

NEW BRIDGE STREET CONSULTANTS

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17 July 1992

N Pearce Esq  
Secretary  
Committee on the Financial  
Aspects of Corporate Governance  
P O Box 433  
Moorgate Place  
London EC2P 2BJ

*Adm'd.*

Dear Sir

New Bridge Street Consultants is a consultancy specialising in incentive and share schemes for executives and other employees. In the course of our work we have undertaken research into Board structures and the process of determining top level remuneration, a field in which we take a special interest.

We have read the draft report of your committee with interest and enclose our comments. We would, of course, be happy to clarify, or amplify, any of the points we raise. If you want to discuss any points please contact me or my colleagues Mark Anderson or Martin Tolson.

Yours sincerely



Carol Arrowsmith  
Managing Director

***Comments on the  
Draft Report  
of the Committee on the  
Financial Aspects of  
Corporate Governance***

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## COMMENTS ON THE DRAFT REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE

### 1. Introduction

New Bridge Street Consultants warmly welcome the Draft Report of the Committee on the Financial Aspects of Corporate Governance and broadly support its findings and recommendations. We have, however, a few areas upon which we would like to comment and which we discuss below.

### 2. Calibre and Number of Non-Executives

We concur with the Committee's views expressed at 4.8 that the calibre and number of non-executive directors should be such that their views carry significant weight. We believe, however, that in practice this can be difficult to achieve as there is only a limited pool of people with appropriate background and experience and perceive (at 7.2 and paragraph 6 of Appendix 3) that you might have similar views.

In general there are likely to be three main sources of non-executive directors:-

- (i) Those who perceive a non-executive directorship as a way of continuing a career after retirement. There is an issue of whether post-retirement executives provide the right calibre of individual (and for how long). They may over time lose touch with the world of business. Nonetheless they should not necessarily be discounted.
- (ii) Executive directors who hold one (or more) non-executive posts elsewhere. In these circumstances there may well be conflicts over time if not actual conflicts of interest. A crisis in the executive's company will tend to take priority and impair the individual's effectiveness as a non-executive director.
- (iii) The "professional" non-executive director holding multiple directorships. This individual is even more exposed to conflicts of interest.

It becomes clear that none of these is an ideal source for non-executives and the pressure on companies to have more non-executive directors will exacerbate the problem. We take some heart, however, from the Committee's comments at 4.16.

### 3. Rewarding Non-Executives

As well as the obvious virtues you are seeking in your non-executives you wish them to be independent (financially) from the company. For non-executives to be able to exercise their independence it is necessary that they can feel able to resign in the event of a dispute of principle with the board - this is their final sanction.

To feel free to do this non-executives should not be reliant on their fees from that company and not in a position where they suffer significant financial loss from their resignation. We argue that if non-executive directors resign on a point of principle they should be entitled to some compensation for loss of office. This should reinforce their independence not compromise it.

This might be thought to be fraught with the risk of abuse, as is perceived where executives who might have "under-performed" are seen to leave with disproportionately high golden handshakes. With a non-executive however the sums involved are perforce likely to be much smaller, not

enabling the individual to lead the life of his choosing, and the persistent miscreant would find it increasingly difficult to find further positions. The executive in the same circumstances might be in the happy position of not needing to seek a further post.

It appears that you suggest that non-executives should receive only a fixed fee from the company. You are against any form of performance pay or share options. As directors they should be interested in the success of the business and may well have much to offer to assist in achieving that success. Companies in trouble and seeking to attract high calibre non-executives might find that a reasonable way to reward them is by results. If performance rewards are introduced they would need to be carefully designed so that non-executives are not locked in. Most executive schemes seek to lock directors in and so would be inappropriate for non-executives but a separate scheme could be effective.

As a particular example, share options match, to an extent, the risks and rewards of shareholders and so should help non-executives align with shareholders' interests. If a shareholding is thought to be "a good thing" for non-executives (and this is something to which the Committee alludes at 4.9 and 4.29) then share options can equally be so, providing they are not forfeit on resignation. The options need to be such that they do not lock non-executives in.

We believe that for these reasons non-executives should not necessarily be ineligible for performance based rewards providing they do not lock non-executives in and so remove their freedom of action. This might be achieved by limiting the size of the reward. In the case of options these could be permitted to continue in force for a suitable period following resignation.

#### 4. Selecting Non-Executives

We are a little disquieted by your comments at 4.13 that "...nomination should be a matter for the board as a whole....". If this process were designed to lead to the nomination of the correct calibre of non-executive it would require the correct calibre of executive Board members. In this scenario the need for strong, independent non-executives would be lessened. While the executive and non-executive members of a board must work together we feel that the appointment of directors is a matter for shareholders. One can foresee a scenario where shareholders felt that a particular person should be appointed, even though he (or she) might not enjoy the unanimous support of the Board.

