Department for Business Innovation & Skills

EXECUTIVE REMUNERATION

Discussion paper

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Contents

Foreword

Executive remuneration that is well structured, clearly linked to the strategic objectives of a company, and which rewards executive directors who contribute to the long-term success of that company, is important in promoting business stability and growth. Shareholders want to see remuneration being used effectively to attract, incentivise and appropriately reward executives, so that the value of the companies they invest in increases over time. The Government wants the UK to be a magnet for attracting and retaining the best talent, and to create a business culture that promotes sustainable growth and rewards long-term success.

Of course, generous rewards are justified where a company has shown strong long-term performance. However, over the last ten years the link between median CEO pay and performance of the FTSE100 has been hard to discern. Although concerns about executive pay are not new, the recent financial crisis has made shareholders, the public and Government more acutely aware of the issue and more critical of perverse incentives or excessive levels of reward. Shareholders and wider stakeholders, such as employees and customers, want to see executive pay that is proportionate and justified and are rightly concerned when it is not.

There appear to be two different markets for pay in operation. At one level, ordinary rules of economics apply. Falling growth in the economy and its knock on effects through the labour market cause cost pressures, rising unemployment and consequently, weak pay growth. For the last few years wage growth has lagged behind inflation as such pressures have come to bear on ordinary workers.

At another level, some of the highest paid in our largest listed companies see salaries and other emoluments rise virtually every year, regardless of the performance of the economy, the stock market or even the company in question.

The general disconnect between pay and long-term performance suggests that there is something dysfunctional about the market in executive pay or a failure in corporate governance arrangements. We want to understand this better, gather evidence about what is causing it and how it can be addressed.

This paper builds on discussions I have had with investors, business leaders, remuneration committee chairmen, remuneration consultants and wider stakeholders who all acknowledge that there is an issue. It sits alongside our consultation on the future of narrative reporting, which considers how transparency on the reporting of pay can be improved. The Government recognises that we need to look further than improving disclosure and so this discussion paper explores wider questions on the role of shareholders and remuneration committees in the process of setting pay and how pay is structured to incentivise and reward. It invites further evidence on how shareholders and companies could potentially promote a clearer and stronger link between executive remuneration and company performance.

I look forward to hearing what stakeholders have to say on this important issue and to continuing this debate through the autumn.

VINCE CABLE

SECRETARY OF STATE FOR BUSINESS

Executive Summary

1. Over the last decade, executive pay in the largest listed companies has increased substantially. The median total remuneration of FTSE100 CEOs has risen from an average of £1m to £4.2m for the period 1998-2010. Growing company size, international competition for talent, benchmarking practices and the changing structure of pay are just some of the reasons cited for this trend. Chapter 1 provides some further background on the growth in pay and how the UK and other countries have regulated on this issue to date.

2. The Government is very clear that generous rewards for leading executives are not an issue. Executive remuneration that is well structured, clearly linked to the strategic objectives of a company, and which rewards executives that contribute to the long-term success of that company, is an important way of promoting business stability and growth.

3. However, over the last decade, the link between pay and performance has been hard to discern. CEO pay has risen faster than the increase in the FTSE100 index, retail prices or average remuneration levels across all employees for the same period. This suggests two possible issues: that the structure of remuneration does not necessarily incentivise directors to act in the long term interests of a company; and that the level of remuneration may represent excessive reward for the performance observed.

4. Building on the existing evidence base and feedback from companies, shareholders and other stakeholders, this discussion paper puts forward a variety of measures that could potentially promote a clearer and stronger link between executive remuneration and company performance, and empower shareholders to hold companies to account. Our aim is to gather further evidence and stimulate debate.

5. It sits alongside our consultation document on the future of narrative reporting by companies, which proposes how reporting of remuneration could be made clearer and more concise. Based on responses from shareholders about the key pieces of information they need to scrutinise remuneration and hold companies to account, the consultation seeks views on the core disclosures that should form part of a remuneration report. These are outlined in more detail in Chapter 2.

6. However, some stakeholders have told us that increasing transparency on remuneration is not enough. We also need to look at the role of shareholders and remuneration committees in the process of setting pay, and how pay is structured to incentivise and reward. This paper presents some of the various ideas that business, remuneration committee chairmen, shareholders and investors, remuneration consultants, governance experts and others put forward in response to *A Long-Term Focus for Corporate Britain,* and in our subsequent conversations with them. It invites stakeholders to provide further evidence on the potential benefits and practical implications of taking these ideas forward.

7. Chapter 3 looks at the critical role of shareholders in holding companies to account on pay. Almost ten years on from the introduction of an advisory shareholder vote on remuneration reports, it asks whether the vote is effective and if a binding vote on pay or votes on exit payments would give shareholders a stronger voice. It also

considers the broader issue of shareholder engagement and whether shareholders could be more directly involved in appointing non-executive directors that they feel would hold companies to account on their behalf.

8. The role and membership of the remuneration committee is explored in Chapter 4. Several stakeholders have suggested that the lack of diversity in remuneration committees stifles innovation and can mean that pay proposals are less likely to be challenged. We therefore invite views on whether independent members or employee representatives on remuneration committees would provide a helpful, fresh perspective and encourage greater challenge; as well as the potential risks and practical implications of such measures. The interaction between remuneration committees, companies and remuneration consultants is also considered; asking whether more needs to be done to prevent potential conflicts of interest in this relationship.

9. The structure of remuneration has become increasingly complex. This has led many companies, investors, remuneration and governance advisors and academics to question whether the symmetry between pay and performance has been lost. Chapter 5 outlines just some of the proposals put forward by stakeholders on how remuneration could be simplified and more clearly linked to sustainable, long-term performance.

10. Finally, Chapter 6 acknowledges the valuable research that has already been undertaken on the trends in quantum and structure of remuneration and the links to performance. It asks whether it would be helpful to bring this together in a more coordinated way to develop the knowledge base on executive pay and highlight good practice.

11. The various proposals set out in this paper, which come directly from stakeholders, are deliberately wide-ranging. They are designed to stimulate debate and generate momentum among shareholders, institutional investors, the business community and all those with an interest in corporate governance to tackle this issue. We know that many of them are already engaging with this challenge and have ideas about how the pay-performance link can be strengthened.

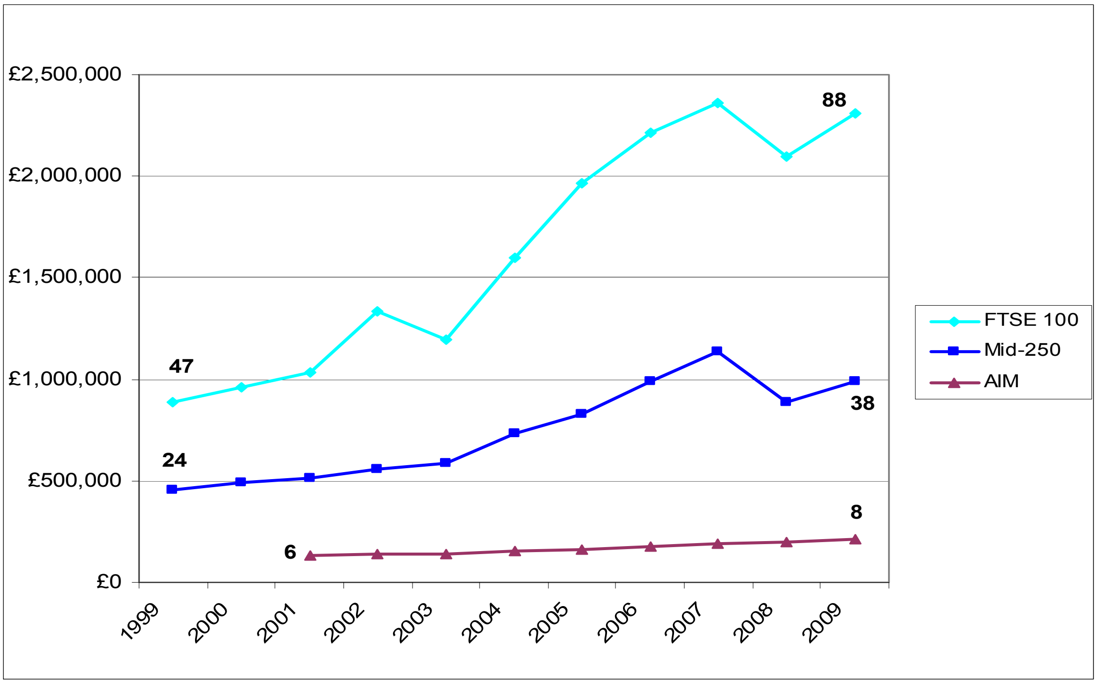
12. We invite feedback on the questions posed throughout this paper and welcome further evidence that will help to build a stronger understanding of the issue and the ways in which Government can work with stakeholders to bring about change.

