Comply Now or Explain Later?

MM&K Remuneration Dinner

On 21st January, MM&K held a dinner for Chairmen, Remuneration Committee Chairs and Chief Executives. The subject for discussion over dinner was the Government's planned new remuneration reporting regulations and the advantages and disadvantages of early compliance.

Summary

Dinner guests generally agreed that companies should comply early in areas which involve no significant cost or risk. By doing so they will have a 'dry run' and may gain the goodwill of shareholders. In more costly or risky areas they should wait until the legal requirement for compliance.

Introduction

Cliff Weight introduced the subject. His key points were:

1. MM&K are actively involved with several companies drafting their remuneration reports in line with the new pending regulations.
2. The new regulations will apply to premium listed (main market) companies with year-ends after 31st October 2013. So far the Government has only published draft regulations for comment.
3. They are set in a history of disclosure regulations starting with the Directors Remuneration Reporting Regulations in 2002. The Kay study on short-termism in equity markets is important background for the changes.
4. With the new regulations the Government's is aiming to:
   a. Encourage and equip shareholders to hold companies to account;
   b. Improve the transparency of reporting;
   c. Provide a framework for shareholder/company discussion on remuneration policy.
5. The Government says its ultimate aim is to "restore" the link between pay and performance. It says it is not interested in the *level* of remuneration which it says is a matter for shareholders. Cliff said he does not believe them!
6. MM&K are just about to publish its 2013 chairman and non-executive director survey, *Life in the Boardroom*. This survey shows that most company chairmen think that the level of executive pay is about right, although there is an increasing minority who think it is too high.
7. But the survey also shows that remuneration and governance are not the principal concern of chairmen and non-executive directors, coming only fourth in their list of priorities and taking up less than 10% of the time

they spend on their duties with a company. The crux of the role is business strategy.

8. Cliff outlined the main changes in the new regulations:
    a. The formalisation of current statements on remuneration policy into a *future policy table* which would be subject to a shareholder vote at the most every three years;
    b. The production of graphs showing the build-up of remuneration in different performance scenarios;
    c. A formal description of the policy for compensation for loss of office, similarly subject to a three-year vote. This would put a very definite constraint on remuneration committees who could not go outside this policy without going back to shareholders;
    d. The reporting of a 'single figure of total remuneration' for each director using a standard definition of each of its components, which would also be reported. Cliff said that this definition is one of pay realised (ie including LTIPs when they vest). MM&K have always advocated reporting two figures, the second being pay awarded (ie including the expected value of new grants). Companies are, of course, free to report the second as well and he would encourage them to do so;
    e. The replacement of the current 5-year comparative TSR chart with one showing changes in the chief executive's total remuneration over 10 years compared with absolute TSR movements over the same period.
9. Cliff's advice to remuneration committees is to prepare a draft of the remuneration report now on the basis of the new regulations in full in order to see what the report shows – before deciding what to include in this year's report.

Discussion followed. The main points made included the following:

1. The discussion began with a debate as to whether there is any first mover advantage to implementing the new regulations any earlier than required by law. The conclusion was that, if reporting this way is not contentious, it would 'tick some of their [shareholders' and proxy agencies'] boxes.
2. Some aspects of the report, such as the future policy table, would be easy to comply with and would make the work of shareholder compliance analysts easier in making comparisons.
3. The 10-year CEO remuneration graph is intended to cross new appointments. This would present problems. One guest said his would cross three appointments – the first CEO was the original founder and owner and did not take a salary. Cliff said that the median tenure for a FTSE 350 CEO is 4 years, but in a quarter of companies the tenure is 8 years.
4. The discussion moved on to question whether there was any real value to shareholders in this new level of disclosure. One guest asserted there has been no value in disclosure from the beginning "it has all been a big mistake" – with the suggestion that it has done nothing but inflate pay. Cliff questioned this as investment bank pay, which was not disclosed, moved much faster without the fetter of exposure to shareholders.
5. This led to a discussion about banking pay. It was suggested that banking is a special case, and the pertinent question is not 'why do bank employees make so much money?' but 'why do banks make so much money?' – a question for society as a whole. Another guest said that the popular picture of bankers making excessive money is not real when applied to most bank employees.
6. The special regulations for banks which have emanated from Europe have had the perverse effect of increasing the fixed components of remuneration within the package and reducing the variable bonus element, something that makes no economic sense.
7. Would the new regulations lead to pay simplification? Cliff thought this was an unrealistic aim – executive remuneration is complex because businesses are complex – different solutions are needed for companies with different business circumstances.

8. One participant said that these reports also have to meet the needs of a number of different parties with different needs. Another classified shareholders as the long-term investors, the good and faithful and arbitrageurs. He said their needs are the ones companies should be concentrating on and they are not necessarily met by meeting the requirements of the "corporate governance chatterati"!
9. The increasing influence of the voting recommendations coming from proxy agencies was pointed out.
10. The result of following governance guidelines in the past has been to make remuneration far too short term – companies need to think along the HSBC lines or partnerships where top executives cannot expect to realise a large part of their wealth until they retire.
11. The listed company remuneration model was contrasted with that applied to private equity portfolio, with participants generally preferring the simplicity of salary, bonus and exit participation –"nothing relative to other companies – it's all on growth". Thousands of such companies are now applying this model.
12. But for small cap companies, whether or not they get red-topped, the shareholders only think about the share price, and expect the directors to manage the company and remuneration matters And in fact for listed companies generally shareholders do not really have a complaint provided the company is making money and gives good returns.
13. Is pay benchmarking a good or bad thing? Cliff expressed the view that, whilst benchmarking of salaries is a curse, benchmarking of performance and its relation to pay is certainly of value to shareholders, although one consequence of the new regulations might be an increase in the deferral of pay so as to reduce the reported total remuneration figure. Paul Norris added that the 10-year graph will be valuable as a means to demonstrating the relationship of pay and performance.
14. Discussion moved on to the past impact of remuneration governance guidelines, and the negative effect of the ABI's love affair with relative TSR in LTIPs. This has led to some executives being highly rewarded even when shareholders were doing badly – guests had different views about the extent to which high rewards should reflect absolute success of the company as well as management performance in difficult circumstances.

15. One participant asked what the effect of the new regulations will be, and suggested that remuneration committees have to respond to three sources of pressure: pay market pressure, moral pressure and the requirement to report in a similar fashion. But he thought the last of these would have some value in showing more clearly the different ways that companies respond to and resolve these pressures.
16. In summary, the dinner guests thought there is value in complying, at least to an extent. Nigel Mills reported some recent research indicating that 25% of companies plan to comply to a significant extent with the new regulations as drafted and 55% to a limited extent. Only 6.7% do not plan to comply at all. Unsurprisingly, no company is planning to have an early vote on the future policy report.
17. Cliff reiterated his advice to companies to draft the report in full first – then decide what to omit. This is an approach that MM&K are taking with a number of clients.