Original Article

The Walker Review proposes 'The Toughest Governance Regime in the World'

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ABSTRACT **We are currently in the midst of the most significant global changes in corporate governance arising from the financial crisis that will fundamentally transform governance obligations, relationships and expectations, as we know them. Governments in the United States, United Kingdom, European Commission and elsewhere are enacting legislation and voluntary codes to enhance governance oversight, facilitate shareholder impact, enshrine risk governance and strengthen board and shareholder control over executive compensation. This article focuses on developments in the United Kingdom, specifically the recommendations within the 'Walker Report'.**
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INTRODUCTION

The difference between the financial crisis of 2008 and the Enron and WorldCom implosions of 2002 is that the financial services sector – directly, indirectly or systemically – affects almost every citizen, business or government. Governments have had to spend billions of dollars bailing out financial service and other companies, have incurred debt, and are therefore more restricted in funding public health, education and social services. Taxpayers and other stakeholders are concerned over the regulatory and governance shortcomings that contributed to this crisis, and, in particular, over inadequate risk oversight and control of executive compensation in the financial services industry that are thought to be contributing factors to this crisis.

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The 'High-Level Group on Financial Supervision in the European Union' found that board members and executives of financial institutions did not understand the characteristics of the 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 High-Level Group's report (Larosière, 2009, p. 10) reads:

> Failures in risk assessment and risk management were aggravated by the fact that the checks and balances of corporate governance also failed. Many boards and senior managements of financial firms neither understood the characteristics of the new, highly complex financial products they were dealing with, nor were they aware of the aggregate exposure of their companies, thus seriously underestimating the risks

> they were running. Many board members did not provide the necessary oversight or control of management. Nor did the owners of these companies – the shareholders.
>
> Remuneration and incentive schemes within financial institutions contributed to excessive risk-taking by rewarding short-term expansion of the volume of (risky) trades rather than the long-term profitability of investments. Furthermore, shareholders' pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies' performance.

In the United Kingdom, Sir David Walker found that bonus schemes encouraged excessive risk-taking within banking institutions. He has proposed significant reforms to strengthen governance of these institutions in a 142-page report entitled 'A review of corporate governance in UK banks and other financial industry entities' (Walker *et al,* 2009).

Sir David, in a statement in the *Wall Street Journal Europe* (2009), stated that his proposals on remuneration were 'as tough, or tougher, than anything to be found anywhere else in the world'. Endorsed by Prime Minister Gordon Brown, some of the salient highlights of the Walker proposals are summarized and commented upon below, including their wider application given developments in Canada, the United States and South Africa.

THE RESPONSIBILITIES OF THE CHAIR AND OTHER NON-EXECUTIVE DIRECTORS

Walker recommends that a greater time commitment be required of directors: a minimum of 30–36 days for directors and not less than two-thirds of a chair's total annual working time.

There is merit to offering prescriptive guidance as to reasonable time and performance obligations of directors; however, caution should be exercised in the development of 'professional' directors, such that independence or participation in management activities or decisions is not compromised at the higher end of engagement. Independence may be compromised as directors (particularly board and committee chairs) increase their time spent on board-related duties.

As a matter of disclosure, to address the inadequacy of time devoted to one's role and responsibilities, which underlies the thrust of Sir David's recommendation above, all significant directorships (that is, public, private, not-for-profit and governmental) and board and committee leadership roles should be disclosed externally for each director on each listed company board, together with any other significant time commitments and employment obligations. In this manner, shareholders may judge for themselves whether adequate time exists for each director to fulfil his or her role and applicable responsibilities effectively.

Walker also recommends that the board chair possess financial industry experience and board leadership capabilities. This recommendation goes on to read that leadership capability of the chair is more important than financial experience because industry experience without leadership capability is unlikely to suffice, in Walker's view.

Walker is correct, and this view is consistent with academic studies showing that having an independent, non-executive chair to lead a board of directors may, in the best of circumstances, be a necessary condition but is not a sufficient condition for effective leadership, governance and performance for shareholders. As Walker has outlined in his report, the leadership skills of the chair of the board are extremely important. In essence, the skills possessed by this individual may be the most important contributing factor as to whether or not a board is effective.

