

# Consultation on the Revised UK Corporate Governance Code

Submission by

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MM & K welcomes the consultation by the FRC, and we have pleasure in offering our comments on the draft changes to the Code.

## Executive Summary

1. We think companies should be managed for the benefit of long term shareholders.
2. Changes to the Code in Section A are not given equal importance in Section D; we think they should be. Main Principle D.1 should mention the long term success of the company and the need to consider risk in remuneration levels and make up.
3. The Schedule A changes could be improved by better drafting. Our suggestions are contained in our detailed response, below.
4. Non-executive directors should be allowed to receive options and restricted shares. Shareholders should approve this, after the event, at the next AGM by voting on the remuneration report.
5. Pay is in many cases out of line with performance. Clearer disclosure will enable shareholders to understand better the executive remuneration plans. Pay for the CEO for each of the last five years should be disclosed alongside key performance indicators. We believe effective disclosure should be a matter for the Code as well as for the Directors' Remuneration Reporting Regulations.
6. Fees for remuneration consultants for remuneration committee advice should be disclosed separately from those for other services. Much advice from remuneration consultants has been for the benefit of executives and promoted short term and high risk strategies. The new Code should try to avoid this. We present below new survey data to support this recommendation.
7. The annual report should explain to shareholders how, if the remuneration committee adviser provides other services to the company, the objectivity and independence of the remuneration adviser is safeguarded.

## DETAILED RESPONSE

### Introduction

8. MM & K are remuneration consultants. We have wide experience of working with listed and unlisted companies and have a particular niche with private equity companies. As experts in remuneration, we have limited our comments to those parts of the Code concerned with remuneration.
9. We are an independent firm. We think we give objective advice for the benefit of long-term shareholders.

10. We have identified seven recommendations which are discussed below
- Recommendation 1. Remuneration of long term success, and risk
  - Recommendation 2. Share options and incentives for non-executives
  - Recommendation 3. Transparency of remuneration report
  - Recommendation 4. The name of the Code
  - Recommendation 5. Improvements to Schedule A
  - Recommendation 6. Disclosure of fees to remuneration consultants
  - Recommendation 7. Remuneration consultants' independence statement.

**Issue 1: Remuneration design should take account of risk and incentivise the long term success of the company.**

11. Changes to the Code, Section A are not given the same priority and importance in Section D. Main principle D.1 should mention the long term success of the company and the need to consider risk in remuneration level and make up.
12. It is instructive that the supporting principle in Section D.1 of the draft Code says "The performance-related elements of executive directors' remuneration should be stretching and designed to align their interests with those of shareholders and to promote the long-term success of the company." It makes a distinction between these two aims, and rightly so – maximising shareholder value (present value of future dividends) is not the same thing as promoting long-term success. But the wording introduces a conflict – you can't do both of these things. Our wording resolves this problem

**Recommendation 1. Remuneration of long term success, and risk**

**The following paragraph should be added as the first paragraph of D.1 Main Principles**

**"The remuneration of executive directors should incentivise the long term success of the company and take due account of risk."**

**and the words "long-term shareholders" should be substituted for "shareholders" in the D.1 supporting principle**

**Issue 2: Chairman's remuneration**

13. Like the current Code, the proposed Code is silent on the remuneration of the Chairman, who is neither executive nor non-executive.
14. The Higgs' Review noted the potential need for innovative arrangements for the remuneration of Chairmen.
15. Although this silence is an apparent anomaly, we think that in practice the lack of guidance has been helpful. Examples of where companies have implemented innovative arrangements are RBS (Sir Philip Hampton) and Cable & Wireless (Sir Richard Laphorne).
16. We therefore are making no recommendation for change.

**Issue 3: Share options and incentives for non-executives**

17. The current Code is strongly against awarding options to non-executive directors, and the proposed Code includes other incentives in this proscription. If companies wish to award options, to comply with the Code they have to get prior approval of any award.
18. We have always thought that the Combined Code in this respect is wrong. The question is the size of the options: it is only when they become excessive that they are going to lead to the non-executive behaving in a way that may not be in the company's best long-term interests.

