own remuneration" should be replaced by, "Care should be taken to minimise the effects of vested interests and conflicts of interests in the setting of executive pay." The wording of the supporting principle "The remuneration committee should also be responsible…avoid conflicts of interest." should be replaced by "When taking internal or external advice on executive pay, the remuneration committee should be mindful of the financial interests of the person or body giving the advice. Advice that reflects the financial interests of the advisor more than shareholder interests should be discounted.

3 - Representation of the ownership interest

Summary

Far from being well represented, the ownership interest of shareholders is actually rather marginalised by the corporate governance arrangements currently set down in the Combined Code. This is a very serious problem. It means that shareholders can have little confidence that companies are being run for the shareholder benefit, even when all the Combined Code's boxes have been ticked.

The Combined Code needs to introduce a new concept: the shareholding non-executive director. Such a director would have a large personal shareholding in the company, and would specifically represent the ownership interest on the board. Shareholding non-executives would have the same eligibility as independent non-executives in respect of membership of the board and its board sub-committees.

The presence of shareholding non-executive directors on a company board and in key board sub-committees would greatly increase the ownership representation on the board. They would increase confidence that the company was being run for the benefit of its shareholders. They would provide greater shareholder credibility to company boards and would give boards far more resilience in fighting off unreasonable requests from institutional shareholders.

Representation of ownership interest in the Combined Code

Corporate governance is all about ensuring that a company is run in the interests of its shareholders. Given this, we should expect attention to the ownership interest to be a key theme running through the Combined Code. However this theme is far weaker than might be expected. The Combined Code's philosophy is rather more that the chairman, chief executive and finance director are principally responsible for communication with shareholders (A.2, A.3.3, D.1), and "Non-executive directors should constantly seek to establish and maintain confidence in the conduct of the company"[18] so providing some checks and balances on the behaviour of the executive directors.

It might be thought that non-executive directors should be the defenders of the ownership interest in situations where conflict arises between the interests of shareholders and the personal interests of the executive directors. Unfortunately, even if non-executives do see this as their role, they have very limited power do it effectively.

The main problem for non-executive directors is that they have very little time to devote to their duties. Often proposals that come before the board have been developed without their input. This, together with the fact that they have no staff reporting to them, restricts their ability to pursue their own agenda. Another big power limiting factor is that most non-executive directors are independent. By definition an independent non-executive director has a very limited relationship with the company. He or she is most unlikely to have a sufficiently detailed knowledge of the company or its historical background to be able to represent the ownership interest effectively. A further power restriction arises from the appointment and re-election of non-executive directors which is mainly in the gift of the board itself, particularly of the chairman. This means that a successful a non-executive director is very unlikely to pursue an agenda that creates conflict with the company chairman. The only real power that a non-executive can exercise comes when he or she threatens to resign. Unfortunately resignation is likely to hurt the non-executive at least as much as it is likely to hurt the board. Post-resignation the non-executive, particularly if he or she is independent, usually has very little incentive to pursue the issue that lead to the resignation.

In fact a closer study of the Combined Code 2003 shows that it does not envisage that the non-executives have any specific responsibility to represent the ownership interest. On the contrary the code envisages that contact with shareholders is much more the business of the chairman and executives than of the non-executives (A.2, A.3.3, D.1). Further, non-executives who have a significant shareholding in the company, or who have any longstanding relationship with the company are unlikely to be considered as independent in accordance with the codes criteria (A.3.1). A non-executive who is not independent cannot serve on the remuneration committee (B.2.1) or on the audit committee (C.3.1) and can only be in a minority on the nomination committee (A.4.1) and on the board as a whole (A.2). Non-executive directors who are not independent therefore have very limited scope in their role, and consequently can have only limited influence.

Unfortunately therefore the Combined Code has the, perhaps unintended, consequence of decreasing rather than increasing ownership representation on company boards. This is a very serious problem. The voice of the underlying ownership interest has become extremely marginalised. This means that the most important checks and balances within the board to ownership relationship are absent.