1. Background

The growth in pay

13. The median total remuneration of FTSE100 CEOs has risen from an average of £1m to £4.2m for the period 1998-2010.[1] This is faster than the increase in the FTSE100 index, retail prices or average remuneration levels across all employees for the same period. By comparison, executive remuneration in FTSE250 companies has grown at a slower rate and growth in median CEO salaries in Small Cap and AIM companies has been more modest.

Figure 1: Median actual total earnings for CEOs of FTSE100, Mid-250 and AIM firms 1999-2009, with ratios to UK median full time earnings [2]



14. Research looking at the reasons for the growth in pay has reached different conclusions, with many studies pointing to the difficulty of identifying causal effects. As a result, no single, clear reason has emerged and the trend is likely to be a combination of factors.[3] Some of the most frequently cited reasons are summarised below. We welcome input that would assist in addressing the gaps in our evidence base on this.

[1] This figure includes all types of remuneration: salary, bonus, deferred bonus, other benefits, long-term incentives, share options and pensions. Taken from: Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011. Available at: http://blog.manifest.co.uk

[2] Analysis from Hutton Review of Fair Pay in the Public Sector, Interim Report, December 2010, using IDS and ASHE data. Figures include actual total earnings during the year and exclude conditional share awards and pension contributions. Available at: http://www.hm-treasury.gov.uk/d/hutton_interim_report.pdf

[3] Frydman, C & Jenter, D., CEO Compensation, Rock Center for Corporate Governance at Stanford, November 2010. University Working Paper No. 77

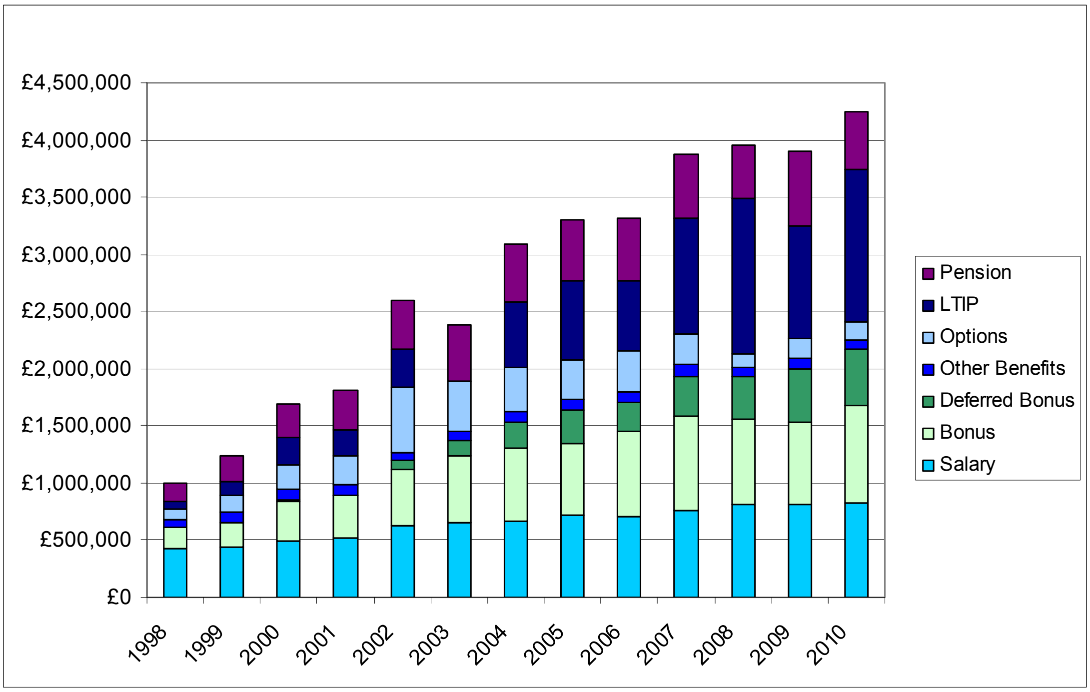
Company size

15. According to one study,[4] the expansion of large companies explains many of the patterns in executive pay, across firms, over time and between countries; and the increase in CEO pay in the United States can be directly linked to the increase in market capitalisation of large companies during the same period. The changing nature of the CEO role as companies become larger and more complex has also been cited as a contributing factor.[5]

Structure of remuneration

16. The structure of remuneration has changed significantly over the past two decades and this itself has been considered by some to contribute to the overall increase. In an attempt to address the principal–agent problem,[6] most large companies have moved towards paying a much larger proportion of remuneration in the form of variable and deferred pay – such as deferred bonus, share options, long-term incentive plans (LTIPs) and pensions – and to more complex models of remuneration that try to link pay to performance. Figure 2 shows how the composition of median CEO remuneration in FTSE100 companies has changed since 1998.

Figure 2: Composition of median total remuneration of FTSE100 CEOs 1998-2010[7]



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[4] Gabaix, X. & Landier, A ., Why has CEO pay increased so much? April 2007. Quarterly Journal of Economics
[5] Kaplan, S.N. & Rauh,J., Wall Street and Main Street: What contributes to the rise in the highest incomes? July 2007. CRSP Working Paper No 615
[6] The principal-agent problem relates to the relationship between the owners of companies (shareholders) and the executives (directors) to whom the shareholders delegate management responsibility. This separation of ownership from control can lead to information asymmetries and leave room for the executive to act in his own self-interest to the detriment of the owner. Methods used to manage the principal-agent problem include structuring remuneration to align the interests of directors and shareholders.
[7] Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, March 2011. Available at: http://blog.manifest.co.uk

17. Despite the efforts to link pay to company performance, the rate of growth of remuneration has greatly outstripped the growth in the total return received by investors. Some researchers have argued that the move towards more complex remuneration structures with a greater proportion of reward being deferred, has actually driven increases in overall remuneration because executives expect higher pay in reward for higher risk. In other words, the value of deferred pay may be discounted because of the possibility it will not be paid.[8] It has also been suggested that complex schemes increase the likelihood that at least some elements will pay out, leading to higher overall pay awards.

Transparency

18. In response to the growing complexity of remuneration, additional reporting requirements were introduced in 2002 to encourage companies to be more transparent about executive pay.[9] Several academics and stakeholders suggest that this has caused a ratcheting effect on remuneration as firms benchmark against each other and feel obliged to pay a salary in the upper quartile to attract and retain executives.[10] The effect of all firms paying above the median rate is to continuously push the median up.

19. However, increased transparency of pay has also prompted remuneration committees to justify pay proposals and encouraged shareholders to play a more activist role.[11] And other countries that do not require the same degree of transparency, such as Switzerland and Spain, have also seen substantial increases in remuneration.[12]

Competition for talent

20. One of the most frequently cited reasons for high levels of pay has been the impact of the international market for CEOs and the need to pay above average to attract the very best talent and mitigate against a flow of UK executives to other countries. However, the evidence to support this is mixed. Globalisation should have increased the number of potential candidates for director level posts, which arguably should have helped depress pay - but we have seen little evidence to support this. Although the international mobility of CEOs may be limited, there does appear to be a fairly active market at director level within the UK.[13]

Link between pay and performance

21. While CEO remuneration in the UK's largest companies has risen rapidly in the last decade, the link between pay and performance is hard to discern. The median total

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[8] PwC, If executive pay is broken, making it more complex is not the answer: The psychology of incentives, March 2011, Available at: http://www.pwc.co.uk/eng/publications/if-executive-pay-is-broken-making-it-more-complex-is-not-the-answer.html

[9] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008. Available at: http://www.legislation.gov.uk/uksi/2008/410/part/4/made

[10] See summary of responses, A Long-Term Focus for Corporate Britain, Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