19. Being able to offer options can, for many smaller, start-up and fast growth companies, be an ideal way to keep costs down and yet be able to attract high-calibre and interested non-executive directors.
20. The problem with having disinterested non-executives is that they may become uninterested in the company.
21. Our data shows that where options are awarded they can be a significant advantage to the company. It also confirms what we've already believed to be true that options in private companies are a key component of reward in many cases. (See MM&K survey *Life in the Boardroom* – copy attached.)
22. Options are also common practice in North American companies quoted on NY Stock Exchange and NASDAC and in Canada.
23. The current wording of the Code in respect of options is at odds with what is common practice.

**Recommendation 2. Share options and incentives for non-executives**

**D.1.3. should be redrafted to read:**

**“Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Grants of share options and other performance related elements could affect the independence of non-executive directors, and should not be significantly large. If options are granted, shareholders should approve the plan, and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board.”**

**Issue 4: Remuneration reports are complex and difficult to understand**

24. Our belief is that through transparency, shareholders will be able to execute their responsibilities much more effectively. We therefore think that the Remuneration Report should be clear, transparent and readily understandable by shareholders. This should be part of Section D of the new Code.
  - a. We note that the FRC removed its original demand in the Combined Code for remuneration disclosure, relying instead on the Directors' Remuneration Reporting Regulations. The 2003 Combined Code (in the preamble) said that Remuneration Reports should be “clear, transparent and understandable by shareholders”. The preamble to the current Combined Code no longer contains these words. We think these words should be reintroduced as a clear goal of what is expected as best practice.
  - b. We think the Code should address this point as well as the DRRR.

**Recommendation 3. Transparency of Remuneration Report**

**An additional paragraph D.2.5 should be added to the code which would state:**

**“The Remuneration Report should be clear, transparent and readily understandable by shareholders.”**

**Issue 5: Should the Code apply to all listed companies?**

25. The last decade has seen no gain in share prices for shareholders (the FTSE 100 index was 6,200 in 1998). However, the total remuneration of the average chief executive of a FTSE 100 company has gone up fourfold. This suggests there may be a serious problem.
26. However the FTSE 250 index has increased by about 80%. The corporate governance problems are more worrying in FTSE100 than other smaller companies.

27. We note on page 15 para 5 of the FRC consultation document states that “smaller listed companies...may judge that some of the provisions are disproportionate or less relevant in their case.” We agree.
28. It is also widely agreed that there have been fundamental and very grave failures of corporate governance and regulatory supervision of the financial services industry on a number of levels. What is less clear is whether such failures apply to the rest of British industry which makes up the vast majority of listed companies.
29. The proposed name of the new Code is The UK Corporate Governance Code. Whilst AIM, private companies, not for profit and charities may wish to regard the Code as best practice, we do not think it is proportionate or fully relevant to them. We therefore think the proposed name is inappropriate.

#### **Recommendation 4. The name of the Code**

**The name should be changed to “The Corporate Governance Code for UK Listed Companies.”**

#### **Issue 6: Improvements to Schedule A**

30. We think that Schedule A to the Combined Code has been misinterpreted by most remuneration consultants, so that they have promoted remuneration arrangements that favour executive management and in particular:
  - i. short-term rewards and
  - ii. rewards for higher volatility rather than steady growth.
31. We welcome the significant redrafting of Schedule A, the basis of which was developed by Greenbury in a bull market. There were many problems with the current Schedule. The proposed changes are an improvement, but we think further changes are necessary.
32. It would be helpful if the paragraphs were numbered.
33. “Bonus” is a bad word. We suggest you use the term “**variable annual compensation**” or some other term which better describes what we mean. Using “bonus” in this loose way is unhelpful.
34. Companies need to steer executives’ activities and Variable Annual Compensation is one tool to do this.
35. The last sentence of para 2 of Schedule A “Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules” should be deleted.
  - a. The proscription of discounted executive share option arose originally because shareholders were concerned that (i) they could reward less than adequate performance, and (ii) result in excessive value of the whole package. Both of these issues have since been dealt with in the Code (Schedule A paragraphs 4 & 5), so the proscription is out of date and unnecessary.
  - b. Some performance shares are offered as nil price options so this drafting is out of date. An award of some nil price options and some at market price is therefore allowed by the Code but breaks the spirit of the Code.
  - c. Sometimes a partly discounted option provides a good hybrid between the two types of plan. The relevant thing is the total value, not the issue of discounting.

