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PIRC RESPONSE / AUGUST 2010

Green Paper: Corporate governance in financial institutions and remuneration policies

The voice of responsible shareowners

We welcome the opportunity to respond to the Green Paper. Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £1.5 trillion and include some of the largest pension funds, asset management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareowner initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

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PIRC'S RESPONSE TO THE CONSULTATION

Response to specific questions

General question 1: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

We provide comments in response to the individual questions below. In addition PIRC believes a further way to increase board accountability would be through the introduction of annual elections for all directors. In the UK the Financial Reporting Council has recently recommended such a provision for FTSE350 companies[1], a reform that PIRC strongly endorses.

1.1. Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

Yes, PIRC believes that directors must devote considerable time to their role on a board if they are to be effective. In the case of executive directors, we believe they should be limited to one external non-executive position. In the case of a non-executive who has no executive positions, we believe they should be limited to a maximum of three other external non-executive positions.

PIRC also believes that for major financial institutions any external roles held by the chair need to be closely monitored. Chairing a large and systemically significant organisation will require a considerable time commitment. We do not believe, for example, that an individual would be able to hold two such roles and carry them out effectively.

1.2. Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?

Yes. We see no need for the roles to be combined, or value from it. We also believe that chief executives should not go on to become chair of the same company. Although they will clearly have valuable experience we have concerns that individuals making this transition may find it hard to accept changes in the strategy they had put in place.

1.3. Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?

PIRC supports the need for NEDs to have adequate financial industry experience along with the relevant skills and experience so as to contribute individually and as a group. We support a greater specificity in the NED's responsibilities in board debate and decision-taking and also the facility to seek external advice. We consider the company should provide a detailed biography of a newly appointed NED with a detailed rationale for appointment, considering the experience and skill set, which should be disclosed in the Notice of Meeting to shareholders upon nomination. Similarly, a detailed disclosure is essential on a NED standing for re-election, in order to inform shareholders' voting decisions.

It would also be sensible for the briefings issued to recruitment consultants, candidate specifications and job descriptions and other material used in the recruitment of NEDs to be made available prior to appointment. This could, for example, be made available on company websites.

[1] http://www.frc.org.uk/press/pub2282.html

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1.4. Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?

PIRC strongly supports the push for greater diversity in the membership of boards. We believe that this is important primarily because it is likely result in cognitive diversity, and in turn should strengthen the challenge function within boards.

Legal theorist Cass Sunstein has recently written about how groups of like-minded individuals reinforce and amplify each others' opinions and how this can lead to more 'extreme' decisions being taken.[2] His own research has shown how judicial panels with political appointees in the US are subject to this bias. Panels consisting entirely of Democrats reach more 'liberal' views than those held by the appointees individually, and panels consisting entirely of Republicans reach more 'conservative' views.

Sunstein himself suggests that this reinforcement effect makes the case for proper independent representation on boards, an argument we would certainly endorse. Going further PIRC also believes it provides ground for considering wider membership of remuneration committees (see answer to question 7.4).

We also believe that the Commission should review what impact the introduction of a quota for female board membership has had in Norway, as the experience could provide valuable lessons for other markets.

1.5. Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?

Yes, PIRC favours an annual performance appraisal process. Boards should look to provide a balanced, meaningful report, bearing in mind the different skills, knowledge and experience the directors bring to the board. The appraisal process should be described for both non-executives and executives, including the criteria used and minimum requirements set. Appraisals should be undertaken in relation to individual directors, committees and the board as a whole, and outcomes should be disclosed. The director or committee responsible for the process should be identified. Companies should consider the appointment of an independent third-party to conduct the review, and we concur with the Review that where this is the case then this should be disclosed, along with any other commercial relationship with the company.

We believe shareholders should be made aware of the exact process for individual director, board and committee evaluations, and these should be clearly specified in the annual report.

1.6. Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?

PIRC supports the recommendation that risk committees should be formally established as a separate entity. It is also to be recognised that it is the responsibility of all board members to oversee and report upon risks and mitigating risk management actions. The creation of a risk management committee should only be viewed as an additional level of support to the board and audit committee functions. Management should remain accountable to the board for monitoring the system of internal controls, and for providing assurance to the board that it has done so.

