The Walker Review in the UK Proposes Tough New Regulatory Requirements

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The High-Level Group on Financial Supervision in the European Union, chaired by Jacques de Larosière, issued its damning report in February 2009. The Group found that board members and executives of financial institutions did not understand the characteristics of the new, highly complex products they were dealing with, nor were they aware of the aggregate exposure of their companies. Further, many board members did not provide the necessary oversight or control of management.

The UK government responded quickly by establishing its own Review of the Corporate Governance of the UK Banking Industry, lead by the former Chair of Morgan Stanley, Sir David Walker. Walker found bonus schemes encouraged excessive risk-taking and accordingly proposed significant reforms to strengthen bank governance in the UK.

The UK Combined Code on Corporate Governance may take up many of these reforms and, if so, they will apply to listed companies beyond banks and other financial institutions. Sir David, in a statement in the *Wall Street Journal Europe*, said the proposals on remuneration were "as tough, or tougher, than anything to be found anywhere else in the world."

Endorsed by UK Prime Minister Gordon Brown, some of the highlights of the Walker proposals include:

The responsibilities of the chair and other non-executive directors (NEDs)

- A greater time commitment is required of directors: a minimum of 30 to 36 days for directors and not less than two-thirds of a chair's total annual working time;
- The chair is to possess financial industry experience and board leadership capability;
- NEDs are to satisfy themselves that risk decisions draw appropriately on external expertise.

Board balance and composition

- The Financial Services Authority (FSA, the UK's regulator of financial services) is to pay closer attention to directors' experience and access to director education;

- An interview process by the FSA is to be required for prospective directors who do not bring recent relevant financial industry experience.

Frequency of director re-election

- The chair is to be proposed by the board to shareholders for election annually, against the background of the board evaluation statement (see below);
- If a non-binding resolution on the report of the remuneration committee garners less than 75 percent of shareholder votes cast (a "say on pay" resolution), the committee chair is to stand for re-election in the following year.

Board information, development and support

- A substantive, tailored development plan for each NED is to be reviewed annually with the chair;
- Dedicated internal support is to be provided to NEDs on any relevant matter from the company's secretariat and through external advice regarding the governance of financial risk;
- Explicit expectations of the chair are to be defined related to information, communication and director accountability.

Board evaluation

- A senior independent director is to evaluate the chair and be accessible to shareholders if communication with the chair is difficult or inappropriate;
- A formal rigorous board evaluation process and a statement thereon are to be developed, with external facilitation every second or third year (and other business relationship, if any, of the facilitator to be disclosed);
- The statement on board evaluation is to include the process for identifying skills and experience of directors and for evaluating contributions and commitments of individual directors;
- The statement is also to include communication by the chair with major shareholders.

Risk management and internal control

- A risk committee of the board is to be established, with the chief risk officer (CRO) who is independent from business units reporting directly to the risk committee and to the board chair if necessary;
- The independence and tenure of the CRO is subject to board approval and the compensation of the CRO is subject to the approval of the board chair or the chair of the remuneration committee;
- The risk committee is to draw on external expertise and oversee due diligence appraisals of acquisitions or disposals, prior to board action;
- A separate risk report is to be submitted to shareholders that includes disclosure of the risk committee members, the meetings and the source of any external advice taken.

Remuneration

- The remit for the remuneration committee is to include firm-wide remuneration with emphasis on the risk dimension;
- The remuneration committee is to oversee remuneration for all executives whose remuneration exceeds the median of that of executive board members[1] and report satisfaction of performance objectives linked to compensation, disclosing total remuneration in bands, number of executives within each band, and pay elements;
- At least half the variable compensation is to be in a long-term incentive scheme, with half the award vesting after not less than three years and the remainder after five years;
- Short-term bonus awards are to be paid over a three-year period with not more than one-third in the first year;
- "Clawbacks" are to be used for entitlements when performance is subsequently found to have been overstated or in cases of misconduct;
- Executives whose total remuneration exceeds the median of executive directors are to maintain a shareholding or retain a portion of vested awards.

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1 In the UK, there exists a greater proportion of "executive directors" on a board than in North America, where typically only the CEO and perhaps another officer (e.g., the CFO) are the only executive directors. In the UK, there exists a minimum level of independent non-executive directors (50% of the board of FTSE 350 companies and at least two independent non-executives in smaller listed companies), according to the Financial Reporting Council.

Stock vesting for this group should not normally be accelerated on cessation of employment;

- The remuneration committee is to seek advice from the risk committee on specific risk adjustments to be applied to performance objectives set in the context of incentive packages;
- The report of the remuneration committee is to state whether any executive director has the right to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised positive discretion;
- Remuneration consultants are to form a professional body to assume ownership of a code of conduct for member firms, to be lodged on the Financial Reporting Council's website (FRC, the UK's regulator responsible for promoting confidence in corporate reporting and governance). Remuneration committees are to retain a consultant who commits to the code.

Engagement between boards and shareholders

- Boards are to be made aware of changes in the company's share register. For substantial changes, the FSA is to contact shareholders to understand their motivation and to contact the board for an indication of whether and how it proposes to respond;
- The FRC is to ratify the Institutional Shareholders Committee's[2] (ISC) *Statement of Principles*, which are to become the core "Principles of Stewardship" (Principles). The ISC, in close consultation with the FRC as sponsor, is to review the Principles annually;
- Fund managers and other institutional investors are to indicate on their websites their commitment to the various Principles and the FSA is to require disclosure of this commitment by such groups on a "comply or explain" basis;
- A Memorandum of Understanding (MOU) is to be prepared, initially by and for major UK investors, to facilitate effective collective engagement on similar shareholder concerns about prospective or actual underperformance, with confirmation by the FSA that the terms of the MOU comply with applicable regulatory provisions (e.g., do not constitute "acting in concert" or "control seeking");
- Foreign institutional investors are to be encouraged by the FRC and major UK fund managers and institutional investors to commit to the Principles and to the MOU;
- Fund managers and other institutional investors are to disclose their voting record and policies.

When Sir David was interviewed the day his recommendations were released, he summarized them in a media interview in two areas: "capability" and "personality" and he stated the need for better-trained non-executive directors. Boards have been "under-qualified and overly collegial," Walker stated.

In my view, the primacy of chair and director independence by regulators (largely other than Canadian) over the last decade - absent scholarly validation and at the expense of competencies, behaviours and assurances that roles are being fulfilled - has been arguably misguided and damaging to corporate governance and, by extension, to economies. The Walker Report in the UK now is explicitly stating that independence standards should be balanced with the skills, experiences and qualifications of directors. The Securities and Exchange Commission in Washington is also moving towards emphasizing the capabilities of directors.

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2 The Institutional Shareholders' Committee is a collaboration of institutional investor bodies (four in total), similar to that of the Canadian Coalition for Good Governance.