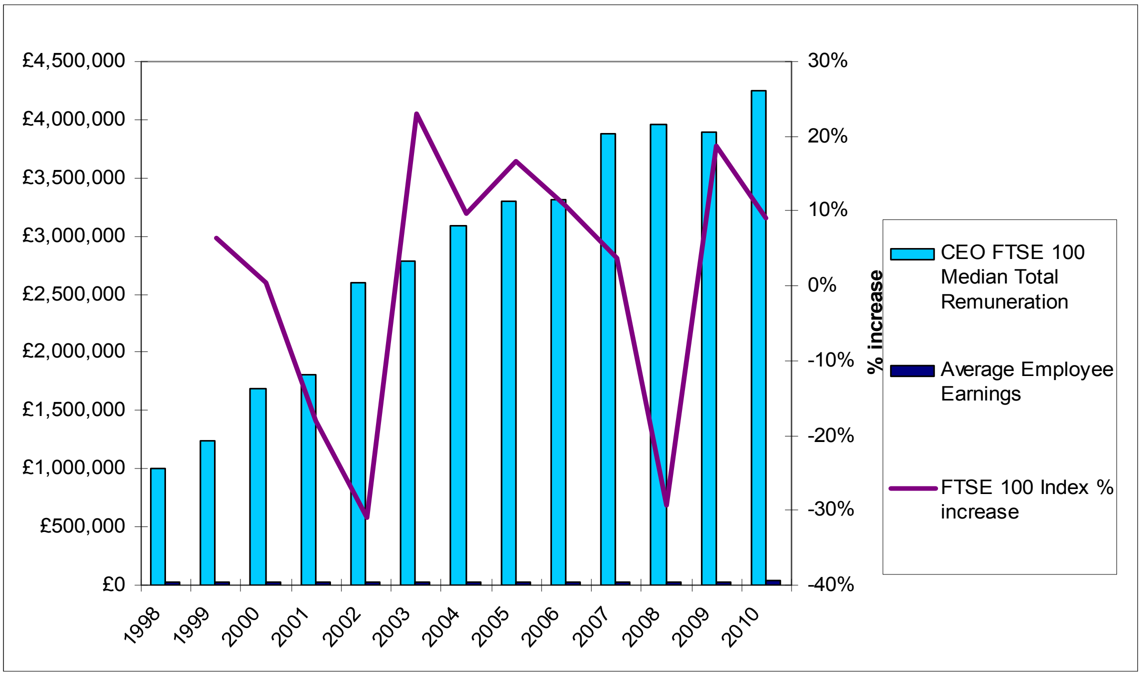
[11] Ferrarini, G. and Moloney, N., Executive Remuneration in the EU: The Context for Reform, 2005, *Oxford Review of Economic Policy* (Summer) 21(2): 304-323

[12] ABI response to A Long-Term Focus for Corporate Britain. Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

[13] Gregory Smith, I. and Main, B. The Executive Labour Market at Work, University of Edinburgh Business School, Research Paper, September 2011

remuneration of FTSE100 CEOs rose annually by 13.6% on average between 1999 and 2010.[14] By comparison, an average annual increase of 1.7% in the FTSE index was observed across the same period. Figure 3 below illustrates how median FTSE100 CEO total remuneration has risen and that extreme fluctuations in the FTSE100 index appear to have had no impact on the level of remuneration awarded.

Figure 3: Comparison of FTSE100 CEO median total remuneration, average employee earnings and FTSE100 performance 1998-2010[15]



22. This suggests two possible issues: that the structure of remuneration does not necessarily incentivise directors to act in the long-term interests of a company; and that the level of remuneration may represent excessive reward for the performance observed. By comparison to the growth in pay for executive directors, employees have seen much slower growth in earnings. Over the last 12 years, average employee earnings have grown 4.7% on average per year, compared to 13.6% for FTSE100 CEOs.[16] The effect of this has been to increase the disparity between senior executives and their employees, with CEOs in the UK now earning over 120 times that of the average worker. This raises questions about the distribution of reward within companies and whether concentration of reward at the top end is really the most effective way of motivating staff and sustaining long-term performance.

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[14] Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, March 2011. Available at: http://blog.manifest.co.uk The average year on year annual percentage changes are calculated by summing the individual annual percentage changes and then dividing by the number of years in the time series.
[15] ibid
[16] ibid

How pay is currently regulated

23. The UK has had legislative requirements on the process of reporting to shareholders on directors' remuneration for more than sixty years. The most notable change in recent years was in 2002, with the introduction of a requirement on quoted companies to produce a separate directors' remuneration report. Shareholders were also, for the first time, given the right to vote on pay, although only on an advisory basis. Annex A illustrates how the regulatory framework has changed over time and the various obligations now placed on companies.

24. All registered companies are subject to basic remuneration reporting requirements, with enhanced requirements for quoted companies. These are set out in the Companies Act 2006 and related regulations. In addition, the Listing Rules set out requirements for listed companies,[17] which includes adherence to the principles for remuneration in the Financial Reporting Council (FRC) UK Corporate Governance Code,[18] on a comply or explain basis. Those companies that are also financial institutions must adhere to the Financial Services Authority (FSA) Remuneration Code,[19] which takes forward internationally agreed standards for pay in the financial services sector.

25. Although there are no specific requirements within company law about the way pay is structured, shareholder groups and other stakeholders in the investment and advisory community have developed their own detailed guidance about how pay should be designed and explained to shareholders. This sets the criteria which many investors and proxy voting advisors will use to judge remuneration proposals and as a result, has proved influential in shaping the design of remuneration over the last decade.

How pay is regulated in other countries

26. For more than two decades, most other countries have seen similar trends in executive pay to those observed in the UK, in terms of both quantum and structure, with the balance shifting from base salary in favour of more complicated variable and deferred pay. As a consequence, these countries have also pursued new measures to improve transparency and ensure the process of setting remuneration is robust.

27. While the UK has been widely regarded as one of the countries with the highest level of scrutiny surrounding executive pay, and the basic foundations of the UK Corporate Governance Code have been widely replicated across Europe,[20] there are recent examples of other countries - particularly those with large financial and banking sectors - introducing measures that go further than current UK requirements.

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[17] FSA, The Listing Rules. Available at: http://www.fsa.gov.uk/pubs/other/listing_rules.pdf
[18] FRC, UK Corporate Governance Code. Available at: http://www.frc.org.uk/corporate/ukcgc.cfm
[19] FSA, Remuneration Code. Available at http://www.fsa.gov.uk/Pages/About/What/International/remuneration/index.shtml
[20] Watson Wyatt, Executive Pay Practices Around The World, 2009. Available at: http://www.watsonwyatt.com/research/pdfs/EU-2009-12528.pdf

28. In the United States, where executive pay is considerably higher than the UK, although the gap is narrowing,[21] the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 introduced new disclosure requirements and, for the first time, a shareholder 'say on pay'. The Act, which is being implemented by the Securities and Exchange Commission, also requires disclosure of a single figure for executives' annual total compensation, publication of the ratio of CEO pay to median employee earnings, the introduction of claw-back policies and new measures to prevent the conflict of interest that can potentially arise in the process of setting remuneration.

29. The Australian government has also addressed conflict of interest issues, particularly concerning the use of remuneration consultants to advise remuneration committees on pay. Reforms which took effect in July 2011 require boards to disclose their use of consultants and impose restrictions on the ability of executive directors to engage remuneration consultants. The reforms also require listed companies' remuneration reports to contain a statement that the board is satisfied that remuneration recommendations have been made free from any undue influence by the relevant director. Australia has also taken measures to prevent rewards for failure, including a new shareholder vote on termination payments of more than one year's base salary.

30. There is variation in the practices adopted across Europe, with the UK having the most developed requirements. In October 2004, the EU Commission recommended that publicly traded companies in Europe disclose their policies on executive remuneration, as well as the level and form of each individual executive's pay.[22] The recommendations are not legally binding, and as Figure 4 below shows, there exists a range of mandatory disclosure regimes in Europe; although the EU Commission has recently consulted on whether there should be a unified system.[23]

31. Elsewhere, policies on executive remuneration vary from country to country and are to some extent informed by wider national or cultural practices. For example in Japan, companies traditionally pay their employees based on their seniority not performance and the disparity between senior executives and the rest of the workforce is less pronounced. However, as pay has risen despite the fall in shareholder wealth, new rules introduced in March 2010 require firms to disclose details of an executive's remuneration, including bonuses and stock options, when the total exceeds 100 million yen (around $1 million).

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[21] Conyon et al (2006) found CEO pay in the US to be 1.6 times higher than in the UK in 2003.
Conyon M, Core, J. and Guay, W., How high is US CEO Pay? A Comparison with UK CEO pay, June 2006, Social Science Research Network

[22] Western European Executive Pay Disclosure Trends Bode Well for Better Credit Analysis, Moody's Global Corporate Governance: Special Comment 5 (Moody's Investors Service, New York, NY), December 2007. Available at: http://v3.moodys.com/sites/products/AboutMoodysRatingsAttachments/2007000000459228.pdf.