Increasing ownership representation under the Combined Code

Michael Skapinker has argued convincingly[19] that non-executives who have significant amounts of their own capital wrapped up in the companies shares are the most effective at improving company performance. He quotes research by Donald Hambrick and Eric Jackson published as "Outside Directors with a Stake: The Linchpin in Improving Governance" in the California Management Review 2000. He also refers to the famously successful investment company Berkshire Hathaway run by Warren Buffet. When appointing non-executive directors Mr Buffet sees a large personal shareholding as more important than any other criteria. Mr Buffet says, "Charlie and I love such honest-to-God ownership. After all, who ever washes a rental car?"[20] A significant personal shareholding is a quality that we should look for in our non-executive directors.

Unfortunately a non-executive director with a significant shareholding would not be considered as independent under the A.3.1 criteria and therefore, in the Combined Code's current form, would not be eligible for service on the board's most important sub-committees.

The concept of a 'shareholding non-executive director'

The Combined Code needs to define a new concept: the shareholding non-executive director. A non-executive director is eligible to be designated 'shareholding' if he or she has a large personal shareholding in the company. The value of the shareholding must be at least 100 times bigger than any remuneration that the non-executive receives from the company. The shareholding must be of a long term nature, and the non-executive must undertake not to sell the shareholding for at least three afters leaving office. A shareholding non-executive director must also be free of compromising links (through family or investment or directorship) with the company's management, suppliers and customers.

Shareholding non-executives should have the same membership eligibility as independent non-executives in respect of the board and the board sub-committees. Over time companies should seek to replace some of their independent non-executive directors with shareholding non-executive directors. Ultimately a board should seek to have more non-executives who are shareholding than independent, although both should be represented.

The presence of shareholding non-executive directors on a company board and in key board sub-committees would greatly increase the ownership representation within the company. It would greatly increase confidence in corporate governance. It would provide far greater credibility to company boards and would give boards far more resilience in fighting off unreasonable requests from institutional shareholders.

Conclusion

The Combined Code should be strengthened by including the role of shareholding non-executive directors. Shareholding non-executives should have the same eligibility as independent non-executives in respect of the board and its sub-committees. Over time companies should seek to replace some of their independent non-executive directors with shareholding non-executive directors. The presence of such directors will significantly increase confidence that a company is being run for the benefit of its shareholders.

4 - Alignment of incentives

Summary

Paragraph B.1.1 the Combined Code emphasises that performance-related remuneration is important and that it should be designed to align executive interests with the interest of shareholders and to provide incentives for directors to perform at the highest levels. This important principle has its focus diluted by Schedule A of the code, to which it refers.

Ultimately, the purpose of performance related pay is to give executive directors incentives to create long term value for shareholders. Unfortunately focus on this objective is often lost, and this can be clearly seen in a study of performance related remuneration schemes for executive directors in UK companies. The schemes are designed to provide many complex incentives, often more associated with the objectives of the company board than with the shareholder interest. Better attention to the purpose of the schemes in their design could significantly improve the incentives on directors and increase confidence that directors are working in the best interests of shareholders.

An extra clause should be added to Schedule A of the Combined Code to ensure that remuneration committees stay focused on the purpose of performance related remuneration when they design incentive schemes for directors.

Incentive alignment and executive performance

The Combined Code says that, "The performance-related elements of remuneration should form a significant proportion of the total remuneration package of executive directors and should be designed to align their interests with those of shareholders and to give these directors incentives to perform at the highest levels. In designing schemes of performance-related remuneration, the remuneration committee should follow the provisions in Schedule A to this Code."[21]

This is a good and important code provision, but it is badly let down by the provisions of Schedule A. Schedule A requires that the remuneration committee should consider whether the directors should be eligible for annual bonuses and benefits under long term incentive schemes. Crucially, however, it does not suggest any basis on which this decision should be made. It makes a number of important points about the design of long term incentive schemes but there is a serious loss of focus on the fundamental principle expressed in B.1.1.

It is far too easy for remuneration committees to forget that the performance related elements of remuneration should be designed to align the interests of directors with shareholders. The alignment of interests is important because it provides shareholders with confidence that the directors have the incentives to work in the shareholders best interests. Ultimately, performance related remuneration for directors is all about generating incentives for directors to work in the best interests of shareholders. This needs to be much more clearly affirmed in Schedule A to help remuneration committees stay focused on the generation of appropriate incentives.

