THE Board Advisory Partnership

Getting the genie back into the bottle

Board and investor practice on CEO pay

A Series of Conversations between Chairmen and Investors

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ANCHOR PARTNERS

THE Board Advisory Partnership

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AUTHORS' FOREWORD

WHERE THERE IS A WILL…

In this paper, we have reported on the many practical insights that we heard from contributors into how Boards and investors can enhance the effectiveness of decision-making on pay. On reflection, it is clear that these shared insights will only have meaning where there is a will to address the issue of pay awards which are deemed to be inappropriate by institutional and private investors.

Different, more effective outcomes will only be achieved if there is a widespread will for them to be so. The need, raised by several contributors, to address inequality of income within companies' levels of hierarchy is now a potentially even more pressing issue than that of the alignment of the interests of investors and management. As highlighted here by the contributors, there may be ways of getting the genie back into the bottle. Whether or not there is a will to do so amongst the mainstream of businesses remains an open question.

When the sums awarded to executives have very little impact on investor returns, there may be little incentive for investors to address quantum within awards or, in reality, for boards to do so either. The 'shareholder spring' has brought about improved effort on communication and higher levels of engagement between boards and Investors. It may have had some effect on quantum. If the 'societal context', or disquiet about the scale of income inequality within companies discussed by some Chairmen continues to gain momentum, it may prove to be sufficient incentive for self-regulation on quantum. If not, the avoidance of government intervention might prove to be a more effective force for change. It is already happening in Europe.

It is rare for Chairmen to have a forum in which to give investors feedback as well as getting input from them. We hope that this summary of their combined thinking will act as a catalyst to broader debate and a strengthened sense of purpose in seeking to get processes on pay to work more effectively.

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INTRODUCTION

Executive remuneration is one of the most important and intractable issues facing boards today, particularly remuneration of the CEO. The Chairmen's Research Group first explored the issue of CEO pay in 2010. That work prompted us to create a forum over the winter of 2012/13 for Chairmen to meet with institutional investors. Our aim was to explore their views on processes on pay and how their implementation, and therefore outcomes, could be improved. How could the processes be made to work as intended?

In many ways, we are addressing the "unfinished business" to which John Plender referred in an article in the Financial Times on the occasion of the 20th anniversary of the UK Corporate Governance Code:

> "The biggest failure (of the corporate governance code) concerns remuneration. The sheer complexity and flawed metrics that characterise so many incentive schemes cannot be blamed on the code. But there is no question that this is the biggest area of unfinished business in corporate governance in the English-speaking world."
>
> *Financial Times, 1.11.12*

It is generally acknowledged that a vigorous system of good governance processes has been put in place since the Cadbury Report in 1992. The hypothesis that emerged from our 2010 work is that, over time, an over-reliance on these processes has developed. This has operated at the expense of the exercise of judgement and discretion, both by boards and by their investors. The quality of outcomes has not been as intended. It also emerged that, to address effectively the imbalances evident between executive remuneration and the return to any other stakeholder, boards and investors need to work together. As there are very few opportunities for in-depth engagement between Chairmen and investors, particularly for Chairmen to give feedback to their Investors, we decided to host a series of discussions with panels of 12-14 contributing at each. Sir David Lees chaired the sessions. To make the most of their time together, we also explored the issues with each contributor individually.

The tone of the debate was highly discursive with differing views on almost all points. For the most part, Chairmen believe that investors should address the internal divide between investment decisions and compliance with governance requirements. Some investors have addressed the issues, others either did not evidence a need to do so or, where they did, suggested that resources limited what they could do. Investors, though not overtly critical of board processes, did not pretend to find the current system to be working well. However, it was noticeable, through the sharing of quite different perspectives, that a strengthened sense of purpose emerged about how to improve the quality of decision-making.

In addition to identifying some practical and actionable initiatives to enhance the quality of decision-making on CEO pay, the conversations became a real-time example of what the Financial Reporting Council states in its UK Stewardship Code: an acknowledgement of the shared responsibility of boards and investors for the stewardship of publicly quoted companies:

> ”The primary responsibility rests with the board of the company, which oversees the actions of management. Investors in the company also play an important role in holding the board to account for the fulfilment of its responsibilities.”

The findings are summarised in the Executive Summary.

We are hugely grateful to contributors for their time, their preparedness to engage in a full discussion and their willingness to lead the debate on the realities of this difficult issue.