[23] European Commission Green Paper: The EU corporate governance framework. Available at: http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf

Figure 4: Current levels of disclosure in EU countries and anticipated future changes[24]

Current disclosure		Country	Potential future developments in disclosure
Individual disclosure Detailed pay policy	High	UK Ireland Netherlands France	More information required on the link between pay and performance, and a focus on peer groups
	Medium	Sweden Germany Switzerland Italy Norway	Pressure to disclose information on individual board members rather than just the CEO/highest paid executive, with more information on remuneration policies
Aggregate disclosure Limited pay policy	Low	Finland Spain Portugal Denmark	Pressure to provide individual disclosure and increased information on remuneration policies

32. Although there is some evidence of convergence on executive remuneration practices around the world, significant architectural differences in the broader corporate governance framework can make comparisons difficult. Different attitudes towards pay and corporate governance, sometimes rooted in cultural norms, means that although it is helpful to look at measures introduced elsewhere, practices that are effective in one country may not work in another.[25]

What the UK could do differently

33. This discussion paper builds on the existing evidence base and feedback from stakeholders and outlines a variety of measures that could potentially promote a clearer and stronger link between executive remuneration and company performance, and empower shareholders to hold companies to account.

34. Despite the disclosure requirements that already exist, we have heard concerns that companies do not provide a clear line of sight between levels and structure of remuneration and directors' performance in meeting a company's strategic objectives. The consultation document on the future of narrative reporting by companies, published alongside this paper, proposes how reporting of remuneration could be improved.

[24]Mercer, Executive Compensation in Europe, 2007. Available at: http://www.mercer.com/referencecontent.htm?idContent=1282000
[25] Gregory Smith, I. and Main, B. The Executive Labour Market at Work, University of Edinburgh Business School, Research Paper, September 2011 (unpublished)

35. However, transparency can only get us so far. Feedback from previous consultations suggests that the corporate governance arrangements currently in place could be improved and that the way pay is structured needs to be examined. This discussion paper explores these wider issues and also looks at how good practice could be promoted.

2. Improving transparency

Background

36. It is important that companies provide clear and accessible information about remuneration to enable shareholders and other stakeholders to scrutinise and challenge where appropriate. Company law already requires all quoted companies to produce a directors' remuneration report and regulations specify what should be in the report. This has helped to improve transparency on pay but over time, remuneration reports have become increasingly lengthy and complex. Shareholders have told us that it can be difficult to identify the main facts and figures amidst a raft of other detailed information. This makes it time consuming for shareholders to assess remuneration and to make comparisons across companies.

37. The Government believes there is scope for more direct and useful reporting on pay, as part of a wider overhaul of company reporting. The narrative reporting consultation, published alongside this discussion paper, sets out proposals for how company reporting can be made clearer and as a result, easier to compare. This builds on an earlier consultation on this issue and has been informed by extensive discussions with stakeholders.[26]

38. As part of these proposals, top level reporting on remuneration would form part of a new Strategic Report, alongside information about the company's strategic objectives, KPIs and risks. This will encourage companies to be clearer about the rationale behind executive remuneration and the link to strategy and performance.

39. Detailed information which underpins these calculations, for example tables showing the various components of remuneration for each individual director, would be provided in an Annual Director's Statement and cross-referred to where appropriate. This information would therefore still be available to those that needed it, and could be audited as necessary, but the top level reporting on remuneration should become more concise. Reducing the length of remuneration reports that companies produce and bringing key information up-front should make it easier for shareholders to scrutinise remuneration and empower them to hold companies to account.

40. A summary of our main proposals on options for improving pay reporting are below. These are set out in more detail in the narrative reporting consultation document, to which stakeholders are encouraged to respond. More information about this can be found online at www.bis.gov.uk/consultations.

Options for change

41. The narrative reporting consultation outlines the key pieces of information that shareholders and other stakeholders have said they need to understand and assess a company's remuneration policy. It asks whether a standard format for reporting on

[26] BIS, The Future of Narrative Reporting: a consultation, 2010. Available at: http://www.bis.gov.uk/Consultations/the-future-of-narrative-reporting-a-consultation

remuneration would encourage companies to make disclosures clearer and more concise. As part of slimming down remuneration reporting, it also invites views on which aspects of current disclosure requirements could be removed.

42. The consultation puts forward some specific proposals on the reporting of pay and invites feedback on whether these would be helpful and informative for shareholders and should therefore form part of all remuneration reports.

Greater clarity on total pay

43. Although companies are already required to provide information about the various different components of directors' remuneration, they are not required to disclose a single, aggregate figure for total remuneration. In response to the Government's initial call for evidence on narrative reporting, and in our subsequent discussions with stakeholders, it has become clear that this is a major deficiency in the current reporting framework. The consultation therefore proposes that the total remuneration of each director should be shown as a single cumulative figure as part of a company's Strategic Report. This figure, which should include the various elements of remuneration, could be calculated in a number of ways, and so the consultation invites views on which would be the most helpful and informative method.

44. Recognising that in some companies, senior managers that are not on the board but take decisions which impact on the success of the company, may be earning as much as or even more than the executive directors, the consultation invites views on whether there would be benefits in introducing a requirement to disclose the remuneration of these individuals. This would be consistent with requirements due to be consulted on for all large banks in the UK and could provide greater clarity to shareholders on how key individuals that have a significant influence over the success of the company are incentivised and rewarded. The consultation also seeks views on alternative ways of improving shareholder oversight of the performance and pay of influential non-board executives.

Improved disclosure about the link between pay and performance

45. The strength of the link between strategy, pay and performance is an important factor for shareholders when assessing remuneration proposals. However, shareholders have told us that the complexity of reports mean that in some cases, the symmetry between remuneration, shareholder returns and the long-term objectives of the company is lost. This view is supported by recent research looking at the remuneration reports of FTSE150 companies, which found that only around a third clearly disclosed how remuneration is dependent on performance.[27]

46. The consultation proposes that companies provide a clearer statement on how remuneration relates to achievement of the company's strategic objectives over the previous year; and asks whether or not this should be supplemented by a graph plotting the remuneration of the CEO over the past five years against an appropriate measure of company performance.

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[27] PwC, Insight or fatigue? FTSE350 reporting, 2010. Available at: http://www.pwcwebcast.co.uk/cr_ftse350.pdf

The link to pay across the organisation

47. Companies are currently required to include a statement of how the pay and conditions of employees across the group have been taken into account, as part of the remuneration report. In reality, few reports provide meaningful information about this; but as executive pay has risen must faster than that of other employees, some stakeholders have argued for better disclosure in this area.

48. In his *Review of Fair Pay in the Public Sector,*[28] Will Hutton recommended that public bodies publish the chief executive's (or equivalent) earnings, median earnings of the organisation's workforce, and the ratio between these two figures in their annual remuneration reports, and suggested that listed companies do the same. This is being taken forward in the United States, where as part of the implementation of the Dodd-Frank Act, the Securities and Exchange Commission will require companies to report on pay ratios in their annual reports.

49. The Government recognises that there are practical limitations with calculating and comparing ratios from different types of companies but invites views on whether this information would be helpful for shareholders; and if so, how it should be calculated.

Clarity on remuneration proposals for the year ahead

50. When describing pay policy for the year ahead, companies are required to explain the performance measures associated with any long-term incentive plans (LTIPs) and share option schemes and why they were chosen; and the relative weighting of different elements of remuneration. This gives shareholders the opportunity to scrutinise the structure of remuneration going forward and any changes from the existing arrangements.

51. However, this element of company reports sometimes lacks a clear explanation of what the proposals mean in practice. In particular, the Government believes that shareholders would benefit from a much clearer statement on how future pay policy is linked to company strategy. To address this, the consultation proposes that companies should be required to explain how the criteria for all performance related pay including cash bonuses, LTIPs and executive share option schemes, relate to the company's strategic objectives, and invites views on whether the criteria for annual bonuses should be made more transparent.

52. It also asks whether this should be supplemented by estimates of the future remuneration of executive directors for a range of scenarios, so that shareholders can gauge how effectively reward is geared to performance.

Disclosure of total expenditure on directors' remuneration

53. Quoted companies are not currently required to disclose total expenditure on executive remuneration as a proportion of profit; or how the total expenditure on board pay relates to the company's expenditure in other areas. In view of the

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[28] Hutton Review of Fair Pay in the public sector, Final Report, March 2011. Available at: http://www.hm-treasury.gov.uk/indreview_willhutton_fairpay.htm

continuing rise in total levels of executive pay, and shareholders' concerns that pay does not always reflect performance, the consultation invites views on whether such disclosure should be required as part of the Strategic Report. This would provide shareholders and other stakeholders with more information about how much of the company's profits are being invested in rewarding directors, compared to dividends and re-investment in the company, for example.

