BIS | Department for Business Innovation & Skills

Executive Remuneration: Discussion Paper. Response form

Please send your response by: 25 Nov 2011

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I am responding on behalf of (please tick)	
	Yourself : Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
x	**Non governmental organisation (NGO)**
	Trade Union
	Lawyer or accountant
	Other (e.g. consultant or private individual)

Questions

Role of shareholders

1. Would a binding vote on remuneration improve shareholders' ability to hold companies to account on pay and performance? If so, how could this work in practice?

Yes	No
x	

Comments
In previous submissions to the FRC and to the Walker Review of Corporate Governance in Banks and Other Financial Industry Entities, we have argued that the advisory vote should be made binding. The Walker Review rejected this on the grounds that the remuneration report "relates to effectively contractual commitments given to executives within the framework of a policy already implicitly or explicitly approved by shareholders". We note that similar objections have been raised in response to this consultation. We do not accept that this is an insuperable barrier to reform. For example, it could be provided that all such contractual commitments were subject to shareholder confirmation; appropriate provisions for adjustment in the event of shareholder approval being withheld could also be devised. In any case, if the remuneration in question were clearly within the framework already approved by shareholders, it is presumably unlikely that it would be rejected; it is when this is not so apparent that there is likely to be concern. The objection that a binding vote would lead companies to focus solely on whether they 'pass' or 'fail' is equally unconvincing. Under the current advisory vote, it is already the case that significant shareholder revolts are often ignored by the company in question and rarely lead to a change in remuneration packages. Conversely, our experience facilitating binding shareholder resolutions is that management often do seek to engage in dialogue with investors, whether or not the resolution is likely to pass (which it usually is not). The key issue at play here would appear to be the company's attitude to shareholder engagement, rather than whether the vote in question is advisory or binding. Finally, we are unconvinced by the argument that a binding vote would be too costly or disruptive because of the implications of a vote against. Indeed, as the discussion paper notes, this would seem likely to encourage directors and shareholders to engage more closely to agree an acceptable package in advance of the vote, in order to avoid the disruption that an unacceptable package would entail. Of course, as the consultation paper notes, it can also be argued that

shareholders would simply become reluctant to vote against. In this regard we would note that shareholders are already extremely reluctant to vote against management. The recent TUC fund manager voting survey found that executive remuneration was more likely to generate votes against management than other issues. Yet overall levels of opposition still remain relatively low. In the most recent AGM season, not one FTSE 100 remuneration report was rejected in the advisory vote – in spite of the fact that executive remuneration continues to increase out of all proportion to shareholder returns. The comfort offered by the advisory status of the current vote does not, in practice, seem to create a willingness among investors to vote remuneration reports down. Indeed, the introduction of a binding vote could send a signal to shareholders that they are responsible for approving company remuneration and must begin to take this responsibility more seriously.

Having said this, the current low level of votes against management does indicate that the introduction of a binding vote would not be a silver bullet. As the discussion paper notes, shareholders can be given the tools, but they must also be willing to use them. We believe that part of the answer here lies in improved transparency and accountability to the savers whose money is managed by institutional shareholders. FairPensions works to educate and empower these savers to hold their agents to account for their exercise of ownership rights. Given the current level of public disquiet over executive pay, this would seem potentially a particularly effective mechanism when it comes to remuneration. However, for this market mechanism to work, much greater transparency is needed over the exercise of voting rights.

As we argued in our response to the initial call for evidence, *'A Long-term Focus for Corporate Britain',* voting disclosure continues to be patchy, and levels of improvement are slow in spite of the positive effect of the Stewardship Code. According to the most recent IMA survey, even among signatories to the Code, only two-thirds disclose their voting records, and only two-thirds of these disclose information about individual votes (as opposed to summary statistics, which do little to improve accountability). Disclosure among pension funds is even lower, with NAPF figures showing that the proportion disclosing voting information to their members stagnated at around 24% from 2008-2010. The government has reserve powers under section 1277 of the Companies Act 2006 to make disclosure mandatory, and we recommend that these powers should be exercised. Much of the executive pay problem is about breaking open the closed circles which set remuneration. Improved accountability to ultimate owners could help to achieve this.

2. Are there any further measures that could be taken to prevent payments for failure?

Comments
No comment.

3. What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

Yes	No
Comments	
No comment.	

Role of remuneration committees

4. Would there be benefits of having independent remuneration committee members with a more diverse range of professional backgrounds and what would be the risks and practical implications of any such measures?

