Executive Remuneration: Discussion Paper. Response form

Please send your response by: 25 Nov 2011

About You	
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I am responding on behalf of (please tick)	
	Yourself : Quoted company
✓	**Other company (remuneration consultancy)**
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
	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
	✓

Comments
Remuneration which is properly performance-related and aligned with long-term value creation is inevitably complex and different shareholders have different expectations and preferences. These are best dealt with by shareholder dialogue and resolved in total by the remuneration committee. The current expression of satisfaction or otherwise with the committee's actions and decisions through a non-binding vote on the remuneration report is a constructive process. Tying the committee to a binding vote is not practicable and will lead to unworkable policies that do not achieve the underlying aims for remuneration policy and may even reflect conflicting aims.

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

Comments
Contracts, long term incentive plans and pension plans must be explicitly clear about what entitlement an executive has on termination. These terms should not be varied without a prior vote from shareholders. Where there is scope for remuneration committee discretion, we support the new ABI principle that it should be exercised within established boundaries and be fully explained to shareholders. In any event a properly constructed LTIP should not pay out for failure to hit the specified targets. On termination of employment, the company's performance to the termination date should be taken into account. MM&K's LTIPs are drafted in this way.

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

Yes	No
	✓
Comments	
This is impracticable in major listed companies where the largest shareholding may only be a small percentage of the whole and shareholders come and go. It is too complex to administer and will not improve accountability to shareholders generally. In any case, shareholders are already represented – by the very non-executive directors who make up the committee.	

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
	✓
Comments	
There are practical difficulties. Legally the remuneration committee is a sub-committee of the board, which ultimately has accountability for its decisions. If this independent committee member were not a legal director of the company, their status and participation in decision making would be much the same as a remuneration adviser, a role that already exists. Remuneration advisers are invited to attend remuneration committee meetings in many cases. The practice should be encouraged. It is consistent with the good governance principle that remuneration committees should have access to independent professional advice. The Hampel Committee (1998) tried to broaden membership and failed. We would be concerned if the principal aim here is to introduce people less contaminated by a 'high pay culture' in the hope that this would somehow bring remuneration levels down.	

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

Yes	No
	✓

Comments

The discussion paper raises the possibility of a conflict of interest arising from the possibility of cross-memberships of committees (you scratch my back and I'll scratch yours…). The paper says "it is extremely common for individual directors to have a role in several companies, either in a non-executive or executive capacity". We do not think this statement is founded in fact. We used the Manifest database to analyse directorships in the FTSE 100 in annual reports with year-ends in the year up to June 2011. We found the following results:

FTSE 100 cross-directorships		
Sample of FTSE 100 companies analysed	97	
Total number of directors serving at some time in year	1005	
Number with one FTSE 100 directorship only	882	88%
Directors on two FTSE 100 boards	105	10%
Directors on three or four	18	2%
Executive directors on board of another FTSE 100 company (as a non-executive director)	52	5%
…of which an executive director in turn serves on their board	0	0%
…of which a NED in turn serves on their board	1	0.1%

It is clearly *not* common for individual directors to have a role in several companies. And there is only one case of cross membership (sometimes referred to as interlocking boards) – and that involves the less risky situation where one of the pair is non-executive in both companies. There is therefore *not* "a strong case for preventing these situations from arising".

Perhaps remarkably, only 25 of the EDs on other boards are chief executives (the rest are mostly finance directors). We think there *is* a strong case for encouraging more chief executives to hold a position as a NED in another FTSE 100 company, and boards to invite them on.

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

Yes	No
	✓

Comments

Different stakeholders probably have very different views of the benefits or disadvantages that might arise from including an employee representative, setting aside the practical problems of appointing an acceptable person.

Shareholders will be concerned with the development and implementation of a successful strategy that will lead to long-term value creation. They want the board to attract and select the right people to lead the company, and reward them in a way that focuses attention on value creating activities and avoids payment for failure. They will want any committee member (a) to be fully competent and understand the company's strategic issues (b) to make these objectives their guiding principle. Being an employee representative could get in the way of both.