Improved transparency about the process of setting directors' remuneration

54. Finally, the consultation proposes that companies should be required to disclose fees paid to remuneration consultants, on the same basis as the fees paid for audit services; and include details of the services provided to the remuneration committee and to management. The consultation also asks whether there is additional information which should be disclosed in relation to the procedure for setting remuneration in order to prevent conflict of interest.

3. Role of shareholders

Background

55. Shareholders in the UK have been entitled to an advisory vote on the directors' remuneration report since 2002. The vote was designed to empower shareholders and give them an effective and more focused way in which to influence directors' pay. It encouraged shareholders to become more engaged in corporate governance and to develop relationships with the companies they invest in.[29]

56. The average level of dissent against remuneration reports in FTSE350 companies was around 5-6% during the first four years after the introduction of the vote.[30] A number of high profile cases in the early years cemented the importance of the remuneration report and shareholder vote.

57. The proportion of dissenting votes reduced to around 3% in 2008 but the financial crisis predictably led to an increase in shareholder activism and in 2009, around one fifth of FTSE100 companies had more than 20% of their shareholders withhold support for their remuneration reports.[31] The frequency of such significant votes against has since declined, but individual cases continue to attract a great deal of attention.

58. Engaging shareholders and empowering them to take action on executive pay is critical. However, this is increasingly challenging as a growing proportion of the diverse UK shareholder base comprises overseas or short-term investors. ONS estimates that over 40% of the UK's shares are now held overseas.[32] For many investors, remuneration may be a relatively unimportant issue in comparison to other strategic decisions. Even those investors who are the most engaged in this area have limited resources dedicated to scrutinising remuneration and may have interests in hundreds or thousands of different companies.

59. Shareholders should play a central role in tackling the issues around executive remuneration and challenging companies to use pay to appropriately incentivise and reward. But we need to look at whether they have the right tools to be able to do this job effectively. Almost ten years on from the introduction of 'say on pay' in the UK, as pay has continued to rise with no clear link to performance, it is right to review whether the vote is effective in holding companies to account; and whether there are other ways in which shareholders could be empowered or engaged on the issue of executive remuneration.

[29] PIRC and Railpen Investments, Say on Pay: Six Years on: Lessons from the UK Experience, September 2009. Available at: http://www.pirc.co.uk/sites/default/files/documents/SayonPay.pdf
[30] ibid
[31] PwC, Executive Compensation: Review of the Year, 2009. Available at: http://www.pwc.co.uk/eng/publications/executive_compensation_review_of_the_year_2009.html
[32] Office for National Statistics, Share Ownershio – Share Register Survey Report, 2008. Available at: http://www.ons.gov.uk/ons/rel/pnfc1/share-ownership---share-register-survey-report/2008/index.html

Options for change

Improving the information available to shareholders

60. In response to *A Long-Term Focus for Corporate Britain,* shareholders and investors told us that one of the greatest barriers to engaging on pay is the time it takes to analyse remuneration reports. As explained in the previous chapter, the narrative reporting consultation, published alongside this paper, puts forward proposals for an improved reporting framework for companies, including more concise and relevant reporting on pay. We encourage all stakeholders to respond to the narrative reporting consultation and more information can be found online at www.bis.gsi.gov.uk/consultations.

Making shareholder votes binding

61. A number of stakeholders have argued that the shareholder vote on pay should have binding effect, suggesting that this would give the vote more legitimacy, encourage shareholders to be more active and require companies to take the process more seriously.

62. While international practice on this varies, as 'say on pay' votes have been adopted in other countries, including Australia, Germany and South Africa, most have done so on an advisory basis – including most recently, the United States. Anecdotal evidence suggests that an advisory vote can have a real effect[33] and some researchers have established an improved sensitivity between remuneration and company performance since the introduction of an advisory vote in the UK.[34]

63. If introducing a binding vote, its legal status would need to be established, including what expectations this would place on a company to revise its remuneration proposals in the event of a vote against; and whether revised proposals would then need to be verified by a second shareholder vote. The financial cost and inconvenience of having to conduct a second vote would be significant. However, this could have the effect of placing greater pressure on the company and shareholders to work together on an acceptable package at the outset.

64. The ability of a company to revise its proposals would also be dependent on the contractual agreements entered into with the directors and the extent to which remuneration has already been awarded. Where there is a contractual entitlement that an individual could reasonably expect to be fulfilled, the dissenting shareholder vote potentially comes into conflict with employment law, although some suggest that contracts could make it clear that remuneration is subject to shareholder approval. An alternative to a binding vote on the overall remuneration report could be to offer a binding vote on the total level of reward for the board as a whole, which the company could then distribute as appropriate.

65. Although a binding vote on pay might appear to give shareholders more leverage, investors, governance experts, remuneration consultants and remuneration

[33] Cai, J. & Wakeling, R. Shareholders' Say on Pay: Does it Create Value? 2009. Journal of Financial and Quantitative Analysis (JFQA) Available at :http://ssrn.com/abstract=1342656
[34] Ferri, F., & the U.K., 2007. Working paper, Columbia University and Harvard Business School.

committees have all queried whether it would have the desired effect. They have fed back that the advisory vote on pay allows shareholders to send a message to management, where despite engagement on the issue, their remuneration proposals fail to meet expectations. This has a real reputational impact and remuneration committees will almost always seek to secure shareholder support. Given that shareholders who are particularly dissatisfied now have the additional option of voting against the annual re-election of the remuneration committee chairman, some stakeholders have questioned whether a binding vote is really necessary.

66. Some have also claimed that a binding vote might cause companies to focus solely on whether they 'pass' or 'fail'; and that shareholders might even be discouraged from voting if the implications of a majority vote against meant significant turbulence for the company in question. There are however, countries that have successfully introduced a binding vote – including Norway, the Netherlands and Sweden – and so it warrants serious consideration. The Government welcomes further input on whether it would assist shareholder governance in the UK and if so, how it could be implemented.

Question 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?

Preventing rewards for failure

67. Individual cases of executives leaving failing companies with substantial exit packages have attracted high profile resistance on the part of shareholders, and outrage among the public. These cases provoke enormous resentment and many companies will make great efforts to avoid such situations arising.

68. Over the last five years, amendments have been made to corporate governance regulation to address this particular issue. The Companies Act 2006 introduced the requirement that compensation payments to outgoing directors be put to a shareholder vote, as should contracts of more than two years in length. In 2008, regulations were amended to require that notice periods of directors be included in the annual remuneration report, and in the most recent revision of the UK Corporate Governance Code, companies are advised to adopt one year contracts for directors.

69. Although most companies have now moved to one year rolling contracts and all are required to disclose the severance terms of these contracts within their remuneration report, there continue to be examples of substantial exit payments for outgoing directors. The mandatory shareholder vote on compensation payments applies only to those made over and above that which the executive director is contractually entitled to. It therefore excludes payments made as part of the company's contractual agreement, which can comprise unearned bonus and unvested share plans, as well as base salary.

70. As shareholders currently have no role in scrutinising contracts, it is incumbent on companies to consider the implications of contractual terms to mitigate against rewards for poor performance. Some stakeholders have called for shareholders to have a stronger voice in preventing rewards for failure, for example through an *ex*

post vote on the contracts of new appointments or a vote on termination payments. This raises issues about the legal status of such a vote and how it would interact with the contractual agreement between the company and the director. Some investors have also suggested that additional votes would risk replacing meaningful engagement,[35] but the Government welcomes views on whether this, or other measures, could genuinely assist shareholders in preventing rewards for failure.

Question 2:

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

Requiring representation of shareholders on nominations committees

71. The Cadbury Report on corporate governance in 1992 recommended that all UK companies adopt a more transparent process for appointing directors by establishing nominations committees.[36] In the UK, these are a sub-committee of the board and lead the process for identifying and making recommendations on candidates for appointment to the board.

72. A recent study looking at how nominations committees have evolved in Sweden – where their membership is comprised predominantly of major shareholders or their representatives – suggests that this model has had a positive impact on the effectiveness of the board. It proposes that the UK would benefit from inviting shareholder representatives to play a similarly active part in choosing board directors.[37] This would enable shareholders to propose non-executives that they believe would actively promote their long-term interests and hold the company to account on their behalf, particularly on the issue of pay.

73. However, as the Companies Act already requires company directors to act in the long-term interests of shareholders and other stakeholders, critics of this model have questioned the need for shareholders to be represented on board committees, claiming that this would undermine the role of directors.[38] Some shareholders have said that becoming a company 'insider' is something they would wish to avoid, if it compromised their freedom to sell their shares.