Yes	No
x	
Comments	
Independent remuneration committee members could help to reduce the danger of 'group-think' as well as dealing with the tendency for committees to be made up of members who are, as the discussion paper notes, themselves "part of a culture of high pay". Non-executive directors (NEDs) should fulfil this role, but in practice cannot be entirely independent due to their business relationships with the executives who appoint them. This may reduce the possibility of challenge on excessive remuneration. In our Walker Review submission, we suggested that determining the independence of prospective NEDs should be left to existing independent directors, and that executives should not participate in this decision. The role of NEDs in setting executives' remuneration was a key reason for this recommendation. In the absence of	

such a move there would seem to be a case for ensuring the presence of truly independent voices on remuneration committees.

Having said this, we would caution against the assumption that adding 'independent' members to remuneration committees will be enough to curb excessive pay. At least equally crucial is the question of weeding out conflicts of interest from existing committee members – please see our response to question 5.

We are somewhat concerned by the suggestion that "professionals with consultancy and advisory backgrounds" would be a valuable addition to remuneration committees. We are unclear what is meant by this, but if it refers to individuals with a background in remuneration consultancy, or indeed to practising professionals whose firms might have an interest in the company's business, then clearly this could introduce a further set of potential conflicts of interest into the process of setting remuneration. At the very least, robust measures would be needed to prevent such conflicts from arising if this approach were to be pursued.

5. Is there a need for stronger guidance on membership of remuneration committees, to prevent conflict of interest issues from arising?

Yes	No
x	

Comments
Steps to prevent conflicts of interest are crucial to dealing with excessive remuneration. We would urge the government to focus not just on who *should* be on remuneration committees, but also on who should *not:* preventing cross-pollination of remuneration committees is at least as important as ensuring diversity of membership, and arguably more so. This process may need to begin before the appointment of the remuneration committee, at the stage of appointment of non-executive directors (NEDs) themselves. In our response to the Walker Review, we argued that there should be an absolute prohibition on any NED being regarded as independent if any other director of the company is also a co-director of the NED in another company and that co-director has any role in determining the NED's remuneration in that company (i.e. whether as a member of the other company's remuneration committee or as a member of its board). At the very least, such a direct conflict of interest should disqualify the NED from membership of the remuneration committee. This could be achieved through amendments to the Corporate Governance Code.

6. Would there be benefits of requiring companies to include employee representatives on remunerations committees and what would be the risks and practical implications of any such measures?

Yes	No

Comments
Please see our response to Question 4.

7. What would be the costs and benefits of an employee vote on remuneration proposals?

Comments
No comment.

8. Will an increase in transparency over the use of remuneration consultants help to prevent conflict of interest or is there a role for stronger guidance or regulation?

Yes	No

Comments
Transparency over the use of remuneration consultants is necessary but not sufficient to prevent conflicts of interest. In our response to the Walker Review we expressed reservations about the proposed Remuneration Consultants Code, arguing that it envisaged an unacceptable degree of self-regulation, and that the Code should instead be overseen by the FRC on the same footing as the Stewardship Code and Corporate Governance Code. We believe these concerns have been borne out by the Code as it currently stands, which contains only very weak measures in relation to conflicts of interest. We therefore suggest that consideration again should be given to transferring responsibility for the Code to the FRC. Other recommendations made in our Walker Review response, which we think merit consideration as part of this review, are:

- that remuneration consultants should report exclusively to the remuneration committee and /or the shareholders;

- that remuneration consultants should be appointed by the shareholders, normally on the recommendation of the remuneration committee; and

- that the entity to which the remuneration consultants belong should have no other business connections with the company.

The continued growth in executive pay in the years since the Walker Review – including increases of close to 50% in both 2009 and 2010 – suggests that our concerns about the regime then put in place were justified and that these proposals should be revisited. Failing this, detailed disclosure by the remuneration committee of any conflicts of interest and of how it has dealt with them (as required in the US) would seem to be the bare minimum that should be required.

Structure of remuneration

9. Could the link between pay and performance be strengthened by moving away from TSR and EPS as the key measures of performance?