Employees will have a sense of fairness, and will probably want to prevent top executives earning what they consider to be disproportionately large amounts. The representative will be expected to influence remuneration committee decisions along these lines. But this is likely to be in conflict with the needs of shareholders – it is pious optimism to hope that there will be an improvement in general employee satisfaction and productivity as a result of having their representative on the committee. A more likely outcome is disillusionment when the representative fails to deliver their expectations.

Our experience on the Continent with two-tier boards is that the practical problems of making remuneration committees work effectively where there are employee representatives has led the 'management side' of the committee to run an informal shadow committee that sorts the business out prior to the formal meeting of the full committee.

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

Comments
What would be the purpose of having such a vote? It could not be a binding vote as the corresponding shareholder vote is not binding. - To make employees feel involved? It will fail in this. It will raise expectations of change that will not happen in the end, and lead to cynicism and frustration. - To improve the decisions made? The response will be too random, or political, for that to be achieved. - To create the impression of democracy? Joint stock companies are governed but not run on democratic principles, and that is probably why they have historically been so successful in creating wealth. Remuneration is not just a governance issue. The vote would depend so much on the way the resolution is framed. Then what would happen if the proposals for a salary structure, or individual salary, or bonus plan, or bonus targets, or pension arrangement are rejected? How is this to be resolved, because it will need to be?

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
There is a conflict of interest where the same firm provides services to management (ie to the executives) as well as to the remuneration committee, in that there is some (possibly subconscious) temptation to make the advice about executive directors' pay more palatable to them if a significant sale of other services to management is in prospect. This conflict arises whether or not the principal remuneration adviser (individual) is also the client relationship manager for the firm to firm relationship as a whole. If these services have nothing to do with management remuneration the case is clear. However, a dilemma arises when the other services being

provided involve advice on the remuneration of other executives and managerial staff Using the same consultant for executive director and senior management remuneration has great advantages in ensuring the policies are vertically consistent and workable. It is often the case that both management and the remuneration committee are demonstrably on the same page as each other or there is an atmosphere of vigorous debate but all are prepared to abide by the outcome. In this environment the professional adviser's principal role is to facilitate a negotiated settlement. MM&K has advised both sides of the debate with some success in the past. Here it is shareholders' interests that the remuneration adviser serves both groups but remuneration reports need to be explicit that this is happening and why.

We feel an increase in transparency would be an improvement (ie information about all fees earned by different parts of the firm from the company), and could be tried before resorting to regulation.

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
✓	

Comments

Yes, but not as a universal rule. The measures should be appropriate to the business circumstances and strategy of the company.

There are many problems in using TSR relative to a peer group or index, not least the lack of 'line of sight' for participants, and problems balancing benchmark relevance with statistical effects in small samples. Fewer than 50% of the 342 chairmen and non-executive directors in the MM&K non-executive director survey 2010 liked relative TSR in any combination.

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

Yes	No
✓	

Comments

Definitely – although the general issue is share retention rather than vesting periods (the performance period). Companies have tended to adopt three years (the ABI guidelines minimum) through fear that a longer period would weaken the incentive and retention impact. The performance measurement period for vesting should reflect the type of company. For some companies (eg highly cyclical companies) a three-year period is inappropriately short.

But in any case companies need to develop a culture of longer-term commitment to share price improvement, which can be encouraged by longer-term share retention. It is consistent with our argument that incentive plan design should reflect what is best for the company that vesting periods should also be appropriate in relation to the company's stage of development, where it is in its cycle and the time frame within which its expects to fulfil its strategic objectives or see the benefits of them in terms of added value.

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

The ABI guidelines used to say that plans should be reviewed regularly. There was a good excuse for companies to revisit the plan when it wasn't paying out because of changed market or other circumstances. Shareholders have recently begun complaining about the frequency of revisions, not least because of the time and costs in approving the new plans. Design and implementation of long-term plans suited to the company needs rather than market norms and prescriptive guidelines would go a long way to improving the situation. The following proposal (Question 12) is a radical and imaginative idea that could not have been considered under previous ABI guidelines.