CONTRIBUTORS

John Allan	Chairman: Dixons Retail, World Pay
John Barton	Chairman: Next, Catlin, EasyJet
Sir Win Bischoff	Chairman: Lloyds Banking Group
Tim Breedon	Board Member: Barclays
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Richard Burrows	Chairman: BAT
Alison Carnwath	Chairman: Land Securities, Isis Private Equity
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Sir Peter Gershon	Chairman: National Grid, Tate & Lyle
Gerry Grimstone	Chairman: Standard Life, The CityUK
Sir Philip Hampton	Chairman: RBS
Richard Harvey	CIO: Cazenove Capital
Michael Harper	Chairman: BBA Aviation, Ricardo; Dep. Chairman: Qinetiq
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David Tyler	Chairman: J.Sainsbury, Hammerson
Rob Webb QC	Chairman: Remco, LSE; Gen Counsel: Rolls Royce
David Wild	Chairman: RemCo, Premier Foods
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*Sir David Lees chaired the series of conversations.

EXECUTIVE SUMMARY

Board Practice

- Contributors all spoke of the governance practices of both the institutional investment industry and boards which make engagement between them on remuneration difficult. These include Fund Managers being spread thinly over a large number of portfolio companies, 'unreadable' remuneration reports which require delegation, multiple governance approaches adopted across the industry to which companies must find a way of complying and a 'tick-box' approach found in many governance teams.

- A key player in the overall process is the Chairman of the Remuneration Committee, (RemCo). The profile of the role needs to be seen as one of the most senior roles on the board. In many cases, a re-positioning of it may be required. (Section 4.1)

- The complex nature of the role of the Chairmanship of the RemCo requires the role to be held by an emotionally intelligent, intellectually rigorous, career-secure, heavyweight board member who can operate simultaneously as a colleague and as a gatekeeper. Experience of sitting on a remuneration committee, ideally that of the company in question, is highly desirable. (Section 4.2)

- Chairmanship of the RemCo is not an ideal role for a new appointee to the board. The strongest advocates of this were those Chairmen of RemCos who had taken the role on first joining the board. In the FTSE 100, 43% of Chairmen of RemCos are appointed on joining the board or within the first 12 months. On the FTSE 250, this figure is 59%. (Section 4.3)

- No-one demurred from the view that the Chairman should attend the RemCo. Only a small number believed that the Chairman should be a member of it.

- The board has a clear responsibility for the formulation of remuneration policy and the RemCo for the process of translation of that policy into practice. It should be made unambiguous and explicit as to where that accountability lies relative to the board and the RemCo. (see Section 4.5, inc. 4.8 'Notes for a new Chairman of RemCo')

- One investor spoke of how Remcos often appear to be *"being run by the Consultantocracy*". The complexity of current remuneration plans has led many Remcos to rely too heavily on external, technically-expert third parties. Many spoke of the need to play to the strengths of remuneration advisors but to limit their role to support rather than leading on design. (4.7)

- Many factors were mentioned which prospective or incoming Chairmen of RemCos could benefit from considering before taking on the role. These include reflecting on their understanding of the dynamics of both the underlying business model and of the board dynamic. (Section 4.8)

Chairman and Investor Engagement

- The complexity thrown up by governance requirements, and the unintended consequences of many were discussed at length. These consequences include remuneration reports over the last two decades made “unreadable” by technical complexity, the inflationary effect of external benchmarking, the spread of Fund Managers’ time across large portfolios, the variation a company may find in the governance preferences of its investors, a ‘tick-box’ approach found amongst many Investment Houses, and the increasing influence of the proxy voting agencies where a ‘Comply or Comply’ approach was extensively observed. (Section 5.1)

- The international Institutional Investment industry is so large and diverse that it cannot be spoken of as a homogenous whole. Some houses have moved to make substantive changes in order to enhance their ability to engage in making voting decisions. Others have done less. (Section 5.2)

- There is a clear desire amongst Chairmen for investors to integrate decision-making on governance and investment rationale. Along with several investors, they believe that some Investment Houses could make the following changes:

    - appoint people into governance teams with a greater understanding of the commercial context of investment, ideally former investment professionals

    - similarly, recruit people into governance departments who display the ability to exercise judgement rather than take a strictly rules-based approach

    - create a mechanism whereby if a vote against or an abstention is recommended, the investment team is involved and becomes the decision-maker. (Section 5.3)

- The scale of the growing span of influence of the Proxy Voting Agencies, especially where there is a substantial US shareholding, was regretted by all contributors. Review by both US and UK regulators will be welcomed. (Section 5.4)