I have conducted a detailed study of performance related pay schemes in the UK. From the study it is very clear that not nearly enough consideration has been given to either the alignment of interests or the incentives referred to in clause B.1.1. Financial modelling of performance related pay schemes shows that many schemes deliver big payouts to executive directors in situations where performance has been very poor. It is clear that the incentives on directors could be significantly improved through a more rigorous focus on the needs of shareholders. Ultimately shareholders want long term growth in total shareholder return, but this is often of rather marginal importance in performance related pay schemes. It is clear that there are some relatively easy changes that can be made to performance related remuneration schemes that significantly improve the interest alignment and the incentives of directors.

My book on this subject is called “Performance and Reward”. Details are given in the section “Reference material and further reading. I would be happy to pass an advance copy to the Financial Reporting Council if requested.

Conclusion

Schedule A of the Combined Code should be amended so that it starts with a clear affirmation. “The purpose of performance related remuneration is to increase the alignment of executive interests with those of the shareholders. This is important because it provides incentives for directors to boost company performance from a shareholders perspective. The design of all performance-related pay schemes for executive directors should be carefully considered to make sure that that they properly serve this purpose. Financial modelling of potential schemes can be used to ensure that they deliver appropriate remuneration outcomes over a wide range of possible performance outcomes for shareholders."

5 - Executive pay as a leadership message

Summary

The question of how much a company board pays its own members is one of fundamental importance to the company board, the company itself and to people who have any kind of relationship with that company. It is one of the most significant leadership messages that a company board gives out. People, quite rightly, examine leaders for consistency between the messages that they speak and the actions that they perform. If consistency is high then the credibility of the leadership is high. If consistency is low then credibility is low. It is essential therefore that the way that directors pay themselves is compatible with their other words and actions.

Given the importance of executive pay as a leadership message it is, to say the least, extremely strange that executive pay is determined by independent executive directors when it is the chairman and executive directors who are most significant in the leadership role of the board. This arrangement came about because of a desire to avoid conflicts of interest. However, as we saw in section 2 “Conflicts of interests in the setting of executive pay” conflicts of interest have been hidden rather than eliminated. Fortunately many company chairmen understand the significance of executive pay and remain very influential with remuneration committees. However the accountability for this influence is not effective with the Combined Code in its current form.

Since remuneration committees became common in the early 1990s the Directors’ Remuneration Report Regulations 2002 have come into effect. These regulations require an annual shareholder vote on the board’s remuneration report. This measure greatly increases the accountability of the board to shareholders on the question of executive pay.

There is therefore now the opportunity to properly align the leadership, responsibility and accountability for executive pay by making it clear that the company chairman is ultimately responsible for the pay received by company directors. The Combined Code should be changed to make this clear. The chairman should therefore normally chair the remuneration committee. He or she should also lead any debate on the report at the annual general meeting, and take responsibility for feedback received from shareholders through the vote on the remuneration report.

Executive pay and the leadership role of the company board

"The board's role is to provide entrepreneurial leadership for the company"[22]. The Chairman and executive directors in particular have very high profile roles within the company. Their actions and words are extremely influential both within the company and beyond it. Even their inactions are knowingly and unknowingly scrutinised by others for information about the values, priorities and direction of a company. Directors are company leaders and whether they intend it or not everything about them conveys messages to the company and about the company.

Executive pay is one of the most telling statements made by a company's leadership. Directors' pay is quite rightly scrutinised by company employees and people who deal with the company to see what messages are conveyed. The next few sections consider some of the different messages that different groups of people might pick up from executive pay. This is very significant because it is a way of determining whether the level of executive pay is appropriate. If people pick up positive messages from the executive pay which tie in with other words and actions by the company board then this suggests that the level of executive pay is appropriate. If people pick up negative messages from executive pay or identify mismatches between the board's statements and behaviours on executive pay then this suggests that the level of executive pay is not right.

