



**Local Authority
Pension Fund
Forum**

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

***Response by the
Local Authority Pension Fund Forum***

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Review of the effectiveness of the Combine Code

1. Background

LAPFF, which was set up in 1991, is a voluntary association of 49 local authority pension funds based in the UK. LAPFF exists 'to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest.' The Forum's members currently have combined assets of about £75 billion.

The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

2. Content of the Code

The composition and effectiveness of the board as a whole

Clearly, one issue that has emerged during the banking crisis is the need for board members of major financial institutions to have a credible background, including relevant qualifications as far as possible. In addition, we note the FSA's suggestion that directors of financial institutions should have regard to the need to promote and maintain systemic financial stability. The Code could make reference to both these aspects of director responsibility in the supporting principles in section A.1.

The Forum also believes that there should be greater disclosure of directors' previous roles, as we believe that in future this will be an important element of shareholders' assessment of director competence. There are already examples of directors' biographies not including references to their roles at companies where there have been significant failures. For example, the biography of Sir Derek Wanless as chair at Northumbrian Water does not make reference to his previous role as a nonexecutive director of Northern Rock and chairman of its audit and risk committees. The Code could therefore, for example, also recommend that companies disclose directors' other positions for the previous five years.

The respective roles of the chairman, the executive leadership of the company and the non-executive directors

As a general comment, the Forum wishes to reassert the importance of the clear division of roles at the head of the company. As is well-known, Marks & Spencer has taken the highly unusual step of moving from having a distinct chair and chief executive, to having an executive chair. LAPFF believes that this has set an

extremely unhelpful precedent for the market as a whole. We have stressed that institutional shareholders must not let companies exploit the financial crisis to argue for a relaxation of compliance with the Combined Code in this area. The Forum will seek to resist any such back-sliding, but it would be helpful if the Code itself was even more explicit on this point. At present the guidance that “The roles of chairman and chief executive should not be exercised by the same individual” is not included in the main principle, but instead appears as a Code provision. Given the importance of this issue, LAPFF believes that this text should be included in the main principle.

LAPFF also believes that a focus is required on the time that non-executives have available to perform their role. Logically this raises a question about individuals with multiple directorships, and the Forum believes that the Code could make explicit reference to this, and should provide guidance on what is considered a manageable number of positions.

The board’s role in relation to risk management

The Forum believes that there is a case that risk directors should have a separate and independent reporting line to audit committees and the board as a whole. The Code could suggest such an arrangement. In addition we believe that risk management should become a formal responsibility of each company audit committee.

The role of the remuneration committee

Some of the problems experienced by leading financial institutions demonstrate why remuneration must remain a core governance issue for investors. A very narrow conception of incentive and reward has resulted in arrangements which encourage inappropriate short-term risk taking at the expense of long-term success.

On a broad point, given the intervention of the Financial Services Authority in respect of remuneration policy at financial institutions, and emerging best practice more generally, it is clear that the Code should be updated. The Code ought to refer to the FSA’s guidance where appropriate.

LAPFF notes that both City minister Lord Myners and the House of Commons Treasury select committee have referred to the possibility that employees or their representatives could have some input into remuneration committees. It has even been suggested that there could be representation on the committee. This may help address what the Forum regards as the failure of committees to properly take into account pay and conditions across the company (discussed further below).

A further area where the Code could provide useful guidance is in how the remuneration committee should respond to the defeat of a remuneration-related resolution (either the remuneration report itself or, for example, a proposal to introduce or amend an incentive scheme). This also overlaps with the guidance the Code could provide in respect of institutional shareholders. At present companies adopt different strategies in response to such defeats. The Code could emphasise the need to properly consult with shareholders and their advisers in the wake of a defeat. The FRC might also consider whether it is appropriate for a change in the remuneration committee chair in the wake of a defeat, although the Forum is firmly committed to annual election of all directors.

In terms of remuneration policy, LAPFF believes that there should be an explicit emphasis on the need for remuneration committees to ensure that structured in a genuinely long-term way. This is in order that management's interests are more aligned with those of long-term share-owners. The Code could promote the introduction of clawback provisions, or bonus-malus arrangements here.

There are two further areas where the Forum is seeking reform of current practice, and where we believe the Code could be enhanced. First, the Forum believes that there should be greater linkage between rewards and management of non-financial issues. This focuses the inclusion of non-financial key performance indicators in both bonus and long-term incentive plan targets. The Forum believes that the Code could refer to and encourage the introduction of such targets in remuneration policy.

Secondly, LAPFF also believes that there is room for improvement in the area of executive pension arrangements. Historically preferential treatment such as better accrual rates in DB schemes, or contribution rates in DC schemes has been offered to directors but not to other employees. More recently companies have begun to offer directors significant payments in lieu of pension.

Yet too often this detail is not included in remuneration reports, and there is almost never an explanation for such generous and/or preferential treatment provided. LAPFF believes that the Directors Remuneration Reporting Regulations ought to be amended to prescribe greater provision of information to shareholders in this area. However in lieu of this, the Code could be strengthened to push for such disclosure. In addition it should encourage companies to provide a rationale for any preferential treatment.

The quality of support and information available to the board and its committees

LAPFF consider there may be a case for appointing an independent adviser to a company audit committee whose role could include engaging with external

auditors, developing agendas, providing technical briefing and recommending when a second opinion should be obtained.

The content and effectiveness of Section 2 of the Code, which is addressed to institutional shareholders and encourages them to enter into a dialogue with companies based on a mutual understanding of objectives and make considered use of their votes.

We believe that this section of the Code must be strengthened. For example, as a supporting principle under E.3, the Code should state that institutional shareholders will use their voting rights. At present some shareholders do not vote all their shares, which LAPFF regards as problematic for the UK's corporate governance.

In addition, as a supporting principle either under E.1 or E.3 the Code should state that shareholders should 'comply or explain' in reference to the Institutional Shareholders Committee's framework guidance on disclosure of voting records. This should make clear that best practice – compliance – is to disclose voting records, and that a failure to do so should be explained. In addition voting disclosure formats should be put on a statutory basis to avoid confusion, inconsistency and obfuscation by asset managers in their disclosures and enable comparative analysis by end-asset owners.

This section of the Code could also require a broad emphasis on the need for long-term shareholders to take their ownership responsibilities seriously, perhaps through a restatement of their 'duty of care' to their beneficial owners and clients.

3. Application of the Code

Remuneration reports

In the Forum's opinion it is important to recognise that remuneration reports are one of the areas that are infamous amongst shareholders in terms of boilerplate reporting. In particular, the Forum shares the view articulated by a number of investors and other interested parties that the guidance that the remuneration committee should "be sensitive to pay and employment conditions elsewhere in the group" is widely ignored. It exists in the Code but has little, if any, practical application.

However, LAPFF continues to believe that this is important guidance to remuneration committees, and the fact that they have ignored it in practice is one of the reasons for the growing divide between the boardroom and other employees. Therefore the Code should be strengthened in this area. In particular the need to be sensitive to pay and employment conditions elsewhere in the group could be made into a new main principle, with a supporting principle

providing guidance on how companies might meet it. The guidance might suggest, for example, that the remuneration committee discloses how it has taken employee pay and conditions into account, and provide comparative data and other examples.

This would also bring the Code into line with The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 which state that “The directors’ remuneration report must contain a statement of **how** pay and employment conditions of employees of the company and of other undertakings within the same group as the company **were taken into account** when determining directors’ remuneration for the relevant financial year.” Emphasis added.