- All direct communication between Chairmen and investors is helpful. Chairmen should take the initiative in being in touch with investors directly. Investors welcome such approaches and get value from the broadly based discussions which ensue. Investors and board members agreed that investors want to hear from the Chairman of the board at the AGM on the remuneration policy. They are happy to hear from the Chairman of the Remco in covering detailed questions. They do not want to hear from remuneration consultants. (Section 5.5)

- Ironically, with greater degrees of investor engagement, what amounts to an 'acceptable level of rejection' of remuneration proposals is changing. Where, for example, 92% may have been taken as admonition in the past, it is proving acceptable now. (Section 5.6)

Investor Frustrations

- Most of the investors made the point that their starting position is to support the strategies of the companies in which they invest. They regret elements of the current public dialogue on pay, for example, the 'No Vote' League, and the degree to which pay is in danger of overpowering important topics such as strategy and succession planning in discussions with investee companies. (Section 6)

Plan Design and Quantum

- Some Chairmen were very aware of the societal discomfort with the current excessive scale of reward differentiation within companies and believe that both investors and board members must become more alive to it. On a practical basis, they believe that internal benchmarking on remuneration is becoming more important than external benchmarking. (Section 7.1)

- Contributing investors represented a wide spectrum of approaches to quantum. The philosophy of some was that they believed that quantum matters, *per se*. Others viewed alignment as the determinative factor and were agnostic on levels of quantum. (Section 7.2)

- Packages can be simplified down to salary, a cash bonus and deferred shares. The variations on this theme caused much debate. The collective view is that it is for RemCos to drive simplification. (Section 7.3)

- While simplification of plan design is agreed to be imperative in principle, many possible problems in implementation were foreseen, especially on deferral periods. "Five is the new Three" is becoming a catchphrase. (Section 7.4)

- Chairmen and investors responded very positively to the opportunity to have these conversations. It was clearly their view that both parties are going to have to work hard and constructively in considering innovative plans aimed at simplification and that innovation must not be rejected on principle. (Section 7.5)

THE FINDINGS

Board Practice

A great deal of the substantive discussion turned on aspects of the role and responsibilities of the Chairmanship of the RemCo. This is the area where individual Chairmen felt they had the greatest capacity to optimise outcomes on pay issues, and where potential vulnerabilities lie in the system.

Key topics arising in the discussions included:

- the skills and attributes required to chair a RemCo effectively
- the dual demands of the role of RemCo Chairman: colleague and gamekeeper
- a preference for 'growing your own', appointing current board members with experience of the company into the role
- the respective roles of the Chairmen of the board and that of the RemCo Chairman
- the role of remuneration consultants.

4.1 The range of skills needed to chair a RemCo is second only to that needed to chair the company

There was consensus about the range of substantive skills needed to chair a RemCo successfully. The significance of the role is seen as being:

> *"Second only to that of the Chairman in terms of its requirements for understanding of the business and its investors, and for influencing and leadership skills."*

The skills and experience identified included:

- sitting as a RemCo member before stepping up to the Chairmanship
- failing that, experience of Chairmanship or at least membership of a RemCo elsewhere
- intellectual rigour and the ability to manage a process with many complex parts
- emotional intelligence to lead all of the parties to the best decision possible in the circumstances
- independence of mind and self-, or 'career-confidence' to be able to make a decision which may meet with opposition from fellow board members.

The ability to give a significant time commitment was also important. Each of the points made above are expanded upon in later sections.

The profile of the role needs to be re-positioned**.** It is clear that there is a gap between historical perception of the role and its current significance. It has never been thought of as unimportant but, at other times in recent history, the Chairmanship of the Audit Committee has attracted a great deal more attention in succession planning, and remains generally more highly rewarded. There are some anomalies in the seniority, in the sense of tenure, of a majority of appointments (see 4.3 below).