Some of the qualities of an effective board chair include those necessary for board members, as well as the following (Leblanc and Lindsay, forthcoming):

- demonstrated strengths in communication and leadership skills;
- strong facilitation and consensus-building skills;
- empathy for fellow directors;
- coaching, developing and feedback-providing skills;
- a forward-looking perspective;
- a clear strategic vision;
- the intellectual capacity to understand complex issues and risks, and the options for handling and reporting and providing assurance on them;
- an appreciation of stakeholder accountabilities and the need to set, monitor and act on standards of performance;
- the ability to assess priorities and focus on what is important;
- the willingness and ability to prepare agendas with clear objectives and to chair productive board meetings;
- political skills and the ability to use power;
- the strength of character to deal effectively with a competent but strong-willed CEO;
- the ability to recognize and manage the creative tension between the board and the CEO;
- the ability and knowledge to challenge views and opinions;
- the ability to manage strong-minded or intimidating members; and
- the willingness and ability to take charge in times of crisis.

The foregoing qualities (or a variation thereof) of the board chair should be assessed by all directors, on a regular basis. Similar considerations apply to chairs of committees.

Walker also recommends that explicit expectations of the chair be defined related to information, communication and director accountability.

It is important that a clear, comprehensive and detailed position description exists and be disclosed by the organization for the chair of the board and the chair of each principal committee.[1] Board and committee chairs should have the requisite knowledge, experience, skills and commitment to fulfil the criteria within their position description, and should be assessed by board and committee members on whether they have accomplished their role and responsibilities and fulfilled the terms of their mandate over the last year in an acceptable fashion.

If incumbent chairs do not possess the competencies and skills for board or committee leadership, and have been peer-assessed by colleagues as such, they should be rotated out of the position, or off of the board, as circumstances warrant. Chair selection, succession and assessment practices should be fully disclosed to the organization's shareholders and other stakeholders to assure them that a robust and sustainable board and committee leadership regime is in place at that organization. Disclosure should be full, clear and accessible.

BOARD BALANCE AND COMPOSITION

Walker recommends that the Financial Services Authority ('FSA', the United Kingdom's regulator of financial services) should pay closer attention to directors' experience and access to director education, and that an interview process by the FSA should be required for prospective directors who do not bring recent relevant financial industry experience.

Walker's focus on industry experience is consistent with the academic literature. To be more blunt, the regulatory emphasis and primacy attributed to director independence over the last 15 years – absent scholarly evidence that independent directors do, in fact, contribute to enhanced board effectiveness or performance for shareholders – has been arguably misguided and damaging to corporate governance, and, by extension, to economies and nations. The above Walker recommendations acknowledge, correctly, that independence standards effecting board size should be balanced with the skills, experiences and qualifications of directors, together with competency development through education.

The Securities and Exchange Commission in Washington (2009b) is also now moving towards emphasizing the capabilities of directors. The Financial Reporting Council (2009), based on the Walker recommendations, is determining whether independence standards should be adjusted to permit greater focus on industry knowledge and experience, without necessarily having to increase the size of the board.

BOARD AND REMUNERATION COMMITTEE CHAIR ELECTION

Walker recommends that the board chair be proposed by the board to shareholders for election annually, against the background of the board evaluation statement (see below), and that if a non-binding resolution on the report of the remuneration committee garners less than 75 per cent of shareholder votes cast (that is, a 'say on pay' resolution), then the remuneration committee chair is to stand for re-election in the following year, under Walker's proposal.

In addressing director elections and shareholder impact on these elections more broadly, beyond the chair of the board and remuneration committee chair (Walker's recommendation above), it is extraordinarily difficult (and costly), at present, for shareholders of listed companies in several jurisdictions to effect change in board or committee membership, both from the point of view of electing prospective shareholder-favoured directors and in discontinuing the membership of particular directors whom shareholders may not favour.

The United States' Securities and Exchange Commission ('SEC') is attempting to address this difficulty, and is considering giving shareholders greater voice and impact in electing directors (or not) to serve on the boards of American publicly listed companies. Recently proposed SEC rule changes would enhance shareholder access to the proxy statement and require, under certain circumstances (for example, ownership thresholds), management to include in the company's proxy materials a shareholder-endorsed nominee for director.[2]

In addition, the *Shareholder Bill of Rights Act* of 2009, introduced in the US Senate by Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA), would grant shareholders a new right to include their director nominees in management's proxy circular, eliminate staggered boards, and require that directors receive a majority of votes cast to be elected (majority voting). This Bill is said to be 'one of the most significant efforts by Congress to reform the shareholder rights and corporate governance realm since the creation of the US Securities and Exchange Commission more than 70 years ago' (Phillips, 2009). The foregoing non-binding and legislative efforts – in the United Kingdom and United States – underscore the changes necessary for shareholders to meaningfully impact the election or removal of directors who are thought to represent their interests (or not). Many generally view such changes as improvements to corporate governance.