Executive pay and the leadership message to shareholders

Shareholders are keen to ensure that executive pay is used to recruit, retain and motivate the most appropriate executive talent available to run the business. If it is clear to shareholders that this has been done then they will be happy.

However excessive executive pay is a matter of great concern to shareholders not least because they bear its direct cost. Higher costs mean lower profit and lower earnings to return to shareholders. However shareholders' concerns about getting the level of executive pay right go far beyond the direct cost.

The more significant problems for shareholders occur when inappropriate executive pay starts to reduce the effectiveness of the business in ways beyond its direct cost. Executive pay that is too high can damage reputations and relationships both inside and outside of the company. It can weaken the internal values and culture of the company. It can create pressure for higher salaries within a business. All this can lead to weaker financial performance and lower returns to shareholders.

The other more profound problem for shareholders is the loss of clarity on the principle that the business is being run by the executives for the benefit of the shareholders. High executive pay suggests that, at least in part, the business is being run for the personal benefit of the executives. This then raises the question of what other parts of the business are being optimised for the personal benefit of executives rather than for the benefit of shareholders? Are personal expenses being authorised for executive benefit? Are company resources being used, or much worse specified for executive benefit? Is the company strategy really designed to generate value for shareholders or is it compromised in ways that make it convenient and profitable for executives?

Executive pay and the leadership message to employees

A low level of executive pay can be used to convey the message that the company needs to be very cost conscious and prudent with money. It can be used to emphasise the importance of non-financial values and the sense that both executives and employees are all in the same boat with interests that are well aligned. However, depending on other leadership actions, a low level of executive pay could also convey a message of stinginess, false economy and reluctance to invest. It might suggest that the company does not value people's talents, skills and experience. It might say that salary aspirations in the company are limited, and this could be demotivating and encourage employees, especially employees with high potential, to move on.

A high level of executive pay can convey very positive messages to employees. It can say that the company believes in its top people and is prepared to set them up as examples. The company wants to reward people who perform well. It suggests that the company is serious about performance and it is prepared to invest money in people to help them to develop and perform better. It values the talents, skills and experience of employees and is committed to recruiting, training, developing and retaining the best people.

However, if executive pay is too high relative to the company's real belief in and actions towards its employees then the employees will pick up a different message. They will perceive that the company values its executives far more than its employees. They might also perceive that the executives are mainly motivated by self-interest. Both these perceptions can cause great cynicism and are very damaging to the company. If these perceptions are strong then it suggests that the level of executive pay is too high.

Whether middle and lower management respond well or badly to high executive pay often depends on how they themselves are treated. An important part of this is the question of how far down the organisation does the high executive pay flow. Is everyone in the company well paid, or is it just the board and the people who report directly to them? Do employees receive the leadership message, "People who do well in this company get well rewarded" or do they understand, "You lot need to do this better, so that I can get paid more."?

The potential for an inappropriate executive pay message is highest at times when a company needs to make expenditure cut backs. How can an executive team lead and promote cost cutting initiatives when their own salaries are very high? Such situations can easily generate internal conflict and resentment. Sometimes executives waive an annual bonus to show willing, but this is usually a one year only initiative, and its impact is likely to be as confined as its generosity. If a year later the executives earn even bigger bonuses for having successfully pushed through the cut-backs then cynicism, resentment and mistrust are certain to fester amongst the people who were adversely affected. The suspicion is always that executives are rewarded for difficulties and sufferings that have been borne by other people.

<u>Executive pay and the leadership message to other stakeholders</u>

Sometimes executive pay can provide a leadership message to customers. An unfortunate example of this occurred at MG Rover in 2003. The public credibility of MG Rover was rocked when the company set aside £12.95 million as a trust fund for directors' pensions. The public concern appeared to reflect straight through into sales. In December 2003 the Financial Times reported that, "MG Rover's share of the car market dropped by almost a third last month as sales at the last British owned mass producer were hit by accusations of corporate greed by its directors…The sharp decline in Rover's sales confirms the worst fears of trade unions, which warned the privately owned company two weeks ago that controversy over a £12.95m trust fund for directors could deter buyers."[23]

Popular culture is very sensitive to the message of executive pay. Films and TV shows frequently depict senior executives as self serving company drones with no capability to evaluate a proposal beyond the financial perspective. For example in the children's' TV show "Biker Mice from Mars" the principal villain is an absurd company boss who panders to his own greed and is devoid of all other values. Such caricatures may be completely unfair but they remain extremely damaging. How will our children learn to create wealth if they grow up with such negative impressions of big business? The leadership message of big business to popular culture is currently in disastrous shape, and the high level of executive pay is a big part of the problem.