4.2 The dual nature of the role: colleague and gamekeeper

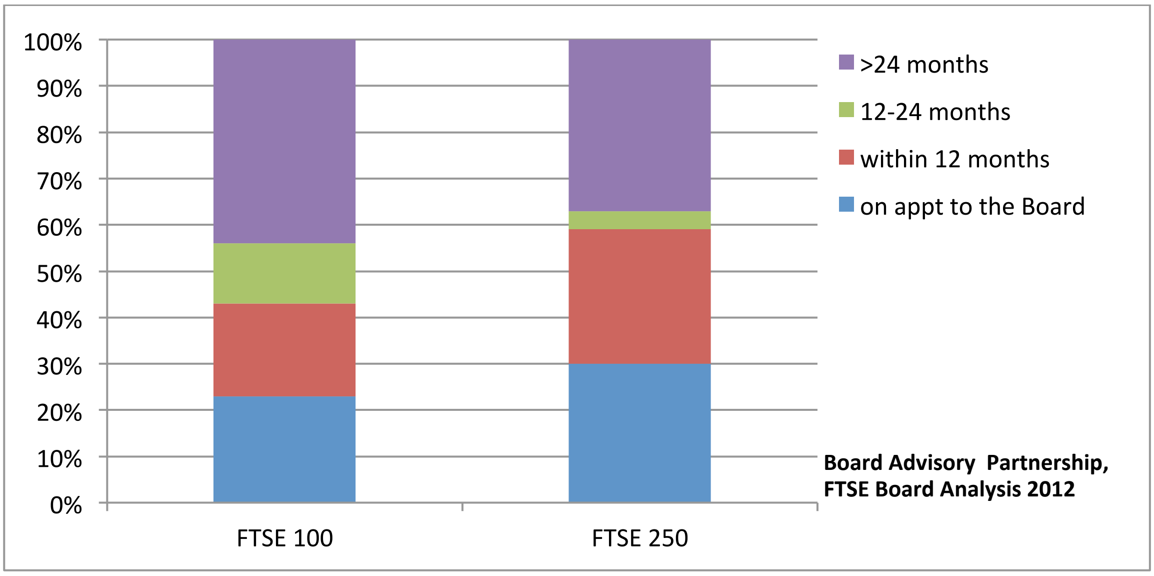
The dual demands of being RemCo Chair and sitting as a colleague of the Executive Directors are seldom discussed. They present a dynamic which is key to being effective in the role.

> *"As a RemCo Chairman, one belongs on a board wearing two hats which can sit uncomfortably with each other: first as a peer of the Executive Directors and, second, as the leader of the committee which can propose unattractive allocations to those Executive colleagues. Managing this dual role is both important and tricky. In your Chair of the RemCo, you need someone with the strength of character to compartmentalise each role. The best way of learning it, I found, was observing skilful RemCo Chairs doing it."*

> *"It's not a role for a 'spiky' person, short on EQ. It greatly helps to have an established relationship with the Executive Directors and with the Chairman before taking on the role. It helps you manage the more difficult aspects of the discussions."*

4.3 New or recent board members form the majority of appointments to Chair RemCos

Our research shows that, for FTSE 100 companies, 43% of RemCo Chairmen were appointed in Year 1 of their tenure and 15% were appointed within their second year. For FTSE 250 companies, the data shows that 59% were appointed within Year 1*.



4.4 Prioritising the role in longer-term succession planning – 'growing your own'

It was acknowledged by some that the traditional process of appointment to the role of RemCo Chair had sometimes been *'Buggins' turn'* where *'Buggins'* was the newest board member. Whether or not this has been true, much emphasis in the discussion was placed on the need to '*play into the middle distance'* in terms of planning board succession to incorporate Directors who are likely to have the availability, skills and experience in the projected time. By prioritising future capability for the role in overall board planning, there was a greater opportunity to "*grow your own".*

In the words of a Chairman of a FTSE 100 and a FTSE 250 company:

> *"It is unlikely that a new board member will be able to deliver what they need to in this role in their first year or two of being on the board. Where possible, you should 'grow your own' and plan for it in your succession planning as much as you plan for everything else."*

While not all agreed that experience on the board in question is a necessity, all thought it ideal and agreed that previous experience on a RemCo should be a *sine qua non* of appointment.

The caveats to the view that the RemCo should be taken on by an existing member of the RemCo included that it is ideal for a new Chair not to be overly invested in the past and to be able to approach everything with a fresh pair of eyes. The answer must be a question of judgement, but the balance of opinion amongst FTSE 100 and 250 RemCo Chairmen themselves was that, in their experience, entirely new board members are potentially at a disadvantage in taking on the role. As elsewhere, it is only when difficulties arise that this disadvantage becomes apparent.

<u>Overlap with the role of the SID?</u>

Some asked if there was overlap in the necessary credentials for this role and that of the Senior Independent Director (SID). This seems an extant link in practice as 25% of FTSE 100 SIDs and 33% of FTSE 250 SIDs also Chair the RemCo*. *(*The Board Advisory Partnership, FTSE Board Analysis 2012)*

<u>The need for experience of the business</u>

One of the substantive points about the value of familiarity with the business was illustrated by one Chairman of RemCo, appointed within their first year on the board:

> *"It was only into the second year on the board that I came to know what amounted to either a stretch or a fairly relaxed performance target in this business. I wouldn't have accepted the role so hard on the heels of appointment (four months) had I known then what I know now. I had to rely on my Chairman a great deal at first. He gave me great support, but that is not quite the point, is it?"*

Is there a pool of qualified candidates?