36. In Para 5, in the last sentence reads “and criteria for paying bonuses should be risk adjusted”. There are a number of problems with this drafting:
- a. The first part of the sentence refers to remuneration incentives [which] should be compatible with risk policies and systems. Our reading of the draft suggests that criteria for paying incentives (including long term incentives, options, and other share schemes) are not required to be risk adjusted. It only says bonus criteria need to be risk adjusted. We assume that this limitation is not intended.
  - b. The purpose of risk adjustment is presumably to ensure that incentive plans (i) do not reward excessive risk taking, ie behaviour outside company risk policy, and (ii) only reward true underlying performance. In most situations the risk-adjustment of performance criteria is unlikely to be the most effective way of achieving these objectives. The use of non-financial measures or deferral with potential holdback is usually a better approach. The Schedule A wording may be intended to embrace these approaches, but it is likely to be interpreted as referring only to the numerical adjustment of financial targets.
  - c. How will the risk adjustment be done? This is a very complex area. We doubt that the cost benefit of doing this will be positive for most companies. Walker and the FSA and FSG have already addressed this issue for BOFI. We see no benefit in putting this into the Code.
  - d. Does the “adjustment” have to be significant? If so how significant? The drafting encourages a tick box approach. Our alternative solution to this issue is described below. See para 40 below.
  - e. The drafting seems to assume a one size fits all approach. We doubt that it is appropriate for the majority of UK listed companies.
37. In the first sentence of Para 5, we suggest it should read **“consideration should be given to the use of non-financial performance metrics”**. Your drafting will require many companies to explain, as they will not wish to apply the code.
38. Para 6. The drafting also seems to assume a one size fits all approach. We doubt that it is appropriate for all UK listed companies. Many smaller companies have fast growth and turnaround strategies, where front end loaded incentives over a 2 to 5 year period are the most appropriate.
39. We recommend that the words “...and criteria for paying bonuses should be risk adjusted” should be deleted – to be replaced by our new Schedule A Paragraph 9 below.
40. We suggest two more paragraphs are added to Schedule A:
- 9. Remuneration strategy should aim to reward the long term performance of the company and its executive directors. The remuneration committee should be aware of the risks inherent in the business of the company and the chosen risk strategy/appetite and should ensure that remuneration is not rewarding excessive risk-taking.**
  - 10. The remuneration design should consider if the company’s culture, code of conduct, human resource policies, and performance reward systems support the business objectives and risk management and internal control systems.**

The proposed words in para 10 above are in the Turnbull report, which excellently considered this issue and needs to be given higher prominence.

41. We have issues with the proposed Schedule A Paragraph 7. "Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement and misconduct."

This paragraph has presumably been prompted by the concerns about 'clawback' provisions in banking. There is an important distinction between adjusting deferred incentive payments when the true performance is known (which some banks have started to call 'holdback'), and recovering money already paid out (true clawback) when there has been genuine deception or misconduct. We wonder if the FRC is clear which is intended in this paragraph – it would seem that true deception is so exceptional as not to merit a paragraph in the code, and in any case would be a case for summary dismissal. If the former is intended it should be reworded and form an additional clause in our proposal for a new Paragraph 9 – for example **"...and reflect underlying long term performance, eg by deferral and potential holdback of part of the payment."**

42. We note that the words "and to give these directors keen incentives to perform at the highest levels" have been deleted from the first sentence of D.1.1. (old Code B.1.1.).
- We suggested in our submission in May 2009 the removal of the word 'keen'. In some banks some incentives were too 'keen'.
  - However we think the FRC should still be asking executive directors to perform at the highest levels.
  - The redraft suggests that merely aiming to promote long term success of the company is all that is required. Should not pay be linked to a higher goal?
  - The Private Equity industry provides incentives for executives to perform at the highest levels. UK listed companies should be able to provide competitive rewards structures, otherwise the shareholder value accruing from enhanced performance will leak away from quoted company shareholders to the private equity industry investors.
43. We are very pleased that the reference to relative TSR as a performance measure has been removed, as our submission strongly recommended this removal.

