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Treasury Select Committee

Via email to: treascom@parliament.uk

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Submission by ShareSoc (the UK Individual Shareholders Society)

Evidence submitted to the Parliamentary Treasury Select Committee inquiry into Corporate Governance and Remuneration in systemically important financial institutions.

Dear Sirs,

Our submission in response to the above inquiry is as follows (in as brief a form as it is possible for such a wide ranging set of questions):

Board Structure and Composition

1. Corporate governance in companies should seek to set standards that uphold certain moral principles and commonly judged best practice to ensure that the interests of various stakeholders in the company are best pursued.

2. It is clear to us that the existing arrangements for board structure, and particularly the nomination of directors, create major problems. In practice directors solely determine who will be appointed as directors (i.e. they appoint themselves), and also determine their own pay (via Nomination Committees and Remuneration Committees that are not independent but solely consist of the same directors). We would prefer to see shareholders have a lot more say in these matters and have suggested that a system of Shareholder Committees consisting of various stakeholders, similar to that in use in Sweden, would provide a much better basis - this is described in a note on our web site here (see bottom right of page): www.sharesoc.org/policies.html

It is also clear to us that the concept of having a number of non-executive directors and a non-executive Chairman has been ineffective in properly supervising the activities of the executives of financial institutions. There are multiple reasons why this is so. For example the executives have dominant control of information resources. Whether a non-unitary board structure would help to control this problem is however debatable.

It would perhaps make more sense to examine the reasons for the failings in non-executive directors before coming to any conclusion on that matter.

3. It is surely recognised that the "light-touch" regulation of financial services that was introduced into the UK over the last 15 years was one cause of the crisis in the banking sector. More intrusive regulation, particularly of financial services which are very important to the health of the UK economy in general, is necessary because there is a recognition that market forces otherwise are insufficient to prevent abuses. Corporate governance is no substitute for external regulation, and typically can only deal with some basic standards about the way the board and certain aspects of the company operate. However, the "comply and explain" approach to corporate governance does seem to have been generally effective in the UK.

Corporate Culture

4. Corporate culture is indeed exceedingly important. Unfortunately the whole financial services sector has become riddled by a culture of high rewards for high risk in recent years. Major contributors to this problem are the generally high levels of pay, short periods of tenure, and aggressive bonus schemes with bonuses providing much too high a proportion of total remuneration. The latter encourages excessive risk taking. Indeed we said this in our submission to the recent BIS consultation on remuneration: "*We suggest that bonus schemes, LTIPs, and share options as elements of total pay have become grossly excessive in recent years and the addition of these schemes, and their complexity has concealed the impact of the growth of total pay. Although we support the concept that executives should share in the rewards generated by a company, and agree that they should be able to build a stake in the company so that their interests are aligned with shareholders, we are doubtful that these provide significant incentives to senior management – at least not in the timescale that is likely to be relevant. We therefore strongly support the simplification of remuneration packages and the reduction in the percentage of total pay that is represented by performance related elements*". We have argued that remuneration schemes need to be simplified and performance related pay should be no more than 50% of base salary.

Impact of previous reviews and new regulatory developments

5. 6. and 7. We do not feel qualified to comment on these points.

Non-Executive Directors

8. There is a general problem in UK company law that it has become ineffective in enforcing adequate standards of behaviour by company directors. This is not specific to non-executive directors (all directors are in essence equally responsible in law). Although the Companies Act lays down the duties of directors (and were clarified in the 2006 Act), it has never lately proved to be practical to pursue any action for breach of duty against the directors of large companies. In addition, there is no concept of "fraud on the market" as is available in the USA which can be used by shareholders to pursue errant directors, nor litigation funding arrangements that would make such cases viable. In addition the fragmentation of the share ownership of large FTSE companies makes co-ordinating any action by shareholders, who might provide some discipline on directors, to be very difficult in recent times.

Regulations are ineffective in controlling abusive activity, and even when the law is broken, directors are unlikely to be pursued. The law and market regulations are too weak and the regulators are not forceful enough and are under-resourced to pursue many of the issues that arise.

Even if actions are practical, the costs of litigation are now so high that only the wealthiest institutions could risk an action against a public company, and most fund managers have no incentive to pursue such claims. Similarly, if the financial accounts of a company have been misleading to shareholders due to failures by the company auditors, the shareholders have no claims that can be pursued in law and more and more obstructions to possible claims against auditors have been put in place over the last few years. Likewise other professionals involved in promoting or regulating companies (brokers, merchant banks, company promoters, etc) are ever more protected from their own failings.

In essence the legal system which acts as the framework for companies has been watered down in the interests of company directors and their professional advisors over the last 50 years, to the detriment of shareholders interests and to that of the wider community. We would like to see a substantial reform of company law to tackle some of these problems.

Our only comment on the question of whether executives should hold non-executive positions in other companies is that generally in FTSE-100 companies we think it is unwise because of the limited time that such executives might be able to devote to such roles. It is hard to see how a non-executive director of a large financial institution can perform a proper and effective governance role, without devoting a substantial proportion of their time to that task.