The effect of the Combined Code on the leadership message

In an effort to avoid conflicts of interest, the Combined Code assigns responsibility for executive pay to a nomination committee made up of independent non-executive directors. As we saw in section 2 "Conflicts of interest in the setting of executive pay" this approach is not realistic in its approach to vested interests. It would be far more realistic to be mindful of vested interest and accountable for them than to try and avoid them when they are unavoidable, or worse still to try and hide them.

However, perhaps an even more damaging result of the independence of remuneration committees is the separation of responsibility for executive pay from the leadership roles of the chairman and chief executive. Given that executive pay sends out such an important leadership message it is essential that the people most responsible for setting the values and standards of the company have significant input to way it is set.

Before the 1992 Cadbury Report many companies had a single person acting as chairman and chief executive. Such people had very strong and direct control over executive pay including their own pay. This obvious conflict of interests was not always well handled, but in most cases it was handled very responsibly with great attention to the good of the company and to fiduciary duty. Certainly the growth in executive pay before the mid 1980's was very small compared to what has happened since. When company leadership meant, amongst other things, controlling executive pay, many leaders felt the need to do this effectively, even though they could have justified paying themselves more.

Also, since the Directors' Remuneration Report Regulations 2002 came into effect, shareholders have had an annual opportunity to vote on the company's remuneration report. This gives shareholders a direct and effective way of expressing their views on a company's remuneration policies. This significantly increases the accountability associated with setting executive pay.

In view of the importance of the leadership message associated with executive pay and the increased accountability arising from the new regulations it is now far more appropriate for the chairman to take leadership responsibility for executive pay by chairing the remuneration committee.

To some people this may sound like a backward step, but in most cases it will simply make visible and transparent the huge influence that chairmen already have over remuneration committees. When remuneration committees were first introduced many company chairmen argued, quite rightly, that they should chair those committees. Later chairmen were excluded to avoid conflicts of interest, but this avoidance is cosmetic and not substantive. It is quite impossible to insist that the directors of a unitary board take collective responsibility for the success of the company[24] and at the same time say that chairmen and executive directors have no responsibility for executive pay. Certainly they are not doing their job properly if they take no interest in this matter, which is of such immediate and material consequence to the success of the company. Certainly if a remuneration report is rejected by shareholders it is inevitably the chairman who has to sort out the mess, as Sir Christopher Hogg had to at GlaxoSmithKline in 2003.

Executive pay has now risen to such high levels that I would expect many company chairmen to fiercely resist taking responsibility for it. Nobody wants the job of defending the indefensible! However this resistance shows that it is all the more important that chairmen do take responsibility for executive pay. The chairman is responsible for running the board, leadership of the board and ensuring its effectiveness on all aspects of its role and setting its agenda.[25] The chairman must therefore be responsible for how much the board pays itself because this lies behind everything else that the board does.

Conclusion

It is possible to check the appropriateness of directors' pay by examining the extent to which it reinforces or undermines the leadership message of the company board. The role of the chairman as leader of the board is essential in this respect. The Combined Code should be amended to make it clear that the chairman takes ultimate responsibility for the way that the board of directors remunerates itself. The chairman should normally chair the remuneration committee. The chairman is accountable to shareholders in this role through the annual vote on the remuneration report.

6 - Company directors as agents of the shareholders

Summary

Corporate governance is fundamentally about ensuring that a company is run for the benefit of its members, the shareholders, rather than for the benefit if its directors. The language of the Combined Code should always emphasise that the company board acts as an agent for the shareholders, working for the shareholders' interests.