Yes	No
x	

Comments
We agree that attempts to link pay to performance may be counterproductive if the wrong measures of performance are used – i.e. short-term results rather than measures which reflect long-term sustainable company success. As the discussion paper notes, efforts to link pay to performance in recent years appear to have been unsuccessful either in controlling levels of pay or in linking it more reliably to company success. One response to this is to reject performance-related pay altogether; in addition, as we suggest in our response to Question 12, it may indicate a need to focus on the *process* of setting pay, its underlying conflicts of interest and accountability deficits, rather than simply on refining the *structure* of pay. If performance-related pay is to continue as the norm, we agree that there would be value in the use of more strategic measures of performance. These could relate to KPIs – in particular, that greater weight should be given in directors' remuneration to the achievement of sustainability KPIs. However, it should also be acknowledged that there are problems at present with the use and reporting of KPIs, particularly non-financial KPIs. A recent study by the Accounting Standards Board found that in their reporting on financial KPIs, 6% of companies were non-compliant with the law with a further 34% falling

short, while in relation to non-financial KPIs, 32% of companies were non-compliant with the law with a further 20% falling short. Improved robustness and transparency around KPIs is an essential prerequisite if efforts to link pay more closely to KPIs are to be effective. As indicated in our response to the narrative reporting consultation, we do not believe that the government's proposals as they stand address this issue.

10. Should more companies be encouraged to adopt vesting periods of more than three years?

Yes	No
x	
Comments	
As we concluded in our response to the Walker Review: "a deferral period of three years seems far too short, when measured against the timescales of typical long-only investors [which are generally measured in decades rather than years]. Similarly, even a five year deferral cannot be said to represent long-termism. We think that there is a case for much longer deferral, perhaps more akin to pension entitlements. This could have the further advantage that if the relevant performance criteria were not met, the withheld benefits could simply be forfeited, which is a far more practicable mechanism than clawback." Furthermore, the relatively short tenure of UK CEOs referred to in the consultation should not present a practical obstacle to deferral designed in this way.	

11. Should companies be encouraged to reduce the frequency with which long-term incentive plans and other elements of remuneration are reviewed? What would be the benefits and challenges of doing this?

Yes	No
Comments	
No comment.	

12. Would radically simpler models of remuneration which rely on a directors' level of share ownership to incentivise them to boost shareholder value, more effectively align directors with the interests of shareholders?

Yes	No

Comments
We agree with the High Pay Commission that there is a strong case for radically simpler models of remuneration. As well as risking the unintended consequence of ratcheting up pay, complex remuneration structures act as a deterrent to shareholder scrutiny. Private discussions with remuneration experts within the UK's largest asset management firms indicate that even they find remuneration packages confusing, and that at times complex remuneration structures can almost appear designed to prevent effective scrutiny. Such complexity prohibits all but the largest and best-equipped shareholders from exercising effective oversight. Moreover, these large investment management firms are more likely to suffer from conflicts of interest, whether through business relationships with investee companies or because questions have been raised about their own remuneration practices, which could discourage robust challenge. Having said this, we would caution against the assumption that a 'technical' solution to excessive pay can be found by changing remuneration structures, unless the underlying conflicts and dynamics driving excessive pay are addressed. As the discussion paper shows, the increasing complexity of executive pay calculations itself arose from a desire to link pay more closely to performance. In fact this seems to have had limited effect and indeed contributed to the continuing rise in levels of executive pay. Understandably, the pendulum is now going into reverse, with policymakers and shareholders asking whether simpler pay structures are the answer. In fact, the lesson of recent decades may be that changing the structure of executive pay is unlikely to be sufficient to ensure that pay is proportionate and that directors are properly incentivised. Rather, there is a need to break open the closed circles which are currently responsible for setting executive pay. As such, although there may indeed be value in seeking simpler and more effective ways to structure remuneration, we would refer back to our response to Questions 5 and 8 (which relate to the need to tackle conflicts of interest more robustly), and to Question 1 (which relates to the need to improve shareholder engagement and to ensure shareholders themselves can be held accountable).

13. Are there other ways in which remuneration - including bonuses, LTIPs, share options and pensions – could be simplified?

Yes	No
Comments	
No comment.	

14. Should all UK quoted companies be required to put in place claw-back mechanisms?

Yes	No
x	
Comments	
However, longer and more robust deferral mechanisms (with the prospect of benefits being forfeited if performance conditions are not met) may be a more practicable means of improving incentive structures than clawback: please see our response to Question 10.	

Promoting good practice

15. What is the best way of coordinating research on executive pay, highlighting emerging practice and maintaining a focus on the provision of accurate information on these issues?

Comments
No comment.