Pay simplification

MM&K Remuneration Committee Dinner

26 July 2016

MM&K regularly hosts dinners for Chairmen, Remuneration Committee Chairs and Chief Executives. For this dinner, the question for discussion was: ***How simple will it be to simplify pay?*** *This document is a record of the discussion.*

STOP PRESS

The Investment Association's Executive Remuneration Working Group published its report on 26 July, the day following the dinner. A summary of its findings and recommendations is attached.

Introduction by Paul Norris and Damien Knight

Last September, the Investment Association set up a working group to look into the simplification of executive pay packages. The group produced an interim report in April and the final report, originally promised for spring and then for early summer is now being launched the day after the dinner, 26 July. Although the focus of their work is larger listed companies, the subject is of relevance to companies of all types.

The main principles identified in the interim report were:

1. Reporting of targets and the use of Remuneration Committee discretion should be clearer
2. Fund management staff (as opposed to investor governance people) should engage better with companies
3. Remuneration committees should be more accountable, apply discretion down *and* up and disclose rem co advisors' global fees for all services
4. Companies should move away from a "one-size fits all" remuneration model, tailoring plans to the individual needs of the business and company strategy and moving away from market comparators as the basis for determining pay
5. Remuneration structures should be simple – meaning that they should be easily understandable for the participant, remuneration committees, investors and other stakeholders.

The last two points were the main focus of the interim report. MM&K supports strongly the fourth principle, but believes it is often not compatible with the aim of simplicity, which should not be an end in itself. Complexity is blamed for creating the opportunity for excessive executive remuneration but this is far from being generally true.

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The report was critical of LTIPs based on relative TSR and offered, for further consultation, a number of alternative options:

- Traditional performance shares with forward looking performance (but with more tailored measures than relative TSR and EPS growth)
- Bonuses deferred into shares (ie grants based on one year historical performance – which are already common)
- Share grants based three year historical performance (these were previously discouraged by ABI guidelines)
- Restricted share grants with no performance measures (absolutely proscribed by ABI guidelines)
- There was no mention of share options, which MM&K was told was deliberate.

MM&K's recent analysis of the remuneration practice of half the FTSE 100 companies shows:

- The use of a much wider range of measures than the traditional relative TSR and EPS growth, with more relevance to the particular industry or company growth stage
- The use of multiple measures where once there would have been one or two only
- Compulsory retention of shares after vesting being widely introduced
- Use of deferred bonuses in parallel with performance shares
- Few share option plans – they are seen widely amongst AIM companies but not in the main market although they may sometimes be entirely appropriate.

The Manifest/MM&K Executive Total Remuneration Survey confirms that the substantial increases in FTSE 100 chief executive pay that are so criticised arise from the value of long-term incentives that actual vested at the end of the (typically three year) performance period. The survey shows this total movement over three years:

- Salaries went up by a cumulative 7%
- Bonuses went down by a cumulative 1%
- LTIP grants (expected value) went up by 5%
- BUT… LTIPs realised went up 47% on the back of FTSE 100 increase of 52% from 2009. It is also likely that the replacement of relative measures (such as TSR) by target-based measures (such as ROCE) has increased the likelihood of vesting.

Paul suggested the following subjects for discussion:

- Are investors in unlisted companies putting increasing pressure on private company boards on this matter?
- Do you think that executive pay is fundamentally complex, or is this only the way it seems, owing to the way pay is presented?

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- One of the problems is the range of vested interests in pay; newspaper and trade unions may be interested in the amount but investors are interested in value creation so the links between pay and performance are more important to them.
- What thoughts have you had about simplification in your companies and what actions have you taken/do you proposed to take?

DISCUSSION

There was general agreement at the dinner that there has been a breakdown in trust between the boards of companies and their employees and the population more broadly. This arises from a belief that people at the top of companies and others at the top of society have progressively enriched themselves at the expense of the average citizen or at least whilst most of society has lost ground. In this climate there is no doubt that the *quantum* of executive pay is a critical issue as is the relative wealth of top executives and the average employee.

