Article for ECB

FRC consultation on proposed changes to the UK Corporate Governance Code

Cliff Weight, ECB Editorial Board Member, Director of MM&K remuneration consultants and author of the Directors' Remuneration Handbook gives his view.

The FRC has fallen into the double trap of failing to remove or revise a number of old provisions that have lost their relevance and of adding in a number of new provisions which are based on a fashionable view of 'best practice' for which the underlying premises are questionable and not universally accepted. It has compounded this by attempting to convert the existing text to fit this view, rather than starting from first principles.

Companies may seemingly support some of these changes. However, many will only go along with them because they need to appear good corporate citizens. The UK Corporate Governance Code has been a beacon to the World, with its moderate comply or explain approach. It should not be tinkered with. However, if a revision is due, it should be set about wholeheartedly and comprehensively, calling on experts as well as representatives; otherwise it would be better left alone for now.

Proposed changes in Section D of the Code?

The proposal is that the original words should be deleted and be replaced with the words "executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be stretching and rigorously applied."

The Consultation Document expresses a concern that the existing focus of this Main Principle is on the executives' needs rather than those of the company in the long-term. But the proposed words, whilst they seem simple, are full of problems. "Long-term success" and "Stretching" are relics of the current Supporting Principle, promoted now to a Main Principle. Long-term success of a company is a very nebulous concept. Evidence seems to show that long-term for most institutional shareholders is two or three years. Given the developments in Stewardship combined with the findings of researcher/commentators such as John Kay, there is an opportunity for the FRC to think through fundamentally what is meant by the term and how executive remuneration contributes to it rather than hindering it. A highly profitable sale in the short/medium-term may be a better outcome than aiming for "long-term success", with its implicit goal of continued independence. Shrinking of the company and retirement of capital is sometimes a better strategy than going for growth.

"Stretching" came to be used repeatedly by large companies as an excuse to increase the upside of bonus opportunity to provide additional reward for "additional" performance. However, shareholders believe that additional performance has not been manifest in practice despite the additional reward.

"Rigorously applied" presumably means with limited remuneration committee discretion and no soft targets or decisions. If the Code means this, it should say so in plain English.

Revision to Supporting Principle D.1

The words "…improvement in performance" have been refined to "…improvement in corporate and individual performance". This change is unnecessary. It is the first example here of the 'fad' thinking that has come in on the back of the banking and financial services remuneration codes. One of the panaceas for ensuring variable pay does not lead 'code staff' to take excessive risks is requiring individual non-financial performance to be taken into account in determining variable pay – for example compliance with risk approval procedures. This is sensible in banks, but it does not mean that this is a universal best practice rule that should apply to all companies. In fact, it can have unwelcome effects. MM&K research shows that the growth of individual performance measurement for executive directors' bonuses, along with the use of multiple measurement frameworks, such as balanced scorecards, has led to a narrowing of the range of bonus outcomes over the past five years or so – a reduction in the volatility of pay-outs. So whereas bonus ranges have often been increased to give headroom for rewarding exceptional 'stretching' performance, the reality is that the variation of pay-outs has become less.

The words "should avoid paying more than necessary" have been moved from the Main Principle but have been kept in the Supporting Principle. These original words need to be examined closely and probably dropped. They are over-simplistic, probably meaningless and contribute nothing to good corporate governance. The 'necessary amount' is a balance between:

- a competitive total earnings opportunity to reduce the risk that executives may move elsewhere
- the right balance of fixed and variable pay
- the right balance of short and long term incentives
- a fair outcome in view of how well the shareholders fared and how well executives managed the particular circumstances.

D.2: Main Principle
The practical reality is that the CEO's package is negotiated as a deal (and not just on appointment). Policy for other directors is built off this. Formality and transparency are not sufficient to resist the pressures on the remuneration committee in this process. The company chairman, who under the current Code may be a member but not chairman of the committee, nevertheless has to take the lead in managing the deal with the CEO.