BOARD SUPPORT, DEVELOPMENT AND INFORMATION

Walker offers three recommendations in this area: (i) dedicated internal support is to be provided to non-executive directors on any relevant matter by the company's secretariat, and through external advice regarding the governance of financial risk; (ii) a substantive, tailored development plan for each non-executive director is to be reviewed annually with the chair; and (iii) non-executive directors are to satisfy themselves that risk decisions draw appropriately on external expertize.

To address the first recommendation, a board, committee or individual director should be empowered to retain any advisor (that is, beyond internal secretariat resources) it or he or she deems appropriate in fulfilling roles and responsibilities, for educational purposes and as an assurance check on management. The company should pay for retaining the advisor and not interfere or unduly influence the process in any way (for example, pre-screening by management, the approval process and so on). The advisor's client is the board or committee, not the management.

The detailed development plan, to be discussed between the chair and each director, ideally should be the product of a peer review of that director, and should be shared with the chair of the board during the developmental meeting. The board chair should also have a developmental discussion with the senior independent director (United Kingdom), or chair of the governance committee or lead director (North America). The King III Report (2009, item 118) indicates, 'Should a deficiency in a director's performance be identified, a plan should be developed and implemented for the director to acquire the necessary skills or to develop appropriate behavioural patterns'.

For directors to satisfy themselves that risk decisions draw appropriately on external expertize, the King III Report suggests that audit committees should ensure that a 'combined assurance model' is applied to provide a coordinated approach to all assurance activities. A number of Commonwealth countries speak of 'assurance', as opposed to 'advisors' providing 'expertize'. There exist differences among advice, expertize and assurance. 'Assurance' invokes a different governance treatment.

An advisor provides an original piece of expertize. Assurance refers to the integrity of certain processes and systems. A provider of relevant assurance provides assurance over something others have prepared. There are three types of assurance providers: management, internal assurance providers (for example, internal audit), and external assurance providers (for example, external audit, an appointed actuary, regulators (inspectorate), an occupational health and safety auditor and so on). Internal or external assurance providers may be properly regarded as independent, depending on their relationships, activities, governance oversight and accountability to the board or a committee. The board and committees should take steps to ensure the independence, competence, appropriate remuneration and other treatment of both internal and external assurance providers who are accountable to them. The board or committee should have regular private or closed sessions with each such assurance provider, without management present.

In addressing risk, and Walker's third recommendation, above, the board and each standing committee should be enabled to affect assurance over any material risks the board or a committee oversees (including the design, implementation and effectiveness of the internal controls and the compliance framework thereof). In South Africa, the audit committee oversees this combined assurance model, including non-financial sustainability risks and integrated reporting. It is interesting that King III is universally applicable to all companies, including small issuers, private and family companies, governmental corporations, and not-for-profit organizations. Therefore a combined assurance model, over all material risks to the company, can apply to non-financial institutions, and a broader range of companies.

RISK MANAGEMENT AND INTERNAL CONTROL

Walker offers four main recommendations in the area of risk management and internal control: (i) 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; (ii) 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; (iii) the risk committee is to draw on external expertize and oversee due diligence appraisals of acquisitions or disposals, before board action; and (iv) a separate risk report is to be submitted to shareholders including disclosure of risk committee members, meetings and the source of any external advice taken.

King III recommends the creation of risk committees of the board for all organizations, that is, beyond large, complex financial institutions that the Walker report addresses. A risk board committee and a risk executive function (for example, CRO) may need to be more broadly interpreted, in the form of a principle perhaps, with various practices that might achieve the objective of the principle, for non-banking institutions.

To oversee risk governance effectively, directors need to understand the business model and drivers of the organization. This understanding is difficult without industry experience. For independent directors who do not possess adequate industry experience, it is important that independent assurance (by internal or external providers at the discretion of directors) of risk management and internal controls over all material risks occur and be reported to the board and relevant committees. The holistic 'combined assurance' model from King III is instructive in this regard. The board and committees should ensure that the results of independent assurance (including stress testing results) are acted upon by management and reported to the board or committee. Management attesting to accuracy or content (a form of assurance over materials) cannot be considered to be independent assurance.