#### **Recommendation 5. Improvements to Schedule A**

**We propose that changes be made to the Code in line with the suggestions above.**

#### **Issue 7: Independence of advice of Remuneration Consultants**

44. Since we made our submission on the Review of the Effectiveness of the Combined Code in May 2009, we have gathered new data on the views of Chairman and Non-Executives (who completed the survey in October and November 2009) which is directly relevant to this issue.
45. In a survey of 290 Chairman and 152 other non-executives, who were asked if fees paid to remuneration committee consultants should be disclosed in the annual report (i.e. in a similar way to auditors fees and non-audit fees), only 11% disagreed. (See attached MM&K survey *Life in the Boardroom*, page 34, for these results).
46. We believe such disclosure will help shareholders (and other interested parties) evaluate if the advice from remuneration consultants is truly 'independent'.

47. We believe that not all remuneration consultants give objective advice for the benefit of long-term shareholders:

"....At all too many companies, the Compensation Committee of the Board has not played as central and vigorous a role as necessary to assure the public that executive compensation policy is determined independently from management or from compensation consultants hired by management...."

*Findings and Recommendations of The Conference Board Commission on Public Trust and Private Enterprise, Part 1: Executive Compensation (September 17, 2002)*

Remuneration Committees have a need for independent advice. The CEO and the senior management team typically obtain expert advice from human resources consulting firms in designing and implementing an executive compensation strategy and specific plans to reward key team members for achieving the strategic goals set by the Board. While this may be entirely appropriate,

"... the balance in the relationship between the board, management and compensation consultants has, in too many cases, been skewed to produce an overly close relationship between consultants and management.... At all too many companies, the Compensation Committee of the Board has not played as central and vigorous a role as necessary to assure the public that executive compensation policy is determined independently from management or from compensation consultants hired by management.... The Compensation Committee should retain any outside consultants who advise it, and the outside consultants should report solely to the Committee."

*Findings and Recommendations of The Conference Board Commission on Public Trust and Private Enterprise, Part 1: Executive Compensation (September 17, 2002), 4,7,8*

Who should the Remuneration Committee trust? Many firms are offering to provide advice to Remuneration Committees. However, questions have been raised about how independent these firms really are.

"Accounting firms weren't alone in the fever for cross selling.... Look at human-resources consulting and the same pattern emerges. Former pension advisers also provide benefits, compensation and other consulting services. A few ... provide outsourcing for human-resources administration. Others ... have sister companies that sell an array of investment services."

*The Wall Street Journal, Manager's Journal, "Cross-Selling Will Outlast The Big Business Scandals" by Ford Harding (Collin Levey, Editor), August 13, 2002*

Para C.3.7 says that the annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded. We agree this should be part of the Code. In contrast the proposed wording in the last sentence of Para D.2.1. merely states that "where remuneration consultants are appointed, a statement should be made available of whether they have any other connection with the company".

#### **Recommendation 6. Disclosure of fees to remuneration consultants**

**An additional paragraph D.2.6 should be added to the code which would state:  
"The fees paid to consultants for advice to the remuneration committee, and their fees for other services to the company and its pension fund should be stated for each consultant."**

#### **Recommendation 7. Remuneration consultants' independence statement**

**The last sentence of Para D.2.1 should be replaced with "The annual report should explain to shareholders how, if the remuneration committee adviser provides other services to the company, the objectivity and independence of the remuneration adviser is safeguarded."**

## **Appendix 1 - About MM&K**

MM & K is a leading independent consultancy specialising in the planning, design and implementation of pay and reward strategies.

Founded in 1973, MM & K focuses on directors and senior executive remuneration, but we have added other services to support our clients' needs through the acquisitions of Independent Remuneration Solutions and The Share Option Centre and the launch of **higher talent**, our specialist recruiter of HR professionals. MM & K is owned by its employees and directors.