Hence, this Main Principle could have been improved. The current text reads "There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration." No change is proposed by the FRC. We think that the Code needs to reflect reality.

D.2: Supporting Principle
The deleted first sentence of the Supporting Principles in D.2 currently reads "The remuneration committee should consult the chairman and / or chief executive about their proposals relating to the remuneration of other executive directors." The proposed new sentence reads <u>"The remuneration committee should take care to recognise and manage conflicts of interest when receiving views from executive directors or senior management, or consulting the chief executive about its proposals".</u> It is not clear why the first sentence has been dropped: it should be left in.

"should take care to recognise and manage conflicts of interest" could be seen as rather superficial. Managing executive remuneration is always managing conflicts of interest – it is inherent in the process of determining directors' pay. If a a problem arises is usually symptomatic of a barrier to communication between the non-executive directors and the chief executive, which may only be resolved by changing one or the other. I am not sure, therefore, whether the new words add anything to good governance.

A stronger statement is needed in D.2 than is proposed.

Proposed changes relating to clawback arrangements
These changes are not necessary nor helpful.

The proposal (with amendments underlined) runs "In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code. <u>Schemes should include provisions that would enable the company to recover sums paid or withhold the payment of any sum, and specify the circumstances in which the committee considers it would be appropriate to do so."</u>

The clawback provision has been promoted from Schedule A, where the original words were "Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct". So the requirement to have these provisions has been hardened from "consideration given" to "should", but the circumstances have been made less specific.

Malus and clawback (as here, often together just referred to as 'clawback') are the second great panacea for curing the unwanted risk impact of variable pay schemes in financial services companies. Introduced originally in the 'CRD IV' remuneration code they have now been imported wholesale into the Alternative Investment Managers Directive (AIFMD) remuneration code. The theory underlying this is expressed in the grand terms of 'ex ante' and 'ex post' risk adjustment and takes as its premise the belief that inappropriate variable pay schemes were a principal cause of the 2007 financial crisis.

The fashion has now spread beyond banking and financial services. This treatment of 'code staff' now appears to be universally accepted as best practice for companies of all types in all sectors, even where the risks of any circumstances requiring clawback are negligible. Yet it is a fashion. Institutional shareholders appear to believe that this practice will lead to improved returns and better risk management, but they have not yet assembled any empirical evidence that this is true.

The FRC should leave the original wording where it is, unchanged, in Schedule A.

The proposed amendments to the Schedule A
The proposed Schedule A has now become a complete muddle. The new drafting attempts to take two original paragraphs, one dealing with treatment of annual bonus plans and the second with the treatment of long-term incentive plans, and convert them into two new paragraphs with a different purpose. The first now deals with the balance between immediate and deferred remuneration; the second with the combination of short and long-term schemes.

Whoever drafted this has been seduced by the idea that deferral is an end in itself – no doubt under the influence of the banking and financial services ex post/malus doctrine. There are some important distinctions to be made and thought about by the remuneration committee. But the committee's thinking needs to start with the balance of fixed and variable pay, move on to the choice of a performance period (short or long), and only then consider the further deferral of amounts already earned by performance. Performance periods have to match the relevant business cycles (the AIFMD code and guidance does at least seem to recognise this); only when these are decided can decisions be made on whether further deferral after the end of the performance period is necessary for risk management, long-term alignment or retention without unnecessarily weakening the incentive or short-term retention impact.

The proposed drafting slips straight from the balance between immediate and deferred remuneration into provisions regarded performance conditions. The reference to non-financial metrics adds nothing.

Another effect of shoe-horning the distinction between immediate and deferred remuneration into paragraph 1 is that "upper limits should be set and disclosed" which originally applied to annual bonuses, now also applies to long-term incentives. Does this include a limit on share option gains, or PSP share price gains? Of course it cannot, but this is not clear. The new, 2013 Directors' Remuneration Reporting Regulations - formally, The Large and Medium-sized Companies and Groups (Accounts and Reports)(Amendment) Regulations 2013- have ducked this one as well – the illustrations of remuneration policy (scenario charts) deliberately ignore share price growth for PSPs; and since they cannot do this for share options (because the consequent value would be zero) the GC100 and Investor Group Guidance falls back on the use of expected or fair value *excluding* performance conditions.