So efforts to improve the simplicity of executive remuneration or to improve the "alignment" of pay packages may therefore be missing the main point – which is how to improve trust in society. This is important if only because there is a serious danger of Government interference in the running of companies if this improvement is not brought about. If the problem is not addressed we will see the Government reacting and introducing unhelpful regulation. The main issue is a political rather than a technical one. Feelings are extremely high about this issue. People are concerned about the quantum of pay and the ratio of the highest to the lowest.

One participant said that the population "north of Oxford" has a much more black and white perspective on this issue than the London business community (who generally voted *Remain*).

But the broad mistrust in society cannot be addressed until we address the mistrust between shareholders and company boards. We need to find a common language for describing the success of our businesses and a way of communicating this common understanding. Then we can show how far the rewards at the top reflect this success in a fair and reasonable way.

One dinner participant said that a force behind the escalation of directors' pay in quoted companies has been the need to compensate for the differential in tax treatment between listed plcs and private equity firms. Kenneth Clarke, when he was Chancellor, changed the taxation of share options. As a result public companies have had to increase the levels of executive remuneration so that it could match what could be earned in Private Equity where various reliefs apply. This was a great shame and we have been living with the results since. The Government needs to change the taxation of long-term incentives.

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Another said that LTIPs have been seen as a "goody" handed out regularly – "sad and blunt". In his company they do not hand them out automatically but decide how much to grant based on company and individual performance.

In the private equity model there is a careful scrutiny and negotiation of the proportion of value created that goes to the shareholder and that which goes to the executives. Listed companies, generally, do not think in this way and perhaps they should.

Also in PE companies participation is wider spread. It has become rather narrow in listed companies.

MM&K is working with one VC company looking at the equivalence of reward value between performance shares, executive share options and carried interest – it's challenging, especially given the 10 year time frame of performance and reward. But you can never factor tax rates into this calculation – in any case the rates could easily change over the long time frame of venture capital investment and returns.

Why the call for simplification? Do investors not understand the plans? Sometimes this is the case. You have to help stakeholders understand why the plan is as it is, as part of the purpose and direction of the company and why the remuneration outcomes are fair.

That means you have to understand the needs of the different constituencies:

- The press – they just want headlines and a story
- Fund managers – they do need to understand remuneration strategy and design.

Simplicity has a role to play in improving this situation, as simpler plans are easier to communicate. But the issue is not so much about simplicity for its own sake, but about the transparency of what is being done. Companies always have to balance three things – the quantum of pay, the simplicity of the structure and transparency.

There was then a discussion on the role of proxy agencies in getting agreement and understanding of remuneration plans and their outcomes. One diner talked about the tick box approach and the remoteness of the proxy advisor. Another said her experience had been exactly the opposite – her company had found that ISS (in this case) had been extremely thoughtful and had sought to understand carefully the company's position: "not algorithmic at all".

A view was offered that the balance between fixed and variable reward has moved far out of kilter in the past 2 years. Whereas a ratio of 20%-80% might be entirely appropriate for a sales role it is not right for the board. 80%-20% was the old way and that is probably still right for most boards.

Another guest disagreed – "if we do a good job we want a fair slice of the rewards".

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The chairman is probably the only person who is really looking after the long term in a company. So often nowadays the CEO is a finance person and the CEO in waiting is the finance director. Company measures are short term and some critical strategic measures can get missed, such as cyber security and protecting the brand.

One participant invited a straw poll on whether the directors around the dinner table felt executive directors are overpaid. A clear majority (60%-40%) thought they are.

Another invited a poll on what ratio of CEO pay to the average employee pay is right. The figure in the US is apparently 335:1. There was no support for ratios up to 50:1, a good level of support for 75:1 and most support for 100:1. The dinner group agreed, however, that if we are looking at the value added by the CEO to that of the average employee the ratio is considerably higher.

There was then a discussion of the importance of doing what the company needs not what "the great and good say". There was a view that some remuneration committees want to comply and be in the herd. Perhaps shareholders should stop putting out formal guidance, so companies have to think for themselves.

Another participant said: not all remuneration committees are scared! But you still have to get the buy-in of the shareholders. Consulting with shareholders is a negotiation and you have to give and take. It helps to have advisers who are well regarded by institutional investors. Her own experience was that British shareholders were cautious and courteous, whereas the US shareholders were enthusiastic about her company's new ideas. But all came round to her company's after long discussion – critically, the shareholders were prepared to invest the necessary time to achieve this.