Leaving the choice of non-executives to the Board as a whole could, until the right number and calibre of non-executives have been appointed, lead to a continuation of what in some cases has been perceived as the appointment of lap-dogs. It makes no provision for achieving the desired state but merely suggests a way of perpetuating it. We believe that positive steps need to be taken to broaden the pool of non-executives and suggest that in certain circumstances this might be achieved by advertising appointments.

At 4.14 it is recommended that non-executive directors be appointed for specified terms. In a scenario where one-third of a board are re-elected annually it would appear that term is three years, unless extended for a further three years by the company in general meeting; or has the Committee some other point in view.

#### 5. The Role of the Board

We note the references at 4.16 to a course on the range of Board responsibilities. This will obviously be presented in the light of the present structures. We are led to believe that in the United States the function, and make up, of the Board is different to that in the UK. There is frequently a preponderance of non-executives and the role of the Board is more strategic.

Would corporate governance in the UK be improved by adopting an approach more akin to that in the US?

## 6. Committees

We agree in general with the Committee's arguments that the various Board committees referred to in the report should consist of (at least a predominance of) non-executives. We agree that, in some circumstances, it might be appropriate to have a committee which is totally non-executive. We do not think this holds true in the case of the remuneration committee where the presence of say the chief executive can help focus minds on the particular.

## 7. Independent Advice

It is important that non-executives have access to independent expert advice. For example, non-executives might want to seek independent advice on remuneration matters. This might be to initiate research or to validate data provided to them by the executive directors. However we believe that the company needs to ensure that access to independent advice is not misused by individual non-executives. The right should perhaps be limited to advice being sought by a committee only (or its non-executive members) rather than an individual; perhaps this is what the Committee has in mind at 4.12.

## 8. Policing

You have suggested that the code should be voluntary and companies should state whether they comply and, if not, why not. Non-compliance would be monitored by the Stock Exchange. Their main sanction would be to de-list the offending company. This sanction might be thought draconian for minor infringements of the code while appropriate for major or multiple infringements.

Further, in other than the short term, would de-listing be a deterrent to a company if a listing on some other EC exchange or medium becomes practical? At the end of the day, despite public rhetoric to the contrary, investors seem to prefer to invest in successful companies which do not disclose or comply than in unsuccessful companies which do.

We believe a more practical way forward would be for the statement about compliance with the code to be obligatory rather than the compliance. If the code can be suitably drafted for the purposes of the continuing obligations, it can surely be drafted in the same terms for the purposes of legislation. This would place the emphasis on disclosure which we believe to be of paramount importance.

## 9. Disclosure of Directors' Remuneration

We support your views that there should be more detailed disclosure (4.32 et seq.). In detail we feel that the following information should be disclosed for each director:-

- Base salary
- Annual bonus
- Long term (or deferred) bonus
- Benefits in kind (excluding pension contributions)
- Share options

## Other emoluments

The disclosure for share options should be the notional gain which would have been achieved by the exercise of the options on the date of the accounts at the price prevailing at that time, which should also be disclosed.

However we have some reservations about disclosure of the detail of incentive schemes which could contain commercially sensitive information such as planned profits etc. The level of disclosure needs careful consideration. We also note that you have not called for further information on share options. Options gains can be considerable and we believe that greater disclosure of the gains made by directors at exercise should also be made. Again care would be needed as the gains from options are frequently not a cost to the company as such. There might be an economic cost (to the extent of the undervalue) but the "cost" is more likely to be borne by the market.

## 10. Small Companies

The code appears to have been drafted with major quoted companies in mind; indeed the report suggests as much at 3.16. For smaller companies, or where there is only a minority listing, some of the points on the code will not be as relevant or as workable. In particular we would have reservations about the appropriate number of non-executives and the constitution of the various committees. Consideration might also be given to those companies (including some listed companies) where a significant minority, or majority, shareholder has a seat, or seats, on the Board. What would be the status of those external directors for the purposes of the code?

## 11. Auditing

We appreciate the problems experienced by the Committee in addressing this particularly difficult area and note the recommendation at 5.12. We trust that, in considering this area, the accountancy profession will acknowledge that in many instances the role of the audit manager is at least as important, in a practical sense if not a legal one, as that of the audit partner. It is important that the guidelines produced address the possible problems and fears in a realistic, and not just a superficial, way.

## 12. Conclusion

We welcome the draft report as a significant contribution to the debate on corporate governance and look forward to the publication of the final report in due course. We are fearful that it might prove impossible to arrive at firm recommendations on all the matters raised in the draft and would suggest that an interim report be produced whose recommendations could be implemented in the short term. Further detailed consideration could then be given to the more contentious issues which might be the subject of a final report for implementation at a later date.