

Review Of The Role And Effectiveness Of Non-Executive Directors

Consultation Paper

Response by Independent Remuneration Consultants

1. Summary

1.1. We have limited our response to areas in which we are expert and therefore qualified to comment, i.e. Remuneration Committee affairs and the remuneration of non-executive directors.

1.2. Directors' remuneration is not only increasing rapidly but is becoming more complex and technical. It attracts massive media interest and the Government's new Directors' Remuneration Report Regulations, designed to improve transparency and accountability, can only increase the already difficult task of non-executive directors on Remuneration Committees.

1.3. We believe that **the independence of consultants** advising and reporting to the non-executives on the Remuneration Committee is crucial. Directors' remuneration is a complex issue and the Remuneration Committee should have access to the best, most independent expert advice. The issue of remuneration policy and practice is too fundamental to UK business to be tainted by the possibility that advisers are working in the interests of the executives rather than the owners of the company, the shareholders. The Enron debacle is only the latest and largest example of the conflict of interest when advisers are not independent.

1.4. We recently did a survey of companies and their Remuneration Committee consultants. We found that

- i. Only BP follows best practice in respect of the way it manages executive directors' remuneration. Its Remuneration Committee "is serviced independently of executive management and actively seeks advice from external professional consultants". Its adviser is appointed independently by the Remuneration Committee and does not provide other services to executive management. No one else in the survey appeared to have followed BP's approach, however we know of a number of companies who are now considering doing so.
- ii. Remuneration Committees receive input and advice from the Chief Executive and in many cases from the HR Director and Compensation and Benefits Director, all of whom have a personal interest in remuneration levels.
- iii. While many Remuneration Committees use remuneration surveys, many do not appear to receive expert, external, independent advice regarding the interpretation of data, remuneration strategy and policy issues.

- 1.5. We believe that remuneration is too critical for companies to either
- i. Allow the Remuneration Committee to adopt a DIY approach as few have the detailed knowledge and experience to ensure all the important points of detail are addressed. Remuneration is one of those areas where the devil is in the detail and often the problem today has been caused by overlooking a small but important piece of detail several years earlier.
 - ii. Allow management to manage the process and make proposals for the Remuneration Committee to “sign off”. The executive directors do have a conflict of interest regarding their own remuneration and this must be resolved by the non-executive directors managing this issue in the best interests of the company.

1.6. Therefore we believe Remuneration Committees should seek independent expert advice. Remuneration consultants who are part of a larger firm such as auditors and accountants, actuaries and those whose parents are insurance brokers are not independent as they aim to cross sell other services to executive management: indeed their business models are predicated on the assumption of such cross selling and referrals.

2. Specific Responses to Issues for Consideration

A5. One of the main conflicts of interest is in setting executive directors' remuneration. This Board responsibility should be delegated to the Remuneration Committee made up solely of independent non-executive directors (NEDs).

To help NEDs be effective, the Remuneration Committee should appoint an independent expert adviser to help them who does not also work for management. The issue of remuneration policy and practice is too fundamental to UK business to be tainted by the possibility that advisers are working in the interests of the executives rather than the owners of the company, the shareholders.

B9 and B10. With regard to remuneration, NEDs require considerable background knowledge and skills, including

- Statistics to interpret market data
- Business acumen regarding performance measures, including but not limited to accounting knowledge
- Financial theory to understand option valuation and risk
- Pensions and actuarial knowledge
- Tax, both personal and company tax that is pertinent to remuneration issues
- Trust law
- Employment law.

A good working knowledge of the above are essential in order to be able to participate in the Remuneration Committee debate. Expert skills are not needed if the Remuneration Committee has access to independent expert advice.

NEDs also require the ability to read and digest long complex reports.

B14. For large companies the NEDs' fees are too low. At present the job is done for altruism not for the money. A 50% to 100% increase should be considered, but it should be paid in shares that cannot be sold until 2 years after the NED has left the company.

C19. Too often Remuneration Committees are just asked to rubber stamp management's proposals. At present executive directors have huge internal resources and pay large fees to their management consultants to prepare and justify their case for more money, bigger bonuses, increased incentives and better benefits. The scales are not evenly balanced. Remuneration Committee need to take the lead and seek their own independent advice.

D26. The company secretary or an external independent adviser should be the secretary of the Remuneration Committee. The HR Director should never perform this role as he/she works for the CEO and is conflicted.