There should be greater clarification of the requirements of the board, audit and risk committees to report upon risks inherent within the company, including non-financial

[2] *Going to Extremes*, Cass Sunstein, 2009

and off balance sheet items. The audit and risk committees should be expected to report upon the processes they use in the reviewing and monitoring of risks.

PIRC's own research on risk management in UK-listed financial institutions suggests that currently risk committees are not viewed by companies as being of a similar status to their audit and remuneration committees. Our analysis found few tables or graphs showing frequency of meetings or attendees, or clear indications of processes and how their work interlocks with the board and other committees. Therefore, the role of the committee and disclosure requirements that risk committees should have needs further emphasis.

In terms of members of risk committees, in order to challenge the potentially excessive-risk taking nature of the sector, independence and risk management experience should take precedence to ensure members are suitably competent.

1.7. Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

Whilst this may have some benefits, PIRC does not think that this needs to be compulsory. However PIRC believes that the risk committee should be fully independent and the chairman should not be the chairman of the board, or the chairman of the audit committee in order to maintain an independent review of risk management.

1.8. Should the chairman of the risk committee report to the general meeting?

PIRC believes that this could help investors hold companies accountable for risk management, and therefore would be welcome. The CRO could also be part of any report back to investors.

1.9. What should be the role of the board of directors in a financial institution's risk profile and strategy?

See answer to question 1.6.

1.10. Should a risk control declaration be put in place and published?

PIRC supports this proposal, but we believe that it is important that financial institutions provide ongoing commentary on risk management. As such we believe that the risk committee should produce its own report. We agree here with the recommendation of the Walker Review:

"The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source."

Going further PIRC believes that what is expected in terms of the nature and content of a risk committee report could be set out at a European level, in order to improve reporting in this area. In particular the Commission could encourage reporting on the mitigation of risks. The scope of such a report needs to be clearly defined as well and should include all of the organisations activities, rather than those the company deems to be of relevance to the balance sheet, thus avoiding items that might have a higher risk profile being kept off balance sheet so as to avoid reporting upon them.

1.11. Should an approval procedure be established for the board of directors to approve new financial products?

Yes, PIRC supports this proposal.

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1.12. Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

Yes, PIRC supports this proposal.

1.13. Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ('duty of care')?

If directors' duties are to be redefined PIRC believes that this would require a proper review on its own. Whilst we would be broadly supportive of a more towards a duty to consider stakeholder interests this requires further exploration.

General question 2: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.

2.1. How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?

PIRC believes that a CRO should be responsible for risk management at the group level, and be independent from individual business units. The CRO should report to the board. PIRC believes that it will be up to individual institutions to decide on reporting lines within the business.

As suggested above, the CRO could also be make presentations to shareholders on risk management, whether at the AGM or in other meetings. Not only would this enhance the CRO's status, this would also hopefully encourage shareholder engagement over risk management, something that has clearly been lacking in recent history to great collective cost.

2.2. How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?

PIRC believes that the CRO should provide regular, scheduled updates to the board, in addition to providing one-off reports if needed in between.

2.3. Should the chief risk officer be able to report directly to the board of directors, including the risk committee?

Yes, PIRC strongly supports this proposal.

2.4. Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?

PIRC has no objection to this proposal.

2.5. Should executives be required to approve a report on the adequacy of internal control systems?

Yes, PIRC strongly supports this proposal.

General question 3: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

For PIRC, a key principle of good governance is that the statutory audit should be perceived to be a wholly independent process. This depends on independence being beyond reasonable and informed challenge, as opposed to being simply an arguable

case. The independence of the auditor is of paramount importance to shareholders, both in respect of individual companies and in terms of audit's public policy function of ensuring investor confidence in financial reporting. Although the auditing profession has long had ethical guidance on objectivity, this has not been sufficient to prevent significant public and regulatory concerns.

During the financial crisis, there has been some speculation about the independence of the auditors at the banks. The argument has been made, for example, that independence might be compromised by the involvement of auditors in securitisation and other non-audit work. Certainly this is an issue that deserves exploration, and PIRC has carried out some initial analysis of disclosures made by UK-listed banks in respect of auditor fees in relation to securitisation and other non-audit work.

Our own analysis has shown that banks' disclosures do not provide a great deal of detail on non-audit work.[3] However, the reports of two banks – Northern Rock and RBS – specifically highlighted work on securitisation. In addition it is notable that in the majority of cases UK-listed banks have paid considerable fees to their auditor for non-audit work. We share the view expressed in the Treasury select committee's report on the failure of Northern Rock published last year that this creates a conflict of interest.[4] In fact the level of non-audit work carried out for banks by their auditors often falls foul, in our view, of best practice in this area.