It's vital to have a remuneration committee chair who has knowledge of remuneration, so they have the capability to push back against both the executives and the investors.

The need for higher transparency is not limited to remuneration. Customers and employees expect it. In future, companies will need to report what customers are saying and what employees are saying about the company. Companies will need to get better at communicating – how many reports and accounts report on the customers' reaction?

You cannot divorce a company's ability to simplify remuneration from the type of business – it is not always a triangle – sometimes it is a many-sided polygon.

The case of a listed asset management company was quoted – the company decided that as it did not know the future it was going to stop all LTIs and pay a profit share, deferring two thirds of the bonus above 50% of salary into share for 5 years.

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But when you gear remuneration to a share of wealth, what happens if there is no profit? The shareholder can sell out; but the girl on reception cannot sell out.

There was then a discussion about the 2010 BP Macondo (Deepwater Horizon) disaster. BP let the problem roll on whereas Exxon cut the Exxon Valdez problem immediately. Following an earlier (2005) disaster at the Texas City refinery, the BP board had been accused by James Baker's 2007 report of being asleep on the job and paying lip service to safety. There was too much focus on EBITDA, revenues and the allocation of profit.

Some remuneration committees have not been firm enough – but unfortunately we are all tarred to the same brush. Now many stakeholders do not trust the remuneration committee.

The institutional investors (their fund managers) are not really interested in the remuneration policy – they may vote it down, but they do not vote the remuneration chair off the board. They have other priorities than remuneration compliance.

But in the end the remuneration committee needs to be able to stand up and defend the decisions it has taken and what the company has done.

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Supplement to the dinner notes

The Investment Association's Working Group on Executive Remuneration: Final Report

The final report[1] was launched at a public meeting in London on 26 July, the day following the dinner. It can be found at

The Working Group has set out to find "market based" (as opposed to regulatory) ways to "rebuild" the level of trust between shareholders and companies "where this has occurred".

MM&K note. The breakdown of trust within society at large was identified at the dinner as the major problem. But strengthening trust between shareholders and companies was seen as an important first step in rebuilding this wider trust.

The report makes 10 recommendations within five areas;

- Strengthening remuneration committees and their accountability
- Improving shareholder engagement
- Increasing transparency around target-setting and discretion
- Addressing the levels of executive pay
- Setting parameters on how alternative structures might operate to gain market trust.

An especially important finding is that the ubiquitous performance shares (LTIPs) may not be working in many companies.

MM&K note: the use of LTIPs was strongly pushed by investors and the IA's predecessor, the ABI, during the 1990s.

The Investment Association will shortly update its *Remuneration Guidance* to reflect the new recommendations.

The **10 recommendations** are as follows:

1. More flexibility should be allowed in setting remuneration policy suitable for the company (In particular the Working Group members at the launch stressed the possibility of using Restricted Shares without performance conditions.

[1] http://www.theinvestmentassociation.org/assets/files/press/2016/ERWG%20Final%20Report%20July%202016.pdf

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MM&K note: this recommendation is completely in line with the sentiments expressed at the dinner on Monday.

2. A NED should be on the remuneration committee for at least a year before taking on the role of chair.

MM&K note: a view was expressed at the dinner that remuneration committee chairs need expert remuneration experience to resist both executives and shareholders. The IA "one year" recommendation could prove difficult to implement in all circumstances. But they make clear the concern is providing sufficient expertise.

3. Boards should ensure the company chairman and whole board are appropriately engaged in the remuneration setting process. This will ensure that the decisions of the remuneration committee are agreed by the board as a whole.

   MM&K note: this is a new emphasis and is somewhat in conflict with Provision D.2.2. of the Corporate Governance Code which requires the delegation of setting ED and chairman remuneration to the remuneration committee. The appropriate formal and informal board processes will need to be worked through.

4. Remuneration committees need to exercise independent judgement and not be over reliant on their remuneration consultants, particularly during engagements with shareholders. To ensure independent advice is maintained, the remuneration committee should regularly put their remuneration advice out to tender.