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 find this the most interesting and constructive proposal in the consultation document. For the right company, this could be an ideal approach. Pay a modest salary, and pay the rest in shares vesting after several years (significantly more than three). Or a mixture of shares and options or growth shares. Again it depends on the company circumstances. Traditionally UK institutional shareholders would have resisted grants of restricted shares unless there were also financial or relative shareholder return vesting criteria, to ensure executives do not get windfall returns or reward for failure. They need to get away from this mindset, and be prepared to allow straight share grants, providing the restriction or holding period is long enough.	

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

Yes	No
✓	
Comments	
There are many ways. But simplification should not be seen as a goal in itself, just because shareholders and other stakeholders find remuneration arrangements difficult to follow. The important thing is that the plans fit the remuneration objectives of attraction, retention, shareholder alignment, sustained added value, focus on objectives, and making sense economically. Different companies will place different priorities on these, and ought to have different plans with some complexity being inevitable. NB the perception that plan complexity is created by self-serving remuneration consultants is largely (but not entirely) false.	

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

Yes	No
	✓

Comments

There is more nonsense talked about clawback (and malus) than any other aspect of remuneration new-think. Most people do not even agree what they mean by clawback. It can mean:

A. Withholding deferred bonuses:

(1) When the year's performance on which the bonus was based turns out to have been an illusion. We think this is an appropriate reason to withhold part of the deferred sum, but it only likely to happen if original profits are measured on a mark-to-market basis (for example, when a business trades assets and holds them on its books for a long time rather than closing out a position) and not a realised cash basis, It is not relevant to most companies except in specialised corners of the company, and is not relevant for senior executives in most companies
OR

(2) When performance in later years drops. Some European legislators are keen on this since it introduces symmetry into bonuses that normally are seen as providing only up-side for participants. But in our experience companies rely on long-term incentives and the price of deferred shares, not clawback, to deal with performance drop-off, for fear of weakening the annual incentive effect, and we think they are right
OR

(3) When a team in one part of the company has locked in its profit (eg closed out its position) and another part has picked up some of the toxic assets and made a loss. This can be addressed through basing part of everyone's bonus on corporate performance. We do not know of, and would not expect to find, any plans that directly raid the bonuses of teams that realised profits in cash just because they traded toxic assets
OR

(4) In a case of misrepresentation or fraud. Everyone is happy to sign up to this, but it does not need changes of remuneration policy, as it can be dealt with directly in the civil or criminal courts. It is a diversion.

B. Going after money already paid to the individual, either by withholding future salary or by obtaining an order for repayment (for any of the reasons above).

This is fraught with legal difficulty, and appalling for motivation so only suitable if the individual is being fired for misconduct or gross incompetence. We do not know of any UK companies with such a policy.

In summary such measures are not necessary for most companies, and should stay in the banking sector where they started.

It is important to point out that the introduction of clawback in banking was a measure intended to reduce the incentive for employees to make decisions which exceeded the risk appetite of the company or departed in other ways from laid down risk policy. The concept is that, if people realised they may have to pay unjustified bonuses back at a later date, they would be less likely to make such decisions. But this a door closed when the horse has decidedly got away. A whole industry was complicit in using risk models that were flawed and shutting its ears to the voices that said so; there was a relentless pressure for high returns with an over-supply of credit from global imbalances; and a culture in which the deliverers of high levels of profit (real not illusory) were championed even if they were running along a cliff edge. The introduction of clawback would hardly have altered behaviour – except to make star performers go elsewhere.

There is no case for clawback for risk alignment in most UK non-financial corporations – the key thing is to ensure that the performance measures are right for the business to ensure executives focus on the right things. (eg ROCE is right for some businesses, profit and cash for others.)

But we suspect that clawback is being discussed outside the financial services industry for another reason which has nothing much to do with risk management. This is to ensure that executives do not get rewarded for failure – ie they only get high levels of reward if this is justified by performance. Few would disagree that this is a desirable objective for remuneration policy. But it does not require a mandated clawback mechanism to achieve this.

Malus (as a noun in Latin) is an apple tree, and like Adam and Eve should be banished.

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
This is best achieved by debate in the general and specialist media, consultant surveys and reports, academic studies and conferences organised by commercial conference companies or professional and industry membership organisations. This is not a role for a new quango or government department – please!

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