Corporate Governance Reform

MM&K Remuneration Committee Dinner

6 March 2017

MM&K regularly hosts dinners for Chairmen, Remuneration Committee Chairs and Chief Executives. For this dinner, the question for discussion was: ***Corporate Governance Reform – has intervention by Government and other "interested parties" taken a step too far?*** This is a record of the discussion.

The subject was set in the context of the Government's Green Paper of November 2016 "Corporate Governance Reform" and the subsequent consultation. It was introduced by MM&K's Stuart James.

Stuart began by saying that it is important to acknowledge that there is a problem of perception about executive pay. Much of this perception originates from the statement, repeated in the press and elsewhere, that there is no link between executive pay and corporate performance. This statement is not true.

He passed around an analysis MM&K had prepared showing that, during the years from 2003 to 2010, a period most often quoted as one that saw the "delinking" of pay and corporate performance, a majority of companies in the FTSE 100 achieved total shareholder returns at levels higher than increases of CEO pay.

This is not suggesting that TSR should be the measure that all organisations use or that some shareholder return should not be expected without any increases in reward. But it does show that the debate regarding executive pay has started from a false position. The danger of the Green Paper is that, in trying to address this perception issue, it will compound the real problem, which is that executive remuneration must be reviewed on a company-by-company basis and not as a global set of standard regulations.

Stuart then summarised a selection of the submissions that some key organisations and trade bodies have submitted to the Government:

The Financial Reporting Council: This sets out the FRC's view that all of a company's Annual Reports (and not just the Financial Statement) should fall within their ambit – with an increase in jurisdiction and powers accordingly.

The High Pay Centre and the CIPD (presented as a joint submission): This made a number of suggestions, including supporting the Green Paper proposal for pay ratios to be published. But the most radical was a pitch for all listed companies to be required to establish a new Board sub-committee to be led by the HR director which would deal with all matters relating to human capital opportunities and risks.

British Venture Capital Association: The BVCA suggested that their own guidelines for the reporting of Portfolio Companies are sufficiently strong and robust. Unsurprisingly, the BVCA considers that there should be no further expansion of rules into the private market and, should there be any change it is the provision of guidelines only.

The Investment Association: The voice of institutional investors, the IA is generally happy with how things are currently working and is not pushing for radical change, especially as the current (2013) regime is still bedding down. Any changes proposed are minimal and refine the current system, an example being that, if there is a substantial vote against the Remuneration Report, a company should be obliged to bring the Remuneration Policy

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back to the shareholder early (within twelve months, if only 50%-75% are in favour, and within six months, if less than 50% are in favour).

Stuart said that MM&K made three main points in its own submission:

1. There is no need to give additional powers to shareholders on remuneration, as they already have sufficient powers to deal with any problems. The Green Paper itself acknowledges that the average vote in favour of the Remuneration Report is over 90%. In any case, shareholders can always sell their shares if they disapprove strongly of company remuneration policy or practice.
2. Incentives should be linked to a company's own KPIs in the main (which supports the thrust of the IA submission) rather than to relative measures.
3. The key question is whether executives are creating value. MM&K advocated "telling the story" of achievement and reward in remuneration reports and also the idea of "town hall" meetings in which the executives told the story of executive pay to company staff.

Stuart put four questions to the company at the dinner:

- How can the value of the management team be better represented to both shareholders and a company's wider "stakeholder community"?
- Would more reporting requirements deliver better governance / remuneration conversations?
- Is the remuneration committee the right place to decide wider pay policies, culture and behaviour for the businesses? If not, where should this be dealt with?
- Should governance codes be extended wider to include private companies?

A thoughtful discussion followed. The following are notes of the main points that arose as the conversation developed:

- There was strong support for the principle that the judgement about whether executive pay is excessive or not, justified by performance, should be made on a company-by-company basis and not by some market-wide analysis. The FTSE, AIM and PE owned companies all have different dynamics and need a different balance of fixed and variable and between short and long term variable. You have to break the problem down by the type of company. But you cannot legislate for specific cases, only for generalities. Also you cannot legislate to change perceptions, although that is what the Government is trying to do.
- The problem really belongs to a small number of FTSE100 companies, but regulation aims to cover a much

wider population of companies. The Government should not be regulating for all listed companies because of the behaviour of a few. But it has trickled all the way down the main market and it will go to AIM as well.