The Combined Code currently contains some language that suggests that a company board is an independent entity, which shareholders, along with other stakeholders, need to influence to make sure that proper account is taken of their rights and aspirations. This "power struggle" approach to corporate governance can never lead to satisfactory outcomes. It can only reduce trust, reduce understanding and reduce partnership. Attempts to replace these crucial attitudes with red-tape, regulations and controls are likely to be value destroying.

The Combined Code therefore needs to be changed to make it rigorous in emphasising that directors run companies for the benefit of shareholders.

Corporate governance and the agency problem

The fundamental principle behind the unitary board structure is that the directors run the company in the interests of the company's shareholders, who own the company.

"The separation of ownership and control creates what financial economists call an "agency relationship": a company's managers act as agents of its shareholders. The principals (the shareholders) cannot directly ensure that the agents (the managers) will always act in the principals best interests. As a result, the manger-agents, whose interests do not fully overlap those of the shareholder-principals, may deviate from the best course of action for shareholders. This is called the 'Agency Problem'."[26]

A company board has certain duties to be independent. It must act independently of the vested interests of suppliers, customers, and even of the interests of specific groups of shareholders. However this independence of the board exists for, and must be exercised for, the interests of the shareholders as a whole. The independence of the board does not in any way entitle the board to work for the collective interests of its own members.

The objective of corporate governance is to overcome the agency problem and to make to ensure that the company board really does run the company for the benefit of its owners. This is what corporate governance is all about. A company is said to have good corporate governance if it is clear that it is being run for the benefit of its shareholders. Corporate governance is said to have failed if directors make decisions that favour their own interests, but are sub-optimal for shareholders.

Corporate governance as a system of constraint

Sometimes a company board can lack proper focus on the agency relationship described above. Instead of seeing itself as agents of the shareholder interest, the board sees itself as an entity in its own right whose objective is to find a way forward for the company that takes sufficient account of the of the aspirations and powers of shareholders and other stakeholders. As shareholders are very powerful it is in the board’s own interest to give priority to the creation of shareholder value. This is good, but there is still a deep problem because a board with this attitude is ultimately seeking its own best collective interest. Such a board may genuinely seek to maximise shareholder value, but it will inevitably do so in a way that allows its members to receive money and power for their own purposes.

If boards have this attitude then corporate governance is reduced to a power struggle in which shareholders seek to enforce their rights and in which boards complain that interference, red-tape and regulation are hindering their efforts to create value. This power struggle thinking lies behind many of the recent developments in corporate governance, which typically seek to increase the information and power available to shareholders. However, giving shareholders more power does not solve the problem of the power struggle relationship, which is extremely unhealthy both for directors and shareholders. Rather, the relationship between shareholders and directors should be one of “partnership and trust, based on mutual understanding”[27], but this can only happen if the directors see themselves as agents of the shareholders interests rather than as self serving entities whose behaviour is constrained by the rights that shareholders have.

Realistic measures to promote partnership

It is, of course, completely unrealistic to expect company directors to act only as selfless agents of shareholder interest! Human nature is such that the power struggle aspect of corporate governance will always be present to a greater or lesser extent. The point is that corporate governance works extremely well under the agent model but works extremely badly under the power struggle model. It is therefore in the shareholder and public interest to seek measures that promote and develop the shareholder agent model and minimise the power struggle effect. I can think of several measures that would help to make this happen.

Firstly the language of the Combined Code should be changed to make it much clearer that the company board is an agent working for shareholder interests rather than an entity with a right to consider its own interests.

Secondly we should require senior figures in the corporate world to consistently give out the high level message that company boards must work for shareholders interests and not their own.

Thirdly we should require company boards to display evidence of their commitment to shareholder interests by exercising restraint on executive pay. Warren Buffet is absolutely correct to describe executive pay as the “acid test”[28] of corporate governance because the level of executive pay is a measure of the balance of priority given to shareholder and executive director interests.

Fourthly we should seek much more rigorous alignment between shareholder interests and executive pay. Whilst alignment is much talked about, the current links are extremely sloppy and could easily be made far more effective. This was discussed in section 4 “Alignment of incentives”.

Fifthly we should make sure that the shareholder interest is properly represented on company boards (see section 3 “Representation of the ownership interest”).