The challenge in appointing a Remco Chairman with the requisite experience varies significantly and depends on a number of factors including the size and profile of the company. One FTSE 100 and FTSE 250 Chairman noted that many of his more experienced board members had asked not to be asked to undertake the role. However, other (notably FTSE 100) Chairmen did not report any difficulty in finding candidates for the role.

The difficulties may arise in finding the personal attributes required rather than the technical skill.

4.5 Accountability for CEO remuneration policy – where does it lie?

There remains a broad range of views. Referred to by one Chairman as the *'hardy perennial of the debate',* it was one of the clearest findings of the discussions that clarity on this point is fundamental for a Chairman of RemCo. Without it they are ill-equipped to navigate through the potential minefield of the role. Some Chairmen believe that they, and therefore surely the board, should stand back from the formulation of policy on the CEO's remuneration. Others believe that they, the Chairmen, must be the primary architects of the CEO's pay. The ambiguity is dangerous and arguably has contributed considerably to the problem under debate.

At one session there was strong agreement with the lack of ambiguity inherent in the statement of one Chairman who asserted*:*

> *"It is Company Law '101' that the board is primarily responsible for the formulation of a remuneration strategy. It can delegate the important and time consuming work on the mechanics, but the board must set the policy."*

Following this logic, as remuneration policy is a board decision, the Chairman of RemCo cannot be held responsible for the remuneration strategy, any more than can any other member of the board.

> *"There should be no theoretical room left for Chairmen of RemCo to be made into sacrificial goats."*

Some Chairmen were adamant that, if the remuneration policy became an issue of contention with shareholders, they believed that if anyone should step down to acknowledge an error of judgement, it should be them.

Given the current level of scrutiny of RemCo decisions which will surely be further heightened by the adoption of the binding vote, a strong recommendation drawn from this discussion series is that RemCo Chairmen should clarify precisely their role and responsibilities with their Chairman and board colleagues.

This discussion also encompassed the invidious position in which RemCo Chairmen find themselves when not *ad idem* on an issue of significance with their Chairman. This situation was acknowledged as rare, and also evidencing a much wider failure of Chairmanship. This would be a clear case for the involvement of the SID.

4.6 The relationship of the company Chairmen and the RemCo

All agreed that the board Chairman, holding the primary relationship with the CEO, *shapes* the pay policy for the CEO and therefore takes a large role in it. Each Chairman will play this out in his or her own way. There was general agreement that it allows for better decision-making if boards retain flexibility as to whether or not the Chairman should attend or be a formal member of the RemCo. It is a highly contextually driven decision. There were one or two voices raised either in favour of it being mandatory that the Chairman sit on the RemCo, and others to the contrary. The overall finding was that the board as a whole, which includes the CEO, must take responsibility for the plan once agreed.

4.7 The use of remuneration consultants

Within the discussion of the use of Consultants, some (but a relatively few) board members disagreed with the point that they can and do make a useful contribution to remuneration design. The emphasis was placed on how they are managed, that that they should be given a tight brief to answer detailed questions put to them by the RemCo. In the words of one Chairman, "*Their role is to advise, when asked, and to answer questions rather than propose solutions*."

One or two board members believed that there was a role for the RemCo to be advised by one set of advisors, and the Executive by another. This view was met by that of a larger group with the strongly held view to the contrary. This latter group held that as Chairman of the RemCo with two consultants involved, one can end up "in the role of a shop steward" between the two.

In the consultation process, Investors were unambiguous that they do <u>not</u> want to hear from the Remuneration Consultants but from the Chairman and/or Chairman of RemCo.