Our consultants' expertise areas include HR, share schemes, law, accountancy, tax, corporate governance, business management and statistics. Our multi-disciplinary approach to remuneration is always tailored to individual client requirements.

MM & K Limited is authorised and regulated by the Financial Services Authority.

### **Who We Are**

#### **Paul Norris, Chief Executive**

Masters graduate in Law and Barrister. Paul started his career with MWP Incentives Limited, and then spent a period in merchant banking before joining the buy-in team that created MM & K in 1985. He advises a number of remuneration committees on business-linked remuneration strategies and is experienced in the design and implementation of cash and share based incentive plans.

#### **Nigel Mills, Director**

PPE graduate and chartered accountant. Nigel joined MM & K in 1985 having spent 6 years at Price Waterhouse after graduating from Oxford. He is an authority on executive and all employee cash and equity based incentive schemes for public and private companies. He also leads the Private Equity business of MM & K and is an expert on carried interest and co-investment plans for Private Equity houses.

#### **Cliff Weight, Director**

Graduate in Mathematics and Statistics from Cambridge. Cliff has 25 years' experience as a remuneration consultant. He was a Director of Independent Remuneration Solutions, who merged with MM & K in November 2006 and previously a director at Hay and Principal at Mercer (part of Marsh and MacLennan Inc) He specialises in advising companies on executive directors' remuneration, annual and long term incentives and non-executive directors' fees. He is a regular speaker at conferences and is co-author of Tottel's Corporate Governance Handbook.

#### **David Henderson, Non Executive Director**

David has been Chairman of Kleinwort Benson Private Banking since November 2004. David began his career specialising in personal tax and UK trusts. He subsequently spent ten years (1974-1984) as a banker at Morgan Grenfell and, following that, eleven years in financial services executive recruitment with Russell Reynolds Associates before joining the Board of Kleinwort Benson Group plc as Personnel Director in 1995. He was appointed Chief Executive of its private banking business in June 1997. David is also a non-executive director of Novae Group Plc, Price Forbes & Partners Ltd and Camp Hopson & Co.

#### **Allan Johnston, Non Executive Director**

MA and Chartered Fellow of CIPD. Allan was an Executive Director of Corus Group plc with responsibility for HR and some of the devolved businesses of the company until he retired from them in 2005. He is Chairman of UK Steel Enterprise Limited and Chairman of the Trustees of the £9.8Bn British Steel Pension Scheme. He is a Councillor of the City and Guilds of London Institute. Specialist in all areas of HR, with particular expertise in change management.

### **Damien Knight, Executive Compensation Director**

Physics graduate. After a period in construction management, Damien has followed a career in human resources and remuneration consulting, spanning 30 years. Damien was a director of the Hay group where he worked for over 20 years and most recently Damien was Senior Consultant with Watson Wyatt. For the past 15 years he has specialised in executive remuneration and has advised the remuneration committees and management of a wide range of companies in the UK and elsewhere in Europe, including several FTSE 100 and other major corporations.

### **Mike Landon, Executive Compensation Director**

BA in Economics & Politics and MBA from London Business School. Mike has more than 20 years of experience as a remuneration consultant and over this period has been at the forefront in developing innovative share and cash-based incentive arrangements for executives and employees generally. This has included assisting with the design and implementation of all types of tax-favoured "approved" share plans, executive and "phantom" plans, as well as extending share plans around the world. Mike plays an active role in ifs ProShare and the Global Equity Organization. He has recently joined MM & K, having previously worked for Mercer, PricewaterhouseCoopers and Watson Wyatt.

### **Ian Murphie, Share Plans Director**

Law graduate and Barrister. Ian left independent legal practice in 2000 and has since then specialised in advising both quoted and unquoted companies on the design and implementation of employee share schemes. With experience gained initially as head of legal services at a specialist set of share scheme advisors, and then as share scheme manager and director at two top 10 audit and accountancy firms, Ian joined MM&K in 2009 on its acquisition of Ian's share scheme consultancy, SharePlanSolutions. Ian now heads the share plan design and administration teams within the group.