   MM&K note. The Working Group's interim report complained of some boards "outsourcing" remuneration to consultants. In MM&K's experience remuneration committees take full accountability for their work and use the consultants as advisers. The interim report recommended that "company annual reports should include the total payment to the firm that provides advice to the remuneration committee, not just the payment for advice on remuneration". This recommendation, aimed at identifying serious conflicts of interest, was dropped in the final report. A similar draft requirement in the 2013 Directors' Remuneration Reporting Regulations was successfully seen off by the large accounting firms.

5. Shareholder engagement should focus on the strategic rationale for remuneration structures and involve both investment and governance perspectives. Shareholders should be clear with companies on their views on and level of support for the proposals.

   MM&K note: guests at the dinner clearly had mixed experiences with their shareholders. At its best this is working very well, but it does seem to depend on the shareholder. Shareholders will need to put more

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resources into this, especially if they are expected to involve the fund managers more actively. But this will need to be paid for and there are pressures on the mandate fees that institutional investors receive.

6. Companies should focus their engagement on the material issues for consultation. The consultation process should be aimed at understanding investors' views. Undertaking a process of consultation should not lead to the expectation of investor support.

   MM&K note: by material issues, the report and the launch discussion make clear that the Working Group means the "significant" issues and not the minutiae.

7. Remuneration committees should disclose the process for setting bonus targets and retrospectively disclose the performance range.

   MM&K note: by "performance range" the report means the performance targets for different levels of payout so the investor can understand why the particular level of bonus has been paid. The report acknowledges that considerable progress has already been made in this area of transparency. We agreed at the dinner that telling a clear story is central to building trust with shareholders.

8. The use of discretion should be clearly disclosed to investors with the remuneration committee articulating the impact the discretion has had on remuneration outcomes. Shareholders will expect committees to take a balanced view on the use of discretion.

   MM&K note: importantly, the report says that committees should feel free to apply upward discretion if the circumstances merit it. But they should explain fully their rationale and it is more likely to be acceptable to shareholders if a high level of trust has been built up. Guests at the dinner expressed concern that proxy agencies will mark companies down if they apply discretion – the report gives some space to describing the responsibility of institutional investors to ensure proxy agencies understand and apply their governance policy.

9. The board should explain why the chosen maximum remuneration level as required under the remuneration policy is appropriate for the company using both external and internal (such as a ratio between the pay of the CEO and median employee) relativities.

   MM&K note: the most radical aspect of this report is the public recognition by investors, for the first time, that the critical issue for trust is the quantum of executive pay which is seen to be escalating in relation to both performance and general employee pay. This corresponds to the majority view at the dinner. However, MM&K believes that the evidence provided by the Working Group for the extent and causes of this escalation is weak. There is a danger that their diagnosis will be assumed to apply to all companies.

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10. Remuneration committees and consultants should guard against the potential inflationary impact of market data on their remuneration decisions.

    MM&K note: the evidence from the Manifest/MM&K remuneration surveys of listed companies is that the market-linked remuneration decisions have been constrained in recent years, with salaries, bonus opportunity and expected value of FTSE 100 CEO grants increasing about 2% per annum over the past three years. But LTI vesting has increased in total 47% over the same period as a consequence of rising share prices and changes to performance share vesting conditions – this is not a consequence of "chasing the median". (See dinner notes for more detailed figures.)

In the Working Group's report, share options were rejected completely as a recommended long term vehicle. A major institutional shareholder expressed a view at the launch reception that this is a serious omission, as there are many companies where they are the right long-term vehicle. The Working Group responded that options provide asymmetrical rewards and too highly geared to share price.

MM&K note: TSR based performance shares can be just as highly-geared to share price and are also asymmetrical because of the vesting pattern. We agree with the shareholder that there are many companies in growth mode where share options are an entirely appropriate long-term reward and indeed they have a longer-term horizon than performance shares. A Harvard Business Review article in May 2016[2] strongly advocates the continuation or addition of share options, whilst toughening share retention requirements so that a meaningful portion of share incentives must be held to retirement or beyond.

For more information, contact Damien Knight at damien.knight@mm-k.com.

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[2] Blair Jones and Seymour Burchman, *How Incentives for Long-Term Management Backfire,* Harvard Business Review, May 2016

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