4.8 Notes for new Chairmen of RemCos

- *You need to have a good understanding of your Chairman, especially the nature of his or her relationship with the CEO.*
- *Possibly decline taking on the role until you have the understanding of the business and board dynamics which two plus years' experience as a board member will engender.*
- *Get clarity on where the board agrees accountability for remuneration policies.*
- *Develop and maintain a regular dialogue with the CEO throughout the year.*
- *Rely on Remuneration Consultants for advice when a remuneration policy is formed rather than relying on them to design it.*
- *In consultation with investors, they want to discuss the issues with you and/or your Chairman in addition to the CEO and CFO separately. They want to hear from consultants only in support of your discussion and not vice versa.*

CHAIRMAN - INVESTOR ENGAGEMENT

5.1 Complexities created by the governance practices of Institutional Investment Houses

The importance and difficulties in realising a good level of direct engagement between Chairmen and investors on remuneration and other matters were the chief reasons for instigating this series of discussions. Some of the structural factors which have come about within the investment industry were acknowledged as inhibiting good engagement and outcomes. These include:

- the diversified structure of 'classic' Institutional Investment portfolios with relatively small holdings in many companies. This means that a Fund Manager has little time to engage well with all of his or her investee companies
- complex, long and 'unreadable' compensation scheme details within Annual Reports require many, but not all, investors to delegate decision making on governance internally, or to outsource it to a third party
- the UK has a healthy, diverse institutional investment industry with the result that boards are faced with significant differences in the governance policies of their many investors. Some board members reported instances of resistance from governance professionals to alteration aimed at simplification, where others had approved it. The negative objection was that the simplification involved a practice not in line with their chosen approach
- board members, speaking to the previous point, believed that their proposals were not being given due consideration; that the approach taken was doctrinaire and fixed on that institution's agreed approach. Where they exist, the governance teams created in the various institutions are of variable quality. Some are deemed by board members and fellow investors to be falling short in their ability to form appropriate judgements. Their strength is often compliance with established formulae rather than forming judgements on consultation. It may be that the few houses of which this is true are having a disproportionate impact. Chairmen acknowledged the quality of engagement with some, but decried their experience with others
- proxy voting agencies have become increasingly significant in their influence, particularly with US clients of investment institutions. They are reported as generally being inflexible, taking a 'tick-box' approach. This leads to a 'Comply or Comply' approach with standard formulae becoming dogma. One contributor did acknowledge that one agency had changed its stance during a consultation process, but this was the exception to the rule.

5.2 The institutional investment industry's response has been variable

Several Chairmen, and especially highly-seasoned Chairmen of RemCos, believe strongly that a large section of the investment industry is not seriously engaging with the need to become internally coherent on governance and investment decision-making.

> *"They need to be challenged on this. There is no excuse for them not looking more to their internal structures and taking seriously the problems this separation of decision-making causes."*

Institutions differ in how they address the issue. The various philosophical approaches were:

- that separation of governance and investment decision-making is a necessary evil and no new measures were being proposed to increase the degree of integration
- others, but a smaller group, recognise the detrimental effect of the separation and seek to minimise its effect by seeking 'to mesh' the two functions:

  "We are working hard to mesh together the frameworks of investment and governance so that the Fund Managers develop sensitivities to governance issues, and the governance team understands the dynamics of investment – getting both to develop broader frameworks than has traditionally been the case."
- some refuse to institutionalise the separation. The Fund Managers are directly involved with governance decisions. It would be fair to say that the Chairmen generally thought that this led to a superior quality of engagement.

5.3 Recommendations on improved practice

There is room for some investors to do more to integrate their investment and compliance governance departments.

The following changes were recommended by many Chairmen and several Investors:

- investors could consider appointing people into governance teams with a greater understanding of the commercial context of investment, ideally, former investment professionals
- similarly, recruiting people who display the ability to exercise judgement rather than take a strictly rules-based approach would alter outcomes positively
- create a mechanism whereby if a vote against or an abstention is recommended, the investment team involved become the decision-maker
- Reduce the number of investee companies in a Fund Manager's portfolio, as per the Kay Report (*the Kay Review of UK Equity Markets and Long-Term Decision Making, July 2012*).

5.4 The Proxy Voting Agencies

Participants are looking forward to the FRC's forthcoming review of the influence of proxy voting agencies. In the meantime, their increasing role is a cause of unease. Some fell little short of describing it as pernicious, particularly in respect of US shareholders where their use is often mandated by pension fund clients.

On the other hand, the response by a mid-cap UK investment firm, where their client pension funds require them to use a voting agency, is that their CIO has been very clear on the criteria on which they make their recommendation.

5.5 More direct communication between Chairmen and investors

One Chairman urged both large and smaller company Chairmen to call their investors directly to discuss the major issues in which Investors take interest, for example, succession planning and of course, remuneration. Investors agreed that it would be a welcome departure if more did so. As in other respects, there is an irony to the symmetry of the 'they never call' complaint. Such conversations would be in addition to the normal investor relations meetings taken by the CEO and CFO in their regular meetings.