9. We have no comments on the FSA approval process for directors of financial institutions.

The Role of Shareholders

10. We certainly support a more active role for shareholders in the supervision of companies, which is typically now termed "engagement". We have pointed out above how we would like to see Shareholder Committees involved in selecting directors and setting their remuneration and they might have a wider role in addition. There are many complex barriers to greater shareholder activism by institutional investors however. Some of these might be capable of being tackled by regulation but the issue of investors not wanting to become "insiders" is a particular problem that needs examining. It means that they are reluctant to ask for information that is essential to exercise proper stewardship. But we see no risks in more shareholder activism – indeed the opposite is surely the case – the lack of effective activism and engagement generates risks.

11. Sovereign wealth funds and hedge funds can indeed take a more active role, although some hedge funds steer clear of public engagement because they fear that the media are prejudiced against them.

Remuneration

12. We see investors as having a key role in setting more reasonable pay policies, but there needs to be an appropriate regulatory framework in place to support them. We suggest there are 5 key elements of a comprehensive solution to the problem of excessive remuneration:

A. A binding and forward looking vote on pay at AGMs via a special resolution.

B. Remuneration and nomination committees should become "shareholder committees", i.e. the members should be shareholder representatives with some role for individual shareholders who are more likely to take an independent stance.

C. Improved pay reporting with a national body producing comparative data needs to be introduced, so that everyone can see comparative data not just the board's remuneration consultants and a few major institutions.

D. The role of institutional investors and their lack of engagement needs to be tackled.

E. The disenfranchisement of individual shareholders needs fixing where most do not or cannot vote due to the use of nominee accounts.

There are some aspects of the role of remuneration consultants which are clearly unsatisfactory at present. In practice the Remuneration Committee, as currently constituted, effectively relies on a secret report from their consultants, who may well have a vested interest in raising general remuneration levels. The report is not disclosed to shareholders so they can verify what it says, or form a different view based on the data provided.

We do not see that involving employees will assist to moderate pay – they also may have a vested interest in raising general pay levels, to the disadvantage of shareholders.

13. It is certainly the case that Remuneration Reports are overly-complex, excessive in length and often confuse the reader as much as they enlighten. Simplifying the structure of remuneration and having a single comparative figure for the individual remuneration of all directors (combining the various elements of pay) which is being studied by the FRC at present would certainly assist.

14. We do not believe the reform of remuneration arrangements has gone nearly far enough. Although we do not wish to see direct Government intervention in setting pay, we suggest there could be much tougher approaches than we have seen to date, as suggested above.

15. Proposals for "strict liability" legal sanctions or automated incentive arrangements rather beg the question. Liability for what exactly? General incompetence? Such arrangements only work in criminal law (which seems to be what is being proposed, or regulations with the force of law), when there are well defined rules and those rules are clearly broken. We are sceptical that such an approach would be workable in practice or lead to fair and reasonable outcomes when issues requiring finer judgement arise.

Governance of Risk

16. We have no comments on whether the management of risk has improved since the financial crisis.

Diversity and background

17. There is no evidence that we are aware of that relates board diversity to company performance in the financial services sector. The merit of board diversity is surely more related to other social and moral arguments that no large public companies should be dominated by a small group of like-minded individuals, and the perception that past failures have arisen from "group-think" by boards which more diversity might avoid. But diversity by itself is not helpful except where it enables people with somewhat different backgrounds, but with good knowledge of the financial services sector, to become members of boards. We would be opposed to the recruitment of directors solely on the ground of their diverse sexual, ethnic or other backgrounds as opposed to their basic competence to act as a director of a FTSE-100 company.

Further information

To quote two points from our manifesto which echo some of the comments above, we suggest:

The legal framework for companies should be changed to improve accountability. Directors and auditors should have a duty to, and be legally accountable to shareholders. The legal concept of "fraud against shareholders" should be introduced in a new law to cover such matters as issuing false or misleading information to the market or the prejudicing of minority shareholders, and provide a basis for legal actions. The legal system should be reformed so that shareholders can pursue grievances at reasonable cost. In addition the penalties for fraud should be increased.

Excessive pay of directors needs restraining. The pay of directors and senior managers in some companies has become excessive and should be controlled by ensuring that shareholders both set and approve board pay in advance (via a Shareholder Committee and vote in general meeting) and not by solely allowing the directors to determine their own pay with retrospective approval by shareholders.

That completes our submission.

Yours sincerely

Roger W. Lawson
Chairman

About the UK Individual Shareholders Society (ShareSoc)

ShareSoc represents and supports individual investors who invest in the UK stock markets. We are a mutual association controlled by the members with "not-for-profit" articles and incorporated as a company limited by guarantee. The organisation is financed by member subscriptions, donations from supporters and by the services it provides to members. More information on ShareSoc can be obtained from our web site at www.sharesoc.org (our objects are fully defined on this page: www.sharesoc.org/objects.html).