PIRC believes that two reforms that should be considered are greater prescription in terms of the disclosure of non-audit work carried out by auditors, and the introduction of a shareholder advisory vote on the audit committee's report.

3.1. Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

PIRC believes that this is a sensible proposition, but we have no expertise to bring to this issue. We note that the FRC and FSA in the UK are exploring how such co-operation might work.[5]

3.2. Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?

Yes, PIRC supports this proposal.

3.3. Should external auditors' control be extended to risk-related financial information?

PIRC believes that this is a sensible proposition provided that the level of service provision undertaken by the auditor does not threaten to compromise their independence.

General question 4: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.

4.1 Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?

Yes, PIRC supports this proposal.

4.2. Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?

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3 PIRC evidence to Treasury select committee - http://www.pirc.co.uk/sites/default/files/documents/Selectcomm.pdf
4 http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf
5 http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/108.shtml

PIRC is broadly supportive of this proposal to the extent that it is not an attempt to 'second guess' management decision-making. It should also be restricted to areas where institutions are likely to breach regulatory requirements. PIRC believes that oversight for the general functioning of the board is the responsibility of the board itself, and shareholders where appropriate.

4.3. Should the eligibility criteria ('fit and proper test') be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?

PIRC is not convinced by this proposal if it is to be extended to non-executives. In particular we would caution against sacrificing independence (commercial and independence of thought) on the part of non-executives for the sake of technical expertise. A well-functioning board clearly needs relevant knowledge and understanding, but also individuals who are willing to challenge.

More broadly, PIRC's policy has been that directors should have continuing professional development. Companies should have a formal induction policy for new directors, and specialist support on particular issues related to certain committees, such as remuneration and audit. We also believe that the areas covered within induction, training and development should be disclosed in the annual report and accounts to provide shareholders with an overview of how these issues are addressed. Continuous professional development should also be subject to externally verified review and appraisal.

General question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?

This is an issue of great significance, since it is really a question about who should be responsible for the oversight of the governance of publicly-listed financial institutions. Currently, in markets such as the UK the formal conception of publicly-listed financial institutions is that they are owned by their shareholders. As a result of the potential for their investments to lose value, shareholders are also assumed to have a vested interest in the ongoing success of the companies they own, and as such expected to engage when necessary.

Recent history does not provide much confidence that this idea of the shareholder-as-owner governance model functions effectively, and there are a number of underlying assumptions that are perhaps challengeable. Many of the largest investors in UK-listed financial institutions hold hundreds if not thousands of individual stocks. The damage done as a result of even a serious failure may not be particularly severe at one or two stocks, and indeed this is the point of holding a diversified portfolio.

As an example, the National Association of Pension Funds has argued that collapse in value of BP will have a negligible effect on pension scheme funding, though it will be one of the largest equity holdings that funds have. Their argument is that because only a minority of their assets are in UK equities in total the impact of BP's fall will be 0.5% of total assets.[6] Given that this is one of the stocks that could cause the most damage to a scheme's funding this gives some idea of how limited the impact of a governance failure might be.

In addition to the impact of portfolio diversification, the use of benchmarks and relative performance measurement may also create conditions in which even institutional investors may not seek to engage. For example, large active asset managers do not sell completely out of many holdings, but rather under-weight them relative to the index.

[6] http://www.napf.co.uk/DocumentArchive/Press%20Releases/00_2010/20100602_02-06-2010%20-%20BP%20and%20the%20Gulf%20oil%20slick%20crisis.pdf

If these companies subsequently underperform, the manager will perform relatively better than those who held an index weighting or were over-weight in the stock. This may provide a perverse incentive not to intervene.

There are inevitably conflicts of interest. For example, many asset managers are part of larger financial institutions. They may also seek to win business from the occupational pension funds sponsored by listed companies in which they invest. These factors may provide a strong disincentive not to engage with companies. In contrast asset managers suggest that there is currently limited client interest in engagement activity, in theory giving them little commercial incentive to be proactive in this area.