74. The dispersed and internationalised nature of the UK shareholder base would also challenge adoption of this model in the UK. In Sweden, just under half of market capitalisation can be ascribed to one shareholder holding more than 20% of the voting shares, compared to just under one quarter in the UK. The diversity of UK shareholders means it may be difficult to find representatives that can be seen to

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[35] Hermes Equity Ownership Services, response to A Long-Term Focus for Corporate Britain. Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

[36] Cadbury Report, Final report of the committee on the financial aspects of corporate governance, 1992. Available at: http://www.icaew.com/~/media/Files/Library/subjects/corporate%20governance/financial%20aspects%20of%20corporate%20governance.ashx

[37] Tomorrow's Company, Tomorrow's Corporate Governance: Bridging the UK engagement gap through Swedish-style nomination committees, 2009. Available at: http://www.forceforgood.com/Uploaded_Content/tool/243201011485875.pdf

[38] ABI response to A Long-Term Focus for Corporate Britain. Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

speak on behalf of all shareholder interests. Shareholders themselves have suggested that few would have sufficient time and resources to dedicate to this level of engagement. Nevertheless, we welcome feedback on whether the UK could learn anything from the Swedish model.

Question 3:

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

Increasing shareholder engagement on remuneration

75. The tools and information that shareholders have available to them to hold companies to account on remuneration, will only have an impact if shareholders are inclined to use them. This is not just an issue for remuneration, but for corporate governance more generally. The Stewardship Code aims to enhance the quality of engagement between institutional investors and companies, to improve the long-term returns to shareholders and the efficient exercise of governance responsibilities.[39] The Code, which operates on a comply or explain basis, requires investors to publish their voting policies and disclose how they make use of proxy voting and external advisors. This helps companies to understand the approach and expectations of their major shareholders. The FRC will be reporting on the take-up and impact of the code at the end of 2011.

76. These issues are also being considered at a European level. The European Commission has recently consulted on the issue of stakeholder engagement, voting practices and disclosure as part of its Green Paper on Corporate Governance and will be looking at whether there are standards that should be adopted across Europe.[40]

77. The Government has also announced the Kay Review,[41] which, over the course of the next year, will conduct a thorough analysis of UK equity markets and the extent to which they promote a focus on the performance and growth of UK companies over the long-term; and the role of shareholders in this process. The questions raised in this discussion paper about how to incentivise effective long-term decision making by UK company executives are therefore relevant to Professor Kay's work. Professor Kay will report his recommendations next summer.

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[39] FRC, The UK Stewardship Code, July 2010. Available at: http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf

[40] European Commission Green Paper: The EU corporate governance framework. Available at: http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf
BIS, UK Government Response to EU Corporate Governance Framework Green Paper, 2011. Available at: http://www.bis.gov.uk/assets/biscore/europe/docs/u/11-1097-uk-government-response-eu-corporate-governance-framework

[41] BIS, Kay Review Terms of Reference, 2011. Available at: http://www.bis.gov.uk/assets/biscore/business-law/docs/k/11-1015-kay-review-terms-of-reference

4. Role of remuneration committees

Background

78. The Cadbury Report on corporate governance was the first to recommend that all companies should have a remuneration committee, comprised mainly of non-executive directors. At the time, around one third of large UK companies reported having a remuneration committee.[42] By 1998, the UK Corporate Governance Code (then the Combined Code) incorporated this as a standard requirement for all listed companies, on a comply or explain basis. The current version of the code sets out the role of the remuneration committee and best practice on membership and ways of working. Although there is no statutory requirement to establish a remuneration committee, all of the UK's large companies covered by the code have done so.

79. Since the introduction of the directors' remuneration report and advisory shareholder vote on pay, the work of the remuneration committee has been given a greater focus. High profile incidences of shareholder dissent in the years immediately after the vote was introduced established the remuneration committee's report and the vote on pay as a key aspect of the UK corporate governance landscape.[43] Interviews conducted in 2006, with the non-executive members of remuneration committees in FTSE350 companies, found that the process of setting remuneration had become extremely challenging and that a substantial effort is spent designing remuneration to link to company performance.[44]

80. However as discontent with executive pay has grown – particularly in the wake of the financial crisis - so has scrutiny of remuneration committees.[45] Stakeholders have told us there is value in exploring whether the role and membership of remuneration committees needs to adapt to respond to the challenges involved in setting executive pay.[46] In *A Long-Term Focus for Corporate Britain,* we invited views on this issue and below we set out some of the policy options that stakeholders have proposed. We welcome feedback on whether or not these would help to strengthen remuneration committees and if so, how they could be taken forward.

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[42] Main, B. G. M. and Johnston, J., Remuneration committees and corporate Governance, 1993. Accounting & Business Research, 23(91A): 351-362.
[43] PIRC and Railpen Investments, Say on Pay: Six Years on: Lessons from the UK Experience, September 2009. Available at: http://www.pirc.co.uk/sites/default/files/documents/SayonPay.pdf
[44] Main, Brian G. M., Jackson, Calvin, Pymm, John & Wright, Vicky, The Remuneration Committee and Strategic Human Resource Management, Corporate Governance, 2008. An International Review, Vol.16, No. 3 (May), 2008, pp.225 - 238.
[45] PwC, Executive Compensation: Review of the Year (2009), Available at: http://www.pwc.co.uk/eng/publications/executive_compensation_review_of_the_year_2009.html
[46] PIRC, response to A Long-term Focus for Corporate Britain. Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

Options for change

More diverse remuneration committees

81. Members of the remuneration committee are drawn from and appointed by the board and in large companies at least three must be independent non-executive directors. The majority of these non-executives tend to be current or former directors of other companies. Indeed it is their experience of working at the highest level in business that gives them the knowledge and skills needed by board members to set challenging goals, negotiate pay and performance conditions and hold executives accountable for their performance. However, the tendency for non-executive directors to be recruited from a relatively narrow pool of talent has been cited in several studies as potentially contributing to insufficient challenge on remuneration issues.[47]

82. Some researchers looking at the impact of this have suggested that non-executives are, by virtue of their past experience, part of a culture of high pay. Their 'frame of reference' for what constitutes high pay may therefore be out of kilter with the average worker and so what may appear extraordinary to the majority of people can seem reasonable to non-executives.[48] This may have the effect of causing them to be less questioning of excessively generous rewards.[49] Some academics and stakeholders have also identified a tendency for remuneration committees to stick to conventional reward schemes and a disinclination to break from market norms,[50] which can have the effect of stifling innovation in the structure of remuneration.[51]

83. As the members of the remuneration committee are drawn from the pool of non-executives that sit on the company board, recent efforts to diversify the membership of boards may have some impact. The UK Corporate Governance Code already states that boards and committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. It notes that the search for candidates should be conducted with due regard to the benefits of board diversity, including gender, and the FRC has recently consulted on whether the code should go further on the issue of gender equality in particular.[52]

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[47] O'Reilly, Charles A. III & Main, Brian G M, Economic and Psychological Perspectives on CEO Pay: A Review and Synthesis, 2010. Industrial and Corporate Change, Vol.19, no.3, 2010, pp. 675-712.

[48] The High Pay Commission, More for Less: what has happened to pay at the top and does it matter? Interim Report, May 2011. Available at: http://highpaycommission.co.uk/wp-content/uploads/2011/05/HPC_interim_report2011.pdf

[49] Ezzamel, M. & Watson, R., Market comparison earnings and the bidding up of executive cash compensations: evidence from the United Kingdom, 1998. The Academy of Management Journal, 41(2): 221-231.

[50] Main, Brian G. M., Jackson, Calvin, Pymm, John & Wright, Vicky, The Remuneration Committee and Strategic Human Resource Management, 2008. Corporate Governance - An International Review, Vol.16, No. 3 (May), 2008, pp.225 - 238.

[51] The Hay Group, response to A Long-Term Focus for Corporate Britain. Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

[52] FRC Consultation document: Gender diversity on boards (2011). Available at: http://www.frc.org.uk/press/pub2574.html

84. However, a more direct and immediate way of diversifying remuneration committees specifically, might be to invite independent members to join, without requiring them to become full non-executive board members. Stakeholders that support this idea have suggested that people from outside the traditional corporate sphere may be able to lend relevant and valuable expertise whilst also bringing a fresh set of views[53] and that remuneration committees would benefit from drawing on skills and experience from the public sector, academia or professionals with consultancy and advisory backgrounds.[54]

85. The practical question of how such arrangements would function, as well as the legal status of committee members who are not full non-executives, needs further consideration. Whereas the role and liabilities of directors are clearly set out in the Companies Act - including that they should act in the long-term interests of shareholders and other stakeholders – the roles and responsibilities and process for selection and tenure of any independent members of the committee would need to be clearly understood. There might also be a risk that this would dilute the accountability of the directors to shareholders for remuneration and performance.

