

30 September 2009

www.mm-k.com

Sir David Walker
HM Treasury
1 Horse Guards Parade
London
SW1A 2 HQ

Dear Sir David

**Review of corporate governance in UK banks and other financial industry entities
Response to consultative document from MM & K Ltd**

Thank you for the opportunity to comment on your review. In summary, we have two major concerns:

1. We feel Recommendation 33 on deferred pay is too prescriptive.
2. You appear to have endorsed the Code of Conduct which was written by a self-interest group of consultants and has been criticised by the ABI and others.

Background

MM & K is a City-based remuneration consultancy, closely involved with banks and other financial services organisations in the development and implementation of remuneration policies, and in the remuneration aspects of corporate governance.

We have studied carefully all the recommendations in your review, but because of the specialist nature of our business we are limiting our observations to those on remuneration, ie Recommendations 28-39.

General observations

We concur with the general conclusions of the Review in relation to remuneration – that much of the focus has been too short term, that clearer and fuller disclosure is required, that performance measures need to take fuller account of risk and that the remit and answerability of the remuneration committee needs to be strengthened.

Our concerns lie in the detail of some of the proposals.



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Comments on individual recommendations

Recommendation 28 – (extension of remuneration committee remit to all firms, with a particular emphasis on risk)

We support this recommendation.

Recommendation 29 – (extension of remuneration committee remit to oversight of package of ‘high end’ executives)

We support the principle. However, we can see practical difficulties in the way ‘high end’ is defined.

- i. Using the remuneration of executive directors as the standard for ‘high end’ is attractive in principle, but the threshold of *median* is likely to cause anomalies and year to year inconsistencies. It might also influence the choice of executives to be appointed to the board. It would be cleaner to require companies to propose their own absolute value threshold for example ‘in line with the level of total remuneration for the lowest paid *full-time* executive director’ or some other recognisable basis.
- ii. The supporting text includes in total remuneration the expected value of long-term incentives. Expected value is open to manipulation, requiring both a probability judgment about future events and a discount rate. A long-term incentive opportunity with an estimated 1% likelihood of a personal £50m payout might well not be picked up at grant under the proposed basis – nor would it be picked up in the exceptional circumstance that it paid out in full. We suggest that the net also catches the alternative definition of long-term incentives *realised* in the previous year, ie cash receipts, deferred payments free of further vesting conditions, and paper gains on share plans where shares have vested or options have been exercised.

Recommendation 30 – (Remuneration Committee responsibility in relation to performance objectives and linkages for ‘high end’ executives)

We support this recommendation. We recognise that the consequent report could be bulky for banks with ‘high end’ executives in several businesses with different business dynamics and incentive plan designs.

Recommendations 31 & 32 – (disclosure of total remuneration for ‘high end’ executives)

We support these recommendations, subject to the simpler definition of ‘high end’, and the inclusion of *realised* remuneration for the previous year, as well as expected remuneration.

Recommendation 33 – (deferral of incentive payments)

Deferral is an important mechanism for encouraging longer-term focus and improving retention.

- i. The Review prefers deferral as the primary risk adjustment mechanism, as it presumes the true performance of a bank or component business only becomes evident in the longer term. Linking a high proportion of remuneration to such longer-term measures ensures that executives only receive the full benefit of high rewards if they or their bank deliver true long-term value, a state of affairs more

acceptable to shareholders and the wider public interest. (Theoretically, paying for actual outcomes is not a risk adjustment mechanism – all losses are known at that stage – but avoids the need for a risk adjustment mechanism.)

- ii. By linking remuneration to eventual outcomes, it is also possible that executives will be less inclined to pursue risky business (ie business outside the stated risk policy) and the behaviour of the executives will be better aligned with long-term success.

We agree with the principle of paying in full only when true performance is verified.

We also agree with the Review's recommendation that clawback should only be used in exceptional circumstances. We assume the term is used to mean the recovery from individuals of money already paid out, or the deduction of money from future or unrelated earnings. (We have noticed the term is sometimes wrongly used to refer to the reduction of deferred amounts, and some clarification in your final report might be valuable.)

However, we believe that there are some potential problems in the detail of this recommendation.

Short term bonus element:

- i. **Front end risk adjustment.** Unlike in the new FSA Code, there is no reference to a charge for capital (risk adjusted or otherwise) in the calculation of bonus pools. It is not in the interests of shareholders that generators of business using substantial risk capital should take a similar share of profits to employees using virtually no capital. And the riskier the business, the larger initial claim on profits the shareholder must have.