Turning to practice, based on our analysis of voting activity in respect of the UK's listed banks, it certainly appears to be the case that shareholders did not utilise their ownership rights effectively. This includes some institutions who market shareholder engagement services to asset owners. In addition a number of investors themselves have acknowledged that they could have been more effective in their engagement with financial institutions.

Based on the preceding analysis, PIRC believes that the Commission is right to argue that confidence in the shareholder-as-owner model has been shaken. Nonetheless we continue to believe that it is a system of oversight that can be effective, and preferable to the alternatives.

The question is, if shareholder oversight is not considered to be an effective model, then what should replace it. Given the lack of a clear alternative put forward in the Green Paper we can only assume that a shift to a more regulated approach (as opposed to, say, a stakeholder model) is envisaged. Whilst we have noted throughout our response a number of points where further regulatory intervention would be welcome, we do not think that an overall shift to oversight by regulators is appropriate.

Obstacles that face shareholders seeking to engage – such as information asymmetry – would also affect regulators. In addition, regulatory staff do not have the same type of self-interest in ensuring the success of financial institutions (as opposed to preventing their failure) as shareholders.

Undoubtedly there needs to be a step change in behaviour in respect of shareholders' ownership activity if the current model of oversight is to function effectively, but PIRC believes this is achievable. We believe that the Commission should focus on three particular areas -

- Setting out best practice in respect of ownership activity in the form of local 'stewardship' codes for institutional investors
- Extending shareholder rights where necessary (such as 'say on pay votes' and annual election of directors)
- Introducing concomitant requirements for investors (such as mandatory disclosure of voting records)

Taken together specific actions in these areas could bring about a significant improvement in investor oversight which we hope would in turn lead to improved governance at financial institutions, mitigating the risk of future failures. We set out our thinking in more detail in answer to the questions below.

5.1. Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

PIRC strongly believes that public disclosure of full voting records by institutional investors should be mandatory. Disclosure of voting policies alone achieves very little, since investing institutions can reach very different voting outcomes despite having broadly similar written policies. As such we believe that public disclosure of full voting records is necessary.

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Our support for a mandatory regime is based on our direct experience of the alternative. The UK's approach to this issue, relying on a voluntary 'comply or explain' regime, has clearly been ineffective. Of the many asset managers which do not disclose, we have only been able to find one which explains its non-compliance. Therefore the system is effectively 'comply or ignore'.

In addition, leaving it to institutional investors themselves to decide what, when and how to disclose has resulted in a wide variation in approaches, and this does not benefit the end user. Some investors disclose full voting records, others only headline statistics. This severely limits the usefulness of the disclosures. PIRC has attempted to carry out comparative analysis of voting behaviour, based on the disclosures that are currently available in the UK, but we have only been able to piece together fragments. We have attached our analysis of voting at UK-listed banks for information.

Ultimately a voluntary approach to voting disclosure suits the investing institution, rather than the beneficiaries. If the intention behind disclosure of voting records is to make investing institutions more accountable for their activities as owners then there is no logic in allowing institutions to decide what to disclose.

In addition, the experience of the system of mandatory disclosure in the US is that the information is used by third parties to analyse where various institutions sit on the ownership spectrum. There have been numerous reports produced since the introduction of the mandatory regime, but a good example is the recent study by the US trade union AFSCME and others on mutual fund voting on remuneration-related issues.[7] If a system of shareholder oversight of governance issues, including remuneration, is to function effectively it is vital that comparable data is available on the exercise of ownership. This logically leads to a mandatory disclosure regime.

PIRC believes that an annual disclosure is sufficient, but it must be a full voting record – all votes on all resolutions at all companies where the investor held stock. Only a standardised disclosure format will make the disclosures useful to beneficiaries. Where voting decisions are delegated – for example by a pension fund to an asset manager – we believe that it is reasonable for the beneficial holder to provide a link to the disclosure made by its intermediary.

PIRC also believes that voting advisers should disclose their voting recommendations, and we have been doing son since the start of 2009.[8] For information, we believe that the programming time involved in creating our online disclosure was less than a day, and therefore the associated cost was trivial. We therefore do not believe that claims by asset managers and their representative bodies that voting disclosure is an unacceptable extra cost have any validity.

5.2. Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.

As detailed in the answer to the previous question, we believe that certain aspects of investors' ownership activity need to be the subject of regulatory intervention. The UK's attempt to encourage asset managers to voluntarily embrace accountability and transparency has not been successful.