- We always reach the conclusion that one size does not fit all. But a participant said they had found that shareholders often behave as though one size does fit all – although generally they are prepared to listen. Another disagreed with the last point – some do and some don't.
- One diner said it is hard to justify a CEO package which is 100 times that of the average employee. Another questioned the basis on which such a judgement could be made. Is it wrong to pay 10% of the returns to shareholders to an individual who creates that wealth, even if that does happen to be 100 times the average pay? It depends on the company. There are reasons for differentials in pay within a firm and they need to be understood and respected.
- It was agreed that there is no way of setting the "right" level of multiple, if only because they vary so much by industry. And in any case, even if top pay were reduced to a low multiple of the average, the general public would still consider the ratio to be too high.
- Paul Norris, who chaired the dinner, supported Stuart's argument about the need to tell the story. He said companies should argue "this is what we stand for, this is what we have done, this is the contribution we have made and this is what we have been paid". But one participant said that the regulations are so prescriptive about what to disclose that the underlying message about what is happening gets lost in the boiler-plating.
- What meaning does a "norm" for pay have if you change the business strategy?
- The discussion moved on to the Green Paper proposal to introduce new governance regulations for privately-owned companies. One participant said this would be unnecessary and potentially damaging. In many private companies the shareholders and the executives are the same people. Another said his company had moved from public to private ownership. With the new ownership, corporate governance had become a totally different game. It would be a nonsense to legislate for private companies.
- The possibility was raised that the proposal on private companies was a reaction to Philip Green's treatment of BHS employees. But this is not a corporate governance issue in that it is not about protecting the shareholder. Whilst the definition of corporate governance is being widened to cover the protection of the interests of stakeholders beyond the shareholders, in a case like this it is a matter for pensions and

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employment law. One diner said the benefit of shareholders is not necessarily the same as the benefit of stakeholders.

- Entrepreneurs and families create jobs and do not need obstructive regulations. In my company, the CEO owns 50% of a company worth £100m. He won't be asking Abercrombie when he is making a decision.
- Stuart described how the Government is using shame as a cheap way of dealing with situations that they do not like but which are essentially political. This is a deliberate "nudge" policy.
- The debate is about the man in the street's view. One person commented that the Government sees high pay as an issue to be addressed because the civil servants themselves do not earn as much. Many CEOs would do the job for less. But it is different for "growth creators" and "managers". Some CEOs are more aggressive than others about remuneration.
- One participant said that the Green Paper revealed a lack of trust in boards. It made him question why he does the job of non-executive director. Shareholders feel emboldened at the moment and able to bully companies. It has gone too far.
- The pay system we have is actually the creation of the shareholders themselves. In the end it is the shareholders who are calling the shots. Companies have adapted to what they believe shareholders want. But there is no consistency among shareholders about what they want. Worse, there are different views over time from the same shareholder. And whatever you do, some shareholders will vote against you.
- Another said we need to recognise that institutional shareholders themselves are under pressure to improve corporate governance. They are affected by the views of the people whose funds they manage. As directors of companies we are on the back foot. What do we do? Having a shareholder committee (one Green Paper proposal) would be better than having employee representatives on the board, which would be a disaster.
- We have had all the benefits of transparency for many years, but it has not solved the problem of excessive pay. It needs outside pressure to put things back in the right place. Another person said they disagree that it is in the wrong place – perhaps we need to pay more money, not less!
- The dinner group discussed whether the remuneration committee should look at pay throughout the organisation. It concluded that it should set executive pay in the context of employee remuneration; it should also have oversight of employee pay and challenge anomalies. The committee should satisfy itself

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that differentials can be justified – for example payments to a new employee compared to that of existing employees. But it is not for the remuneration committee to decide employee remuneration.

- Diners agreed that the FRC is wrong in wanting to stretch its influence on corporate governance and pay. The meeting was also dismissive of the idea of a Human Resources Committee chaired by the HR director (which, of course, implies a seat on the main board for the HRD). It was not felt there is room for the HRD on the board, although the role's input to the board and to the remuneration committee is always valuable and provides a two way channel with staff and executives. HR are facilitators, but it is not a board role.

- It raises another interesting dynamic, which is the one between the Chairman, the CEO and the Chair of the Rem Co. But it is not a problem – it is part of the normal business that has to be dealt with.

Possible actions points as a result of the dinner findings:

1. Clarify your remuneration philosophy, prepare the "narrative" and numbers about company achievement and executive remuneration and decide your programme for conveying this to shareholders and employees.
2. Consider informally reviewing executive pay level movements in your company over the last five-ten years against the movements in wider employee pay. This will enable you to be forearmed against criticisms on pay ratios.
3. Write to BEIS (corporategovernance@beis.gov.uk) expressing your concerns, which may include:
   - the uncritical acceptance of press assumptions about executive pay – particularly generalisations made from a few FTSE 100 cases. Policy should be based on facts;
   - the possible extension of corporate governance regulations to private companies for which they are entirely inappropriate;
   - the fact that there is no one right answer – it depends on the company;
   - the reality that institutional shareholders carry a lot of the responsibility for any problems and should not be put at the heart of the solution;
   - a concern that policy is being driven by populist political concerns rather than free market principles.

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