CONTROL OVER EXECUTIVE REMUNERATION

Perhaps Walker's recommendations for the control over executive compensation were the most intrusive. He offered recommendations in this area, summarized as follows:

- 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 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 3 years and the remainder after 5 years;
- short-term bonus awards are to be paid over a 3-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. 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; and
- 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. Remuneration committees are to retain a consultant who commits to the code.

A number of the recommendations above centre on the intersection of risk and compensation, specifically that compensation committees now should oversee (and receive assurance on) that compensation incentives or other arrangements should not be designed to incent an employee, or group of employees, within the organization to take inappropriate or excessive risks, individually or in aggregate, that may potentially harm or put the organization at risk.

The US Department of the Treasury and the Federal Reserve System (2009, p. 25) followed suit and, after continuing the awarding of large bonuses to financial executives of firms receiving taxpayer assistance, issued guidance on sound incentive compensation policies for financial institutions. Part of this guidance included balanced risk-taking initiatives and described 'Four methods currently … often used to make compensation more sensitive to risk'. These methods include (similar to the Walker recommendations) 'Risk Adjustment of Rewards'; 'Deferral of Payment'; 'Longer Performance Periods' and 'Reduced Sensitivity to Short-Term Performance'.

The Treasury guidance goes on to define the foregoing four methods, and provides suggestions for how risk management processes and internal controls should reinforce and support the development of balanced incentive compensation arrangements. Some of the more salient of these recommendations are that risk management personnel should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining excessive risk-taking; and that compensation for risk management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.

The recommendations by Walker and the guidance by the US Treasury are designed to ensure that executive compensation policies do not undermine the safety and soundness of banking organizations.

BOARD EVALUATION

Walker offers four recommendations in the area of board evaluations: (i) 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); (ii) 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; (iii) the statement is also to include communication by the chair with major shareholders; and (iv) a senior independent director is to evaluate the chair and be accessible to shareholders if communication with the chair is difficult or inappropriate.

The evaluation of boards requires further guidance, standards and independent assurance. Firm-specific criteria are often inconsistent and vague, impeding the development of system-wide robust criteria and comparables. Processes are opaque and informal. Management may unduly influence the process by non-specific perfunctory criteria being employed and evaluations being completed internally (with management in control). Robust criteria, third-party attestation and significantly enhanced disclosure are needed in this area in particular.

The Institute of Directors ('IOD'), in responding to the Walker recommendations, has gone further in the area of board evaluation and is calling for a 'Standardised Independent Governance Analysis' to be carried out by appropriately trained and accredited personnel. The IOD writes in its submission (2009, p. 6):

> Although board evaluation has become more widespread amongst larger companies in recent years, evaluation techniques vary in rigour and objectivity. According to a recent ICSA [Institute of Chartered Secretaries and Administrators] report (based on the 2008 reporting season), only 21 per cent of the 200 largest UK companies utilise external assessors to undertake a board evaluation. A PwC report in 2007 found that less than 50 per cent of the FTSE 350 disclosed that their boards were operating in an effective manner. In many cases, these disclosures in the annual report were unhelpfully "boilerplate" in nature.

Follow-up and action-planning based on the evaluation and disclosure of a summary of results and the process to shareholders may be equally boilerplate in nature, and not meaningful. Therefore, independent reviews conducted by capable parties, the use of rigorous board performance criteria, and assurance to shareholders within a detailed board evaluation statement that a robust assessment regime is in place are positive developments.

CONCLUDING REMARKS

When Sir David Walker 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. Walker stated that boards have been 'under-qualified and overly collegial'.

The Financial Reporting Council, the regulator responsible for promoting confidence in corporate reporting and governance, is currently assessing which of the Walker report's proposals should apply more broadly to all UK listed companies.

NOTES

1 Richard Leblanc recommended that Toronto Stock Exchange (TSX) listed companies in Canada have position descriptions for the chair of the board (and each principal committee), and that they be disclosed. Many Canadian listed companies now do so. Directors should also be assessed based on their applicable position description (also the case).

2 See also the following Weinberg Centre for Corporate Governance blog posting: 'HealthSouth has become the first major US corporation to take advantage of a recent change in Delaware law which allows companies, by by-law, to reimburse shareholders for expenses incurred in board elections. Many shareholder activists have noted that access to a ballot, without reimbursement, is a barrier to entry for shareholders wishing to influence board composition. The Delaware law enables reimbursement, something that the SEC's proxy access proposals currently do not', http://www.delawarecorporategovernance-blog.com/

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