As the Commission will be aware, more recently the UK has introduced a Stewardship Code for institutional investors. PIRC is very supportive of this initiative as we believe it could encourage institutional investors to take their ownership responsibilities seriously, strengthening oversight and mitigating the risk of future failures. PIRC would welcome

[7] http://www.afscme.org/docs/AFSCME-2009-Report_Compensation-Complicity.pdf
[8] http://www.pirc.co.uk/public-voting-disclosure

the promotion of the Code at a European level, and encouragement of equivalent codes in other markets.

Over time we believe that the Stewardship Code will supplant other best practice standards for investors that have been developed over the years. In the longer term this will be positive, since there should be no confusion amongst investors about which standards to adhere to.

5.3. Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to 'empty voting'?

Yes, PIRC supports this proposal. For example, we see no reason why share purchasers should not be required to disclosure beneficial ownership to the company upon purchase, and identified in the company's share register.

5.4. Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

PIRC believes that consideration should be given to ways to strengthen the position of long-term investors in respect of the governance of financial institutions. There are a number of areas that might be explored including qualifying periods for voting rights, loyalty dividends, and the formal involvement of shareholders in nomination committees.

General question 6: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

There maybe some merit in exploring whether certain governance principles – such as the separation of chair and chief executive positions – should simply be mandated. PIRC notes that such an approach has been considered in Ireland.

More broadly, however, we favour giving the owners of companies the necessary tools to encourage companies to adhere to governance best practice. On a practical level this implies both the introduction of new rights – such as advisory votes on remuneration, and the annual election of directors – and the incentivisation of genuinely long-term investment.

6.1. Is it necessary to increase the accountability of members of the board of directors?

PIRC believes that all board members should face annual re-election in order to increase their accountability. In the UK the Financial Reporting Council has recently recommended that directors of FTSE350 companies should face annual re-election and we firmly endorse this, though we would like to see the provision extended to the whole market over time.

6.2. Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?

Yes, PIRC supports this proposal.

General question 7: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.

As a general comment, we are disappointed that in the efforts to reform the financial sector in the wake of the financial crisis, very little attention has apparently been paid to the assumptions underlying remuneration policy. It is taken for granted that the

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provision of variable pay is a way of positively affecting performance, and that the principal issue to consider in respect of reforming remuneration is the structure of incentive schemes (ie the length of time over which awards are made). Essentially post-crisis remuneration reform has largely been an exercise in incentive redesign.

PIRC is sceptical about the ability of incentive schemes to lead to better performance unless the task concerned is simple and measurable. There is an extensive and growing literature on this question that informs our scepticism.[9][10][11]

As the economist John Kay has recently written: "There is a role for carrots and sticks, but to rely on carrots and sticks alone is effective only when we employ donkeys and are sure exactly what we want the donkeys to do."[12]

We believe that many of the tasks that we should expect the boards of financial institutions to undertake are not easily measurable, and that therefore incentive plans of any kind are likely to be at best irrelevant to performance.

Going further, we believe that the existence of large financial incentives may help create unhelpful 'norms' in the boardroom, a point made by George Akerlof and Rachel Kranton: "[T]he most important consideration in incentives for executives could be their role as fiduciary. Office holders should fulfil the duties of their office. If jobholders have only monetary rewards and only economic goals, they will game the system insofar as they can get away with it."[13]

In a sense incentive schemes may play a performative role – helping create or reinforce the financially-motivated and self-interested behaviour that the implementation of such schemes implicitly assumes already exists.

We accept that a shift away from performance-related pay will be considered a very radical departure by many, especially as the assumptions underlying the current approach are widely held, if largely unacknowledged. However we believe that the EC could play a very important role in the remuneration debate if it devoted even part of its efforts in this area to the consideration of the deeper issues around variable pay.

We have set out our own thinking on these issues in a recent briefing note for clients.[14]

7.1. What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?

PIRC has proposed that the contractual terms of new board appointments should be put to a shareholder approval vote. This would reduce the risk that over-generous terms are offered which result in future 'rewards for failure'. More broadly we recommend that the Commission support the introduction of annual advisory votes on remuneration policy at listed financial institutions in all markets.

However, PIRC would stress that the granting of such rights should be matched by an accompanying requirement on institutional investors to disclose how they are used. At present too few investors in markets like the UK use the legal ownership rights that they have to challenge questionable remuneration policies.