I have no problem with moving the reference to risk policies and systems to the first paragraph. This is presumably to stress its importance.

It would be helpful if the paragraphs were numbered!!

Paragraph 2 retains the relic words that "Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules." These words date back to a time when there were no vesting conditions for share options – investors were concerned that this was giving away value for nothing in return. Now that share options have demanding vesting measures, there is no case for keeping this paragraph in the Code. In practice, it is ignored when nil cost options are granted – they are recognised as Performance Shares and no-one has any problem with them as they are fully subject to vesting conditions in the same way a contingent share would be. A discounted option with vesting conditions is merely a hybrid between a share option and a performance share and may have advantages to the company in some circumstances. Provided the fair value of the grant is built into the total remuneration calculations there is no danger of giving something for nothing.

The original words in Paragraph 3, "The total rewards potentially available should not be excessive" can by now be seen to be meaningless. *The major part of rewards potentially available come from share price gains*. The theoretical potential reward is tending to infinity. It would be better to require remuneration committees to consider limiting the ratio of executive directors' remuneration and shareholder returns and/or other key ratios. (For example the QCA Remuneration Committee Guide says "Full consideration should be given to what is an appropriate proportion of cash, revenue and profit to expend on key executive's pay and it should be agreed what degree of dilution is acceptable.")

Paragraph 4 is now a mess of drafting. The requirement to build up a shareholding and to hold shares acquired from share plans cannot be treated as though they are independent things. When redrafted, the last line might read "should never be exercisable in less than three years. Longer periods should usually be considered".

Paragraph 5 is a relic of the time in the early 1990s when share options were the only prevalent long-term incentive and the practice was to provide a large single grant up to the Revenue limits for an approved plan and the ABI limit of 4 times emoluments. This led to some executives holding options, all of which were under water, whilst their colleagues had large amounts in the money because they had been granted their options at a different time. The provision is hardly necessary any more – in any case there are circumstances, for example a turnaround, where a single grant is the right remuneration strategy. The provision should be dropped.

Schedule A should be left alone until a fundamental review can be conducted by a panel which includes remuneration experts.

Question not put by the FRC: Do you agree with the decision not to remove the requirement to disclose the use of remuneration consultants…?

On Page 8 of the Consultation Document, the FRC explains why it intends to make no change to the requirement to disclose the use of remuneration consultants. I think the FRC is missing a chance to correct a fundamental flaw in the Directors Remuneration Reporting Regulations. Companies are only disclosing the fees paid for services to the remuneration committee. They do not disclose the fees for remuneration services to management, nor for other consulting, audit and other services for management, nor for services to the company's pension fund.

The Code has the opportunity to require companies to disclose these amounts spent on other services provided by firms who advise the remuneration committee. Waxman found these other services were typically 11 times those for Compensation Committee advice (this is US data – see the Waxman enquiry report). In drawing up the 2013 Directors' Remuneration Reporting Regulations, BIS backed off from including this requirement. I understand that they were persuaded by the large multi-service firms that, as the data was likely not to be readily available in either the user company or the providing firm, companies might choose to favour small single service firms as a practical measure. This, it was argued, would create an unfair bias against the multi-service firms.

I do not accept this argument. A good approximation can be made for these figures (which are not subject to audit). There is a clear potential conflict of interest in providing board remuneration advice and other services to the executives whose pay is impacted by this advice and the extent of the conflict needs to be clear. I hope that the FRC, despite the vested interests of many of the firms that constitute its advisory bodies, would rise above these arguments and require proper disclosure.

In summary: if it ain't broke, don't fix it.

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