All acknowledged the pressures on investors' and Chairmen's time, and that larger companies are more self-evidently likely to get a positive response, but no one demurred from the fact that it would be helpful if Chairmen called their investors directly and more often - not waiting for there to be a problem and not delegating the call to their IR person or broker. The conversations and relationships which ensue are invariably helpful, both in an upswing and when there is an issue of performance or other source of investor discontent.

Investors and board members agreed that investors want to hear from the Chairman of the board at the AGM on the remuneration policy. They are happy to hear from the Chairman of the Remco in covering detailed questions. They do not want to hear from remuneration consultants.

5.6 The downsides to greater engagement: 'acceptable levels of rejection'

Some Chairmen discussed the paradox that the more you engage with your top 10-20 shareholders, the more preferences and weighting of priorities you are going to hear and have to seek to reconcile; the less clear the picture of 'investors' views' becomes. A few investors reflected this and equally candidly asked the rhetorical question – *How much engagement do Chairmen really want?*

The potential of the Investors' Forum as raised in the Kay Report was discussed. The question as to how to maintain the healthy diversity of institutional views and avoiding the creation of a cumbersome 'clearing mechanism' was left unresolved.. There was a considerable scepticism from both investors and Chairmen as to whether a formal forum would be a constructive addition to the present structure.

Concerning lower acceptable levels of shareholder agreement, several Chairmen observed that one form of resolution of this difficulty is a tolerance of rejection votes at higher levels than would formerly have been seen as acceptable:

> *"You can learn to live with votes at or around 92% these days. Maybe a bit lower. At 80%, it would look like you've lost trust, but if you are to have a high level of engagement, some disagreement will happen and must be seen as healthy."*

None of the above should detract from the self-evident assumption amongst participants that, if one were to minimise engagement with investors, it would likely result in a very high degree of dissent and subsequent discontent amongst investors.

INVESTORS' FRUSTRATIONS

6.1 Most of the investors wanted the point to be made that their starting position is to be supportive of the strategies of their investee companies

Within this context, it is clear that investors are not keen on 'public' engagement, i.e. negotiation through the media. When the media is reporting on a shareholder/board issue that, of itself, indicates a breakdown of trust and makes good decision-making less likely. Investors want open, frank, but private dialogues with their investee companies.

6.2 Levels of frustration

A small group of investors expressed a high degree of frustration with the system in which they operate. Some are weary to the point of being sceptical that the equity market is a place where the interests of the ultimate beneficiaries of institutionally-managed funds are well-served. This is for many reasons beyond the scope of this paper but of which the difficulties around CEO pay are in large part indicative.
Some radical suggestions were made as to how to simplify the design of remuneration packages in order that investment professionals were not faced with *"hundreds of completely indigestible, almost unintelligible annual reports which <u>have</u> to be delegated to someone else to read".* As soon as such a suggestion is made in conversation with both fellow investors and Chairmen, all of the innate divisions of investor and individual board member, with their differing views and preferences on the subject, come to the fore. This emphasises the need for closer company/investor relations.

Smaller institutions, with smaller portfolios seem to suffer less under this strain.

6.3 The NO-vote league table

The FRC's most recent update on the implementation of the Stewardship Code reflects that, "*Genuine stewardship may suffer if public confrontation becomes the default mode of engagement*." (12/2012).

It was in the light of such a confrontational tone that some investors reported coming under pressure to "*show the public that they were doing their job*" by voting against management's plans. Those reporting this pressure felt able to resist it if it encouraged them to make decisions on any but investment criteria. *"Which public, 'The Daily Mail' or our actual clients?"* was the question with which several of them responded.

One investor received a gift of pastries from the management of the café opposite their Head Office in thanks for their having taken a strong stance on a particularly high profile CEO's pay.. It had made headlines in the daily newspapers. While the anecdote caused laughter, the underlying point of the politicisation of pay for the quality of investment decisions is significant. It reflects the degree to which investors must simultaneously:

- be aware of the genuine and not ebbing, public outrage at levels of executive reward *vs.* performance delivered

- be secure in their professionalism to make voting decisions on the best investment case.