Conclusion

The Combined Code should be changed to emphasise that a company board acts as agents of the company’s shareholders, and in the shareholders best interests. Language which suggests that the board only needs to take account of its obligations to shareholders should be removed.

Specifically this means that the supporting principle to A.1, “The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met” should say, “The board should set the company’s values and standards ensuring that the company always works for the interests of the shareholders as a whole and its obligations to other stakeholders are understood and met.” Similar language in the Higgs guidance on pages 63 and 72 should be changed in the same way.

The next sentence of the A.1 supporting principle, “All directors must take decisions objectively in the interests of the company” should be expanded to make it plain that the company means the company’s members, the shareholders. Alternatively the language of the government’s white paper could be used so that directors, “promote the success of the company for the benefit of its members as a whole”.[29]

Conclusions

The Combined Code would benefit from a clear mission statement setting out exactly what it means by good corporate governance. I would suggest this:

> A company has good systems of corporate governance if it is clear that the company is being run for the long term benefit of its members, the shareholders, as a whole.
>
> Behaviours that unduly favour the interests of other vested interest groups over those of the shareholders represent failures in corporate governance. Behaviours that do not respect the legitimate interests of employees, customers and other stakeholders are, in the long term, damaging to the ownership interest and so are also failures in corporate governance.
>
> It is the responsibility of the company board to ensure that the company has good systems of corporate governance. The Combined Code provides company boards with guidance to help them fulfil this responsibility.

A clear mission statement like the above would make other policy decisions on corporate governance much easier because there would be a clear standard to test the policy decision against. It would further strengthen the "comply or explain" approach by providing an objective principle against which any "explanation" could be examined. It would make it easier to avoid the pitfalls of a box ticking approach to corporate governance, because it would provide a basis for assessing the importance and relevant of a particular "box". Above all a clear mission statement would preserve the Combined Code from drifting forward as the unprincipled outcome of a power struggle between different vested interest groups.

The particular focus of this paper has been the difficult topic of directors' pay. I have suggested specific changes to the Combined Code which would significantly improve the system of corporate governance envisaged by the code, by focusing it more clearly on the mission statement set out above. The proposed changes are not, in general, focused on the specifics of executive pay, but rather are concerned with the framework and processes whereby decisions about executive pay are made. This is undoubtedly where the problem lies. If the framework and processes can be properly aligned with the high level objective set out above then better practices on executive pay will naturally follow.

Inland Revenue statistics show that a total of £22.4bn of employment income was earned by individuals earning in excess of £200,000 during the tax year 2002/3.[30] Executive pay is therefore a huge part of the UK economy, even as a direct cost. However its significance is much greater than its direct cost because the incentives and behaviours arising from executive pay have a decisive influence over the entire private sector of the UK economy. Questions about directors pay lie at the very heart of all discussion on executive pay. It is therefore absolutely essential that the Combined Code is improved in the ways that I have suggested so that arrangements for director pay can be optimised.

Reference material and further reading

ABI 2004

Association of British Insurers – Principles and Guidelines on Remuneration – 7 December 2004 (available from: http://www.abi.org.uk/Display/File/38/ABI_-_Guidelines_Draft_-_Final_Doc_-12_Nov_2004.doc)

Bebchuk 2004 (Lucian Bebchuk, Jesse Fried)

Pay without Performance: The Unfulfilled Promise of Executive Compensation (USA: Harvard University Press)

Cadbury 1992a

The Report of the Committee on The Financial Aspects of Corporate Governance – 1st December 1992 (London: Gee and Co. Ltd) available from: http://www.ecgi.de/codes/code.php?code_id=132

Cadbury 1992b

The Financial Aspects of Corporate Governance – The Code of Best Practice (London: Gee and Co. Ltd) (see also page 58 of Cadbury 1992a)

Combined Code 1998 (superseded in 2003)

The Combined Code: Principles of Good Governance and Code of Best Practice Derived by the Committee on Corporate Governance from the Committee's Final Report and from the Cadbury and Greenbury Reports. Available from: http://www.fsa.gov.uk/pubs/ukla/lr_comcode.pdf