This is not an easy area to manage. It requires banks to have the systems to allocate capital and risk at the level at which bonus is calculated. Moreover, pay market pressures might lead firms to increase the proportion of profit allocated to employees once the capital charge has been made.

Nevertheless, the principle is important and cannot be ignored for practical difficulties. Firstly a capital charge encourages effective use of capital and attention to risk; secondly with the pending increases in regulatory capital, it may prove the means by which bonuses which have become excessive in relation to the wealth created will eventually be brought to a more reasonable level – by lowering the demand curve in the labour market.

As an aspiration, therefore, we believe the risk adjustment of bonuses at the front end should stand equally with deferral of payments as a mechanism for proper risk-alignment of remuneration.

- ii. The accompanying text describes the purpose of deferring the bonus (in cash or unvested shares) as allowing part or full cancellation of awards in the event that the performance on which the award was based was subsequently found to be overstated. This is in line with the principle of linking remuneration to eventual outcomes, with which we concur. But the period necessary to recognise the

eventual outcome is highly dependent on the type of business – some earn cash profits in the current year; others generate assets which are valued with great uncertainty in the short term. We believe therefore that the universal recommendation for pay-out over three years is far too prescriptive.

- iii. The text implies that the performance measures used to release or vest the deferred amounts should apply at the same level of business as the original bonus calculation. This is desirable, and the conclusion could be made more specific. The Review appears to have rejected a requirement to link the eventual payout to the longer-term success of the firm or large division, and we think this is the right decision if this wider result is largely beyond the control of the individual or the team within which he or she works.
- iv. The supporting text also lists one purpose of deferral as enabling the award to be reduced if subsequent individual performance were poor. Unless the rules are clear at the outset, this appears to us to be bad motivational practice and also against natural justice. In so far as the deferral programme has specific and relevant longer-term measures, and later poor individual performance shows in the measured results, then the rules should be clear. Otherwise any reduction of award will be seen as arbitrary.
- v. A third purpose of deferral described is the possibility of reducing or cancelling the payment if the individual leaves before it is made. We support any intention to provide a retention device (although this can always be bought out by a rival firm) – and we can see that shareholders may not want to reward at the highest level those not committed to the long-term future of the firm. But the period of deferral necessary for this is likely to be firm-specific, and again we feel the three-year payout is too prescriptive.

Long-term bonus element:

- i. The Recommendation proposes that, for ‘high end’ executives, at least one-half of variable remuneration offered in respect of a financial year should be in the form of a long-term incentive plan. Whilst there is no specific recommendation on the vesting conditions to be used, there is a strong sense in the text that these will be mainly related to long-term performance of the firm as a whole.
- ii. We feel it is wrong to specify the proportion of variable pay in such a long-term incentive plan. Whilst this approach may align the executives’ reward with long-term shareholder value, it is by no means clear that it will align their behaviour (either their focus of action or their long-term commitment) in the same way. The reality is that they do not have the influence and control on the overall firm results, even though their local results may from time to time have a large impact. The situation is different for main board directors, who are involved in leadership of the whole firm.
- iii. Such a requirement is likely to make a listed bank an unattractive workplace for senior traders, M&A and corporate finance specialists, wealth managers, fund managers, and in-house private equity and hedge fund managers – and they will be tempted to move to private or overseas organisations where the strictures do

not apply.

- iv. Whilst some significant company share interest is essential to encourage ‘one-firm’ behaviours (and we would increase the shareholding proposal in Recommendation 34), we believe the incentive payment recommendations should focus on ensuring that incentive reward is correctly linked to the eventual performance outcomes of business at the level of personal or team control (which may not be a long-term issue), and to the relative contributions of the executives and risk capital.

Recommendation 34 – (shareholding guidelines)

We believe that the figure of one times total remuneration in shareholding is probably too low for both executive directors and ‘high end’ executives. Whilst we believe the company long-term incentive plan is not the right vehicle for a large proportion of remuneration for most ‘high end’ executives, it is perfectly reasonable to expect ‘skin in the game’ from these people if they have high earnings. Companies will want to explore ways of deferring taxation if executives are making a large investment of this sort.

Recommendation 35 – (remuneration committee taking advice from risk committee)

We support this recommendation.

Recommendation 36 – (remuneration chairman standing again for election)

We question whether this measure will encourage the most effective remuneration committee chairmen to offer themselves for the position.