6.4 Regret that pay is currently dominating the dialogue

Several investors made the point summarised by two voices:

> *"We want to hear about pay as a function of strategy rather than engage in what we regard as highly politicised conversations about pay. If there is one thing that as an investor I would like everyone to work on, it would be more 'joined up' thinking between the pieces of the puzzle: risk, strategy and pay. They don't operate as separate realities and it distorts logic to treat them as such".*

PLAN DESIGN REVISITED

Plan design was not a core part of this study. However, discussion of it was inescapable. The main themes which emerged were:

7.1 Income inequality within companies

One of the points made by some Chairmen related to the levels of income inequality that have arisen over the last two decades. In the words of two:

> *"Executive pay has been increasing despite the context in which we are operating. Boards and investors must wake up to the societal pressure prompted by the imbalance between executives' pay and the diminishing incomes of those in middle management and elsewhere."*
>
> *"I am not sure that all of us are sufficiently aware of the levels of societal discomfort with the ever-widening pay differentiation within companies. If only out of 'enlightened self-interest', companies and investors must deal with this or we will get regulation, as is already happening at a European level."*

7.2 Quantum

When asked if they objected to high quantum per se, some investors made it clear that they had an absolute objection to current and possibly rising levels of quantum. Others, probably the majority of those in the discussion, took the view that, as alignment was their sole concern, they had no sense of there being inherently appropriate or inappropriate levels of quantum. Those investors making this point stated, most emphatically however that they do not welcome schemes where management is generating high levels of income '*masquerading as wealth*', i.e. pay awards that are not based on proven performance, but in anticipation of and unconditional on it.

One investor suggested that there is more conflict between boards and investors than is apparent:

> *'Shareholders are much more pragmatic than boards; they just care about alignment, not quantum (unless it meaningfully affects their returns). The Battle of Alignment was won long ago, but the Battle of Quantum is left almost entirely to the board. And this is not an easy environment for boards to be tough with executives.*
>
> *Therefore, there needs to be a sort of model covering CEO remuneration quantum. Not prescriptive, but a debating starting point. Unless this intellectual argument is won in public, the Board has no hope."*

7.3 Simplification is the zeitgeist, along with clearer performance criteria and longer deferral of vesting

The common theme was well summed up by one Chairman of a RemCo:

"Be clear about what the company is trying to achieve, and keep the metrics chosen few and simple."

There was no unanimity about what forms simplification can take. The main themes to emerge in discussion were:

- design should be based directly upon the underlying business plan and strategy
- reward must be tied more securely and directly to performance delivered and de-coupled from poor performance
- packages can be simplified down to salary, a cash bonus and deferred shares. The variations on this theme caused much debate and considerable clash of philosophy
- external benchmarking is increasingly being seen as indicative rather than persuasive. Internal benchmarking on quantum across management and employee levels is becoming more significant than external benchmarking.
- the radical suggestion of some is that salaries could be tolerated at 'high' levels and be accompanied by cash bonuses and a simple set of options. This suggestion was driven largely by frustration at the generally unhelpful and unnecessary complexity of remuneration reports, which requires their scrutiny to be largely delegated to non-fund managers. From that division of roles, many of the difficulties under discussion can be said to have arisen. The suggestion met with a gale of opposing views.

7.4 Deferred periods of vesting

Increased deferral and vesting periods were generally held to be desirable goals, and to be much under discussion in current rounds of consultation. 'Five is the new three' has becoming a catch phrase. Few plans with markedly extended deferral periods have yet been agreed except at HSBC, whose plan is coming to describe generically the longest of suggested vesting periods.

7.5 Innovation aimed at simplification must not be frustrated on principle

There was general agreement that implementation of simplified plans will be fraught with difficulties, that the concept is sound and that it will require governance teams and board members to work hard on plans which depart from past practice. Several Chairmen gave anecdotal evidence of the difficulties incurred when consulting on new schemes, including some leading investors proposing schemes for their own executive leadership adopting principles aimed at simplification as discussed. They believed that inertia and resistance to change was a major factor.

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Kate set up The Board Advisory Partnership to support Chairmen and other individual board members. This includes advising board members at moments of role change, reviewing board capability for Chairmen and facilitating board development. The Board Advisory sponsors, and Kate leads, The Chairmen's Research Group - a peer group think tank comprising some 50 FTSE Chairmen, chaired by Sir David Lees. The group is dedicated to in-depth examination of contemporary governance issues with the purpose of encouraging the dissemination of best practice amongst boards.

Her professional training is that of a barrister with an earlier training in healthcare. She spent 15 years as a search consultant and has spent a further ten advising individuals on career choices and leading the Chairmen's Research Group. Kate is a graduate of the law school of the School of Oriental and African Studies at London University, and was called to the Bar as a member of Grays Inn. She is a Trustee of The Arvon Foundation which fosters creative writing, where she chairs the Development Board. She is also associated with The Academy of Ancient Music and Concertina, which brings music into Homes for the Elderly.

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