Question 4:

Would there be benefits from having independent remuneration committee members with a diverse range of professional backgrounds and what would be the risks and practical implications of any such measures?

86. It is extremely common for individual directors to have a role in several companies, either in a non-executive or executive capacity. The potential for this cross-pollination of directorships to cause conflict of interest on remuneration committees was raised in several of the responses to *A Long-Term Focus for Corporate Britain*. There may be risk of this where a non-executive is involved in setting the pay of someone who, in another company, may have a role in setting theirs. Some stakeholders have commented that this is difficult to justify and that there is a strong case for preventing these situations from arising.

Question 5:

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

Giving employees a say on remuneration

87. Several stakeholders have suggested that the most effective way of moving away from the status quo on remuneration and to encourage greater challenge would be to invite employee representatives to sit on remuneration committees. They claim that this would bring a different perspective to the discussion on executive pay and ensure that pay and conditions elsewhere in the company, which remuneration committees

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[53] TUC, response to A Long-Term Focus for Corporate Britain. Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

[54] The Hay Group, response to A Long-Term Focus for Corporate Britain. Available at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

are required by the UK Corporate Governance Code to consider, are genuinely taken into account.[55]

88. Proponents of this approach suggest that proposals that appear to reward failure would face greater scrutiny, as would proposals that are disproportionately generous when compared to modest pay increases, pay cuts or even redundancies across the business. Some of the research into the impact of employee representatives on supervisory boards in Germany suggests that this has led to the adoption of tighter performance conditions for pay than in similar US companies,[56] although other studies have pointed to the challenges of making employee representation work effectively.

89. The practical question of how the committee might function needs to be considered, for example the level of employee representation that would be required to mitigate the risk that a lone employee voice could be outnumbered. Any employee representatives would need a good knowledge of the company's strategy, objectives and risks or else they might be disadvantaged in comparison to other members of the committee. Nevertheless, some stakeholders have claimed that given proper training, support and access to the appropriate information, employee representatives could potentially make a thoughtful and insightful contribution to the discussion on pay.

90. As is the case for independent remuneration committee members, the legal status of any employee representatives would need to be determined; as would their responsibilities, who they represented (whether that be the workforce, shareholders or both), and how they were elected. Amongst the European countries that already require employees to be represented on company boards - including Austria, Denmark and the Netherlands – there is variation in the number of representatives appointed, how they are elected, their duties and the interests they represent.[57] The fact that UK companies typically choose a unitary board system means that the models applied in other countries are not directly transferable. Company law implies that any board or committee member is considered a director of the company, and critics of the concept of employee representation on remuneration committees have suggested that this makes it an unworkable model in the UK.

Question 6:

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

91. An alternative and potentially simpler way of securing input from employees into the remuneration process could be to offer them an endorsement vote on the remuneration report. This exercise, which some stakeholders suggest could be conducted in advance of the remuneration committee putting its final proposals to

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[55] TUC response to A Long-Term Focus for Corporate Britain. As above.
[56] Buck, T & Sharhrim, The translation of corporate governance changes across national cultures: The case of Germany, 2005. Journal of International Business Studies, 36 (1): 61
[57] Thorsten Schulten & Stefan Zagelmeyer, Board level representation in Europe, European Industrial Relations Observatory, 1998. Available at: http://www.eurofound.europa.eu/eiro/1998/09/study/tn9809201s.htm

shareholders, could provide the committee with helpful and challenging feedback; although there may be a risk it would introduce conflict or uncertainty into a firm.

92. This process would require the committee to clearly describe their remuneration proposals and why they were appropriate. Although the outcome of the vote would not be binding, results of employee feedback could be included in the remuneration report to demonstrate how the committee has taken into account views from across the workforce.

93. The Government invites views on the legal implications and mechanics of such a vote - including the timing and the eligibility of different employees to vote - as well as the cost that this would place on companies.

Question 7:

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

Improving transparency in the use of remuneration consultants

94. Almost all remuneration committees of large companies secure the assistance of remuneration consultants to aid with the design and reporting of remuneration proposals. Executive management may also use remuneration consultants to advise on what scale and type of remuneration they should expect to receive, and the firms that provide remuneration consultancy may simultaneously provide other services to the company.

95. Even where a remuneration committee seeks advice from remuneration consultants, it is the remuneration committee which is ultimately responsible for making decisions on remuneration, but consultants clearly play an important and potentially influential role. The Walker Review on corporate governance in the banking sector[58] recognised that this causes the potential for conflict of interest and welcomed the introduction of a Remuneration Consultants Code, which sets out professional standards for the provision of advice to clients and on how the consulting–client relationship should be managed.[59] The code, overseen by an advisory committee and independent chair has been signed by all major remuneration consultants operating in the UK. An annual review of the code has recently concluded and will lead to a revised code later this year.

96. To encourage greater transparency on the use of consultants, the Walker Review also proposed that all remuneration committees use the code as the basis for determining the contractual terms of engagement with their advisers; and that the remuneration report should indicate the source of consultancy advice and whether the consultant has any other advisory engagement with the company. Although the UK Corporate Governance Code already requires companies to disclose where they have appointed remuneration consultants and whether they have other connections with

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[58] A review of corporate governance in UK banks and other financial industry entities, 2009. Available at: http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/walker_review_information.htm
[59] RCG Code. Available at : http://www.remunerationconsultantsgroup.com/?P=THE_CODE

the company, some stakeholders have expressed strong support for disclosure in this area to be made more detailed.

97. In response to this, the narrative reporting consultation brings forward proposals that companies should be required, as part of the remuneration report, to provide a more comprehensive explanation of the services used and fees paid. Some stakeholders have however, argued for more robust measures to prevent conflicts of interest. Other countries have recently introduced new regulations in this area: this year the Australian Government tightened its rules around engagement with remuneration consultants; and in the United States, committees are required to disclose how any conflicts of interest were dealt with. We invite views on whether additional measures to prevent conflict of interest in the use of remuneration consultants are necessary and if so, the practical ways of doing this.

Question 8:

Will an increase in transparency over the use of remuneration consultants help to prevent conflict of interest or is there a need for stronger guidance or regulation in this area?

5. Structure of remuneration

Background

98. The structure of executive remuneration packages has changed substantially over the last decade, becoming increasingly complex - particularly in our largest companies. In 1998, base salary made up over 40% of total remuneration for FTSE100 CEOs. By 2010 it accounted for less than 20%, with the remainder made up of a combination of bonus, long-term incentive plans (LTIPs), share options and pensions.[60] This trend can be partly attributed to regulatory changes that have made different types of remuneration more favourable or cost-effective than others, but also reflects attempts to incentivise directors more effectively over the longer-term.

99. The prevalence of LTIPs has grown significantly and this type of pay now represents around 30% of median total remuneration for FTSE100 CEOs.[61] These plans award shares on the basis of performance criteria being met at a defined point in the future - typically three years. Their popularity grew as companies considered them an effective way of tackling the principal-agent dilemma by aligning directors interests with the interests of shareholders. The main challenge with these schemes has been choosing long-term performance measures and targets which both shareholders and executives can identify with; leading some companies to use a combination of different metrics. This, and the fact that a company typically has two or three different schemes running in parallel, means that this element of pay has become increasingly complex.

100. The use of annual bonuses – which typically reward individual performance or achievement of shorter-term corporate objectives - has also evolved, with deferred bonus becoming a much larger share of total pay in recent years. Following the financial crisis, the Walker Review proposed that a substantial proportion of annual bonuses be deferred, to prevent individuals from being incentivised to take risky short-term actions to deliver immediate reward.[62] Although aimed predominantly at financial services, the move towards deferred bonus has been replicated across other sectors. Most large companies now require a proportion of annual bonus to be deferred or offer the option of deferral with the prospect of additional reward if supplementary performance conditions are met.

101. Our consultation with stakeholders has shown that the growing complexity of remuneration packages has prompted a number of concerns. Firstly, it makes it harder to disentangle and explain what executives are actually earning. The Government's proposals on improving narrative reporting respond to this and will challenge companies to be more transparent and concise in reporting pay.