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[9] *Motivation Crowding Theory: A Survey of Empirical Evidence* - B Frey and R Jegen, 2000

[10] *Large Stakes and Big Mistakes* - Dan Ariely, Uri Gneezy, George Loewenstein, and Nina Mazar, 2005

[11] *Not Just for the Money: Economic Theory of Motivation* – Bruno Frey, 1998

[12] *Obliquity*, John Kay, 2010

[13] *Identity Economics: How Our Identities Shape Our Work, Wages, and Well-Being*, G Akerlof & R Kranton, 2010

[14] *Pay and behaviour*, PIRC, 2010. Available on request.

7.2. Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?

PIRC does not believe that stock options are a unique problem that requires specific attention. We would instead recommend a much broader review of the effectiveness of all financial incentive schemes.

7.3. Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?

As suggested in the answer to general question 7, PIRC is sceptical that remuneration policy has a significant role in excessive risk-taking. Instead we believe that this is likely driven more by an institution’s internal culture, and in this light we note the UK regulator’s comments on the importance of culture, and how regulators might address it.[15] Poorly-designed remuneration policies may contribute to the creation of a culture of excessive risk-taking, but we are not convinced that this is a primary cause.

7.4. Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

PIRC believes that proper consideration should be given to either employee representation on the remuneration committees of financial institutions, or some other way to allow employees and their representatives to feed into decision-making. Our support for such a reform is based on repeated examples of remuneration committees acting irresponsibly and failing to exercise restraint. As an example, consider the case at RBS in the UK where remuneration committee members considered that the departing chief executive – widely held responsible for the crisis at the bank – deserved an enhanced pension.

We believe that poor decision-making of this type results at least in part from the current make-up of remuneration committees, whereby all members are likely to have a shared belief in the need for large rewards. Cass Sunstein’s research into decision-making by groups sharing similar views, referred to in our response to question 1.4, would seem to underline the dangers of such a situation. We believe that employees or their representatives are likely to hold different views about remuneration and that this is likely to disrupt the reinforcing tendency of current remuneration committee membership.

7.5. What is your opinion of severance packages (so-called 'golden parachutes')? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?

To a large extent, ‘golden parachutes’ are simply contractual terms for directors. As such, as noted above, PIRC believes there is a strong case for providing shareholders with an upfront advisory vote on contracts.

General question 7a: Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?

As noted above, PIRC is sceptical that any redesign of remuneration policies will have a significant impact on the behaviour of individuals within financial institutions, which

[15] http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/101.shtml

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would presumably be the aim of such reform. PIRC believes that the Commission may achieve more by considering what, if anything, can be done to affect internal cultures.

7.6. Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

Vested interests will argue that any reduction of cap will drive talent out of those institutions. Unfortunately, many institutional investors have also made this argument, as evidenced in the nature of comments made by asset managers to Lord Myners, the UK's former Financial Services Secretary. Myners wrote to the UK's leading institutional investors to ask what action they had taken in respect of remuneration policy at the banks whose shares they held. PIRC obtained copies of the responses sent by asset managers, using a Freedom of Information request. One of the most common arguments deployed by asset managers was that putting too much pressure on remuneration policy would indeed reduce banks' ability to recruit and retain top talent.[16]

Those financial institutions that are, as a result of the crisis, either wholly or partly state-owned have an opportunity to test these assumptions. Based on our experience of the UK market, we doubt that there is much appetite for outright suspension of variable pay, therefore a reduction in the level seems most appropriate.

General question 8: Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.

As noted in our response to general question 5, we acknowledge that conflicts of interest are a potential obstacle to effective oversight by institutional shareholders. However we believe that through a combination of a requirement for transparency in respect of ownership activity and the setting out of expected best practice this problem can be addressed.

Specific questions:
8.1. What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?

Further to our response to question 5.1 the Commission could consider whether there should be a requirement to disclose the policy on how conflicts of interest are handled when:

- Asset managers (or other institutional investors) that are part of a larger business hold stock in the parent company
- Asset managers vote on issues at listed companies with whom them have a commercial relationship (ie a mandate from the company's pension fund)
- Proxy voting advisers undertake consulting with the companies that they analyse and making voting recommendations on

8.2. Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?

Yes, PIRC supports this view.

[16] http://www.pirc.co.uk/news/investor-responses-myners

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