Recommendation 37 – (remuneration report declaration on enhanced pension rights)

We believe this recommendation could go further. We made a submission recently to the FRC in its review of the Combined Code. We recommended that reported remuneration should state the maximum amounts payable to an executive in any circumstances on leaving the company.

Recommendations 38 and 39 – (remuneration consultants’ code and professional body)

We have some concerns that the report seems to endorse the sample code drafted by a small group of remuneration consultancies in what we would judge to be a defensive move. The majority of those remuneration consultancy practices are part of larger consulting or accountancy firms with a serious potential for conflict of interest in providing consultancy advice. The sizes of their remuneration practices are also not necessarily large – they carry an apparent importance due to the size of their parent firms.

There are many other consultancies serving the needs of remuneration committees and boards, most of which are truly independent. Our own firm, MM & K, has submitted its own draft of a code of practice to the FRC in its Combined Code. We are attaching a copy of this draft. We would hope that a final code could be decided by an independent body, rather than by this self-interest group with the resources of the large multi-service firms behind them.

We trust you will find our submission useful, and offer our best wishes on the conclusion of your valuable contribution to corporate governance in the UK.

Yours sincerely,

Cliff Weight
Director

Damien Knight
Principal

Attachments:

- Overview of MM & K
- Code of practice for remuneration consultants, drafted by MM & K for FRC review of the Combined Code

About MM & K

MM&K is a remuneration, share plan and executive recruitment agency located in the City of London. We were founded in 1973 by Morgan Grenfell with two partner consultancies.

We specialise in the planning, design and implementation of pay and reward strategies. The principal focus is director and senior executive remuneration, but we can also support broader client needs following the acquisition of The Share Option Centre (design and administration of share plans) and Independent Remuneration Solutions (remuneration data and advice) and the launch of Higher Talent (the specialist recruiter of HR professionals).

Our strengths include the ability to provide, in-house, legal, accounting and tax advice in relation to remuneration.

MM & K is owned by its employees and directors.

Draft code of conduct for remuneration consultants, prepared by MM & K, and submitted to the FRC on 22 May 2009 for their review of the Combined Code

CODE OF ETHICS

FOR UK REMUNERATION CONSULTANTS

Application Any remuneration consultant who is appointed by or on behalf of the remuneration committee of a UK listed company (Remuneration Consultant).

Scope The Code applies at all times to Members' conduct in their work as Remuneration Consultants, but will also be taken into consideration where conduct in other contexts could legitimately be considered to reflect on the profession of remuneration consulting.

Status The Code will be taken into account where a Member's conduct is called into question.

Purpose The Code contains principles which Remuneration Consultants are expected to observe in the public interest in order to build and promote confidence in the work of Remuneration Consultants.

Definition: Member means any Remuneration Consultant, either an individual or a firm, who agrees to follow the Code.

THE PRINCIPLES OF THE CODE

1. Integrity: Members will act honestly and with the highest standards of integrity.

1.1 Members will show respect for others in the way they conduct themselves in their professional lives.

1.2 Members will respect confidentiality except in the exceptional circumstances that disclosure is required to comply with the law or the enforceable requirement of a regulatory body.

1.3 Members will be honest, open and truthful in promoting their business services

2. Competence and Care: Members will perform their professional duties competently and with due care and attention.

2.1 Members will not act unless they have an appropriate level of relevant knowledge and skill.

2.2 Members will take care that the advice and services they deliver are appropriate to the instructions and needs of the client, having due regard to those parties (such as shareholders, bond and loan holders or analogous persons) whose interests may be affected by the work of the Member.

2.3 Members will agree with the client in writing the scope and nature of any appointment or instruction.

2.4 Members will agree with the client in writing the basis of their remuneration before commencing an appointment or instruction and before any material change in the scope of an existing appointment or instruction is acted upon.

2.5 In giving advice to a client, due regard shall be had to the client's risk appetite and risk map, the expressed views of the client's shareholders and general levels of remuneration and increases in salary across the client's workforce.

2.6 Members will keep their competence up to date.

3. Impartiality: Members will not allow bias, conflict of interest, or the undue influence of others to override their professional judgment.

Definition: A conflict of interest arises if a Member's duty to act in the best interests of any client conflicts with:

- a) the Member's own interests, or
- b) the interests of the Member's firm, or
- c) the interests of other clients.

3.1 Members will ensure that their ability to provide objective advice to their clients is not, and cannot reasonably be seen to be, compromised.