Combined Code 2003

The Combined Code on Corporate Governance – July 2003 (London: Accounting Standards Board, Financial Reporting Council) Available from: http://www.asb.org.uk/documents/pagemanager/frc/combinedcodefinal.pdf

Ellig 2001 (Bruce R. Ellig)

The Complete Guide to Executive Remuneration (New York: McGraw-Hill)

Financial Reporting Council (FRC) 2004

Regulatory Strategy (December 2004) Available from: http://www.asb.org.uk/documents/pagemanager/frc/RegulatoryStrategy(final).pdf

Gerard 2005 (Patrick Gerard)

Performance and Reward: Managing Executive pay to Deliver Shareholder Value (Leicester: Matador) (http://www.troubador.co.uk/book_info.asp?bookid=274)

Government 2005

Company Law Reform – White paper, March 2005 Cm 6456 (London: DTI) Available from: www.dti.gov.uk/cld/review.htm

Greenbury 1995

Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury – 17th July 1995 (London: Gee Publishing Ltd). Available from: http://www.ecgi.org/codes/code.php?code_id=131

Hempel 1998

Committee on Corporate Governance: Final Report – January 1998 (London: Gee Publishing Ltd) Available from: http://www.ecgi.org/codes/documents/hempel_index.htm

Hemscott 2003

The current population of non-executive directors – Full dataset – 20th January 2003 Available from: http://www.dti.gov.uk/cld/non_exec_review/pdfs/finalcensus.pdf

Higgs 2003

Review of the role and effectiveness of non-executive directors – January 2003 (London: DTI) Available from: http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf?pubpdfdload=03%2F636

McNulty 2003 (Dr Terry McNulty, Dr John Roberts & Dr Philip Stiles)

Creating accountability within the board: The work of the effective non-executive director available from: http://www.dti.gov.uk/cld/non_exec_review/pdfs/stilesreport.pdf

Paddock 2003 (Jane Paddock, Alicia Ash)

Tolley's Directors' Remuneration: A Practical Guide (Oxford: Butterworths)

Regulations 2002

Statutory Instrument 2002 No. 1986: The Directors' Remuneration Report Regulations 2002 (London: The Queen's printer of Acts of Parliament)

Notes on the text

---

[1] FRC Regulatory Strategy (December 2004): Page 3
[2] FRC Regulatory Strategy (December 2004): Page 3
[3] Greenbury 1995: Code of Best Practice, C2
[4] Financial Times, Lex Column 09/07/05
[5] Greenbury 1995: Code of Best Practice, C2
[6] Greenbury 1995: Page 37, paragraph 6.12
[7] Hempel 1998: Page 33, paragraph 4.4
[8] Combined Code 1998: B.1.2
[9] Combined Code 2003: Supporting Principle B.1
[10] Greenbury 1995: Page 50, paragraph 8.6
[11] Financial Times 29/07/05: Page 10
[12] Combined Code 2003: Main Principle A.1
[13] C.f. Combined Code 2003: Supporting Principles A.1
[14] Combined Code 2003: Main Principle B.2
[15] Combined Code 2003: Supporting Principles B.2
[16] The Higgs review identified lack of time as the biggest barrier to non-executive effectiveness. See Higgs 2003, Paragraph 12.12
[17] Combined Code 2003: Supporting Principles B.2
[18] Combined Code 2003: Page 63
[19] FT.com 08/06/04
[20] Berkshire Hathaway Chairman's letter to shareholders 2003
[21] Combined Code 2003: Paragraph B.1.1
[22] Combined Code 2003: Supporting Principles A.1
[23] Financial Times 04/12/03: Front page
[24] Combined Code 2003: Main Principle A.1
[25] Combined Code 2003: Main and Supporting Principle A.2
[26] Bebchuk 2004: pages 15-16
[27] Combined Code 2003: Paragraph 7 of the Preamble
[28] Berkshire Hathaway Chairman's letter to shareholders 2003
[29] Government 2005: Part B, Chapter 1, B3, 1, page 89.
[30] Statistics from http://www.hmrc.gov.uk/stats/income_distribution/table3_6.pdf