3.2 Members will disqualify themselves from acting where there is a conflict of interest that cannot be reconciled. In particular, the Member will decline to act where the Member's firm acts also as the client's auditor or as search consultant on behalf of its nomination committee.

3.3 Members will fully document the steps they have taken to reconcile a conflict and agree them with all clients who are affected by the conflict whenever such agreement is necessary for them to be effective.

3.4 Before accepting any assignment, Members will consider carefully whether they should consult with any Member who previously advised the client, with a view to ascertaining whether there might be any professional reason or 'reason of conflicting interests' why the assignment should be declined.

3.5 Members will ensure, before commencing work on a contingency fee basis, that:

a) they can comply with paragraphs 3.1 and 3.4 and
 b) the client understands and agrees a contingency fee arrangement and either this basis of charging is not unusual for the work in question or the client has particularly requested a contingent basis of remuneration.

3.6 Members will disclose promptly to their clients any relevant interest, including income, which they or their firm have. Members will take reasonable steps to ensure that they themselves are aware of any such interests.

4. Compliance: Members will comply with all relevant legal, regulatory and professional requirements, take reasonable steps to ensure they are not placed in a position where they are unable to comply and challenge noncompliance by others.

4.1 Members will notify their clients, or their employers, or both, if they believe, or reasonably ought to believe, that a proposal or course of action is or may be unlawful, unethical or improper.

4.2 Members will fulfill any obligations to report information to relevant regulatory authorities.

4.3 Members will promptly report any matter which appears to constitute misconduct or a breach of any relevant legal, regulatory or professional requirements. To the extent that the consent of a third party is required for this purpose in order to disclose information, Members must take all reasonable steps to obtain such consent.

5. Openness: Members will communicate clearly and completely and meet all applicable reporting standards.

5.1 Members will ensure that their communication, whether written or oral, is clear and comprehensive, indicating how any further explanation can be obtained, and that their method of communication is appropriate, having regard to:

a) the intended audience;
 b) the purpose of the communication;
 c) the significance of the communication to its intended audience; and
 d) the capacity in which the Member is acting.

5.2 Members will take such steps as are sufficient and available to them to ensure that any communication with which they are associated is accurate and not misleading and contains sufficient information to enable its subject matter to be put in a proper context.

6. Complaints: Any complaint by a client shall be referred to the managing partner or chairman, or similar person, of the firm who shall use his best endeavours on behalf of the Member's firm to resolve the complaint with all reasonable dispatch to the reasonable satisfaction of the client.

Annexe to the code of ethics - this illustrates the operation of the principles in practice.

Qualifying the nature of advice

Advice can be provided at a number of levels. The consultant should make it clear at the outset at what level the service is being provided

- (a) Raw (uninterpreted) market data and practice information- it is unlikely that any consultants appointed by the remuneration committee would be providing this, but the survey departments of the bigger firms do
- (b) Interpreted market data and practice information - data which the consultant has selected to be relevant to particular roles and to the client company
- (c) Advice about the context and options for future remuneration policy
- (d) Recommendations for future policy

Market data (Levels (b) to (d) above)

Rational basis for selection of comparison data

Relevance of comparison data to the remuneration of a particular executive explained

Openness with the client about the sources and limitations of data provided - sample sizes, data aging; degree of approximation

Making the client aware of the other factors that should be considered before applying market data

Avoiding the ratchet - stressing the difference between comparing pay levels and comparing pay rises

Advising clients that total cash and total remuneration comparisons should be viewed in the context of company performance comparisons

Evaluation of remuneration plans (Levels (c) and (d))

Providing the client with a full understanding of the financial implications of remuneration plans

Openness about the limitations of the valuation methodology used

Clarity about the assumptions used, eg discount rates, volatility, growth

Relating advice to strategy (Levels (c) and (d))

Insisting on a proper understanding of the business, business strategy and intended management culture/reward philosophy before providing advice or recommendations.

Taking a long-term company success perspective

Dealing with conflicts of interest within the board

Clarity about the personal client - ie who to take instructions from (normally the chairman of the remuneration committee)

Nevertheless, providing advice from the perspective of the interest of the company as a whole

Without compromising the requirement to provide this objective advice, act in a way that generally promotes harmony in the board

Having the courage to say explicitly when their objectivity is being compromised

Not providing advice to any executive (or their subordinate) about the competitiveness or design of their own remuneration package, without the explicit involvement and agreement of that executive's superior manager, and/or the remuneration committee (where relevant)

Draft 22 May 2009 prepared by MM & K Limited