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[60] The Manifest/MM&K Executive Director, Total Remuneration Survey, May 2011 Edition. Available at: http://blog.manifest.co.uk

[61] ibid

[62] A review of corporate governance in UK banks and other financial industry entities, 2009. Available at: http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/walker_review_information.htm

102. A number of stakeholders have also claimed that the increasing complexity of pay may have resulted in higher overall pay. This could be for a number of reasons. As pay is broken down into more components, each with their own criteria, the likelihood that at least some of those criteria will be met may increase. Research has also suggested that executives tend to discount the value of remuneration subject to complex long-term performance criteria, particularly if they feel they have little control over those criteria. Because the perceived risk is greater, there can be an expectation that the total potential reward should be higher to compensate.[63]

103. Thirdly, despite attempts to link pay and performance, the evidence that this has succeeded is variable,[64] with academics drawing different conclusions as to whether the link has got stronger or weaker.[65] There is a clear need for more research into the link between pay and performance and which models of remuneration have been shown to be effective in driving performance.

104. Currently there are no statutory requirements prescribing the structure of executive remuneration in companies (with the exception of those which are also financial institutions and so required to comply with internationally agreed standards on risk and reward structure).[66] The UK Corporate Governance Code offers high level guidance on the design of performance-related remuneration, stating that payouts should be 'sufficient to attract, retain and motivate' and subject to challenging performance criteria reflecting the company's objectives.

105. More detailed guidance on the design of remuneration has been produced by large investors such as the Association of British Insurers and National Association of Pension Funds, as well as by organisations that provide corporate governance analysis and advice to investors.[67] As these guidelines provide a clear benchmark for what investors will support, they have been influential in shaping how companies structure their remuneration. Over time, these guidelines have been updated to reflect emerging practice or to address shareholder concerns about particular issues.

106. The Government recognises that companies need the flexibility to structure remuneration appropriately, but the evidence suggests that it is worth exploring whether there are some general principles which if applied by companies and investors, could simplify the structure of pay and make it easier to see how directors are being incentivised; or promote stronger links between pay and performance and

[63] Towers Watson, Getting Executive Pay right, 2011,.Available at: http://www.towerswatson.com/assets/pdf/4232/Getting-executive-pay-right.pdf
[64] Gregg, P., Jewell, S. & Tonks, I., Executive Pay and Performance in the UK, 2010, AXA Working Paper No5, Discussion Paper Series No 657.
[65] Conyon, M. J., Peck, S. I., Read, L. & Sadler, G. V., The structure of executive compensation contracts: UK evidence, 2010. Long Range Planning, 33(4): 478-503.
[66] Internationally agreed standards on banking stability were implemented in Europe through an amendment to the Capital Requirements Directive. This included guidelines on how certain types of staff in financial institutions should be incentivised and rules on disclosure. The Financial Services Authority has implemented this in the UK via its Remuneration Code. Available at: www.fsa.gov.uk/pubs/policy/ps10_21.pdf
[67] ABI (2010) Executive Remuneration: Guidelines on policies and practices. Available at: www.ivis.co.uk
NAPF (2010) Corporate Governance Policy and Voting Guidelines. Available at: www.napf.co.uk
PIRC (2011) UK Shareholder Voting Guidelines. Available at: www.pirc.co.uk

help to prevent rewards for failure.[68] We know that shareholders and investors, remuneration experts, companies and academics are already looking at this and there are wide-ranging views about how this might be done. We have set out just some of the options below and welcome discussion of the structure of remuneration, how it could be improved and how this would best be taken forward.

Options for change

Alternative measures of performance

107. When the Government consulted on *A Long-Term Focus for Corporate Britain,* a number of respondents said that the tendency of companies to rely on Total Shareholder Return (TSR) and Earnings per Share (EPS) as performance measures is unhelpful.[69] Not least because the quarterly reporting of these measures may impose pressure to perform over the short-term and as a result, discourage directors from taking a long-term view.[70] The inherent volatility of these measures, which can be affected by factors outside the control of an individual director, may also contribute to executives demanding higher pay to compensate for perceived risk.[71]

108. There is already evidence that around half of FTSE100 companies are no longer focusing solely on TSR and EPS but combining them with alternative performance metrics such as cash flow and return on invested capital.[72] In one study of the remuneration structure in high performing firms in the UK, the most successful companies were found to be more likely to use relevant measures, directly linked to company strategy, in addition to traditional measures such as TSR and EPS.[73]

109. One drawback of a more tailored approach is that it could become harder to compare between companies and that overly frequent refinement of performance metrics could make it impossible to track a company's performance over time. Nonetheless, the use of more strategic measures – ideally where these relate directly to a company's KPIs - has been broadly welcomed by shareholders, provided there is a rationale for using a particular measure and that this is clearly explained. The narrative reporting consultation published alongside this paper sets out proposals for improving the way companies do this.

[68] Forum for the Future (2011) Overcoming the Barriers to Long-Term Thinking in Financial Markets, Available at: http://www.forumforthefuture.org/sites/default/files/project/downloads/long-term-thinking-fpf-report-july-11.pdf

[69] A Long-Term Focus for Corporate Britain, summary of responses. Available at: http://www.bis.gov.uk/assets/biscore/business-law/docs/s/11-797-summary-responses-long-term-focus-corporate-britain.pdf

[70] Rappaport, A. (2005) The Economics of Short-Term Performance Obsession, Financial Analysts Journal Volume 61 Number 3. Available at: www.expectationsinvesting.com/TCO/economicsofshortterm.pdf

[71] PwC, If executive pay is broken, making it more complex is not the answer: The psychology of incentives, March 2011, Available at: http://www.pwc.co.uk/eng/publications/if-executive-pay-is-broken-making-it-more-complex-is-not-the-answer.html

[72] Deloitte, Your Guide to Executive Directors' Remuneration, September 2010. Available at: http://www.deloitte.com/view/en_GB/uk/services/tax/employers/ef41969db86d9210VgnVCM200000bb42f00aRCRD.html

[73] PwC research on high performing companies, awaiting publication.

Question 9:

Could the link between pay and performance be improved by companies choosing more appropriate measures of performance?

A longer-term view

110. While the proportion of remuneration awarded as deferred pay has increased, the typical vesting period for LTIPs and other share plans has remained largely unchanged with most companies using the minimum three year vesting schedule recommended in the UK Corporate Governance Code. Some stakeholders and academics have however questioned whether three years can truly be considered long-term for a large company and proposed that this be extended to five years or even longer.

111. There could be a number of reasons preventing more companies from looking beyond three years, including the difficulty of plotting performance and a perceived risk that executives will not be motivated by a reward that is too distant. The average tenure of CEOs in the UK is relatively short at around six years,[74] and this may make it challenging to structure rewards over longer time periods. There are however, some examples of companies that have successfully established schemes with a longer vesting period and it is worth exploring whether this could be an effective model for more companies.

Question 10:

Should companies be encouraged to defer a larger proportion of pay over more than three years?

112. Adding to the complexity of LTIPs and share option schemes is the fact that companies frequently have several schemes running in parallel. Not only does this make it difficult to understand the value of an individual director's package, but each new scheme presents a further opportunity to negotiate on targets and terms. Some of the stakeholders we consulted made the case for less regular adaptation of LTIPs and share option schemes. This would allow less flexibility but might encourage companies to place greater importance on identifying the right long-term performance measures from the outset, and mean a clearer line of sight between the company's objectives and how its executives are being incentivised.

Question 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?

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[74] Hutton Review of Fair Pay – Final Report, HMT, March 2011. Available at: http://www.hm-treasury.gov.uk/indreview_willhutton_fairpay.htm

Simplifying remuneration

113. A number of stakeholders have suggested that the challenges involved in establishing the right performance measures and lack of convincing evidence to demonstrate that more complex remuneration structures have helped to motivate executives and drive company performance,[75] points to a need for a radical simplification of remuneration.

114. One way of achieving this could be for executive directors to receive a substantial proportion of remuneration in the form of shares, to be held for several years before their value can be released. The rationale behind this model is that directors would be incentivised to increase share value over the long-term in order to increase the value of their own rewards. As such, no additional performance criteria would be required.

115. Some proponents of this model have suggested that shares should actually be held until retirement so that directors maintain a long-term interest and attach more importance to succession planning.[76] However, career holding requirements also raise questions about the impact on the behaviour and decision-making of senior executives coming close to retirement. Nevertheless, stakeholders have indicated that it could be an attractive model and one that warrants further consideration.

Question 12:

Would radically simpler models of remuneration which rely on a directors' level of share ownership to incentivise them to boost share value, more effectively align directors with the interests of shareholders?

Question 13:

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

Claw-back

116. Following the Walker Review, and the application of internationally agreed standards for remuneration in the financial services sector, the FSA Remuneration Code for financial institutions requires that provision is made for 'claw-back'[77] where performance turns out to have been miscalculated or misstated.[78] Although these proposals were targeted at financial services - where the true impact of decisions may not be known for some time - the lessons have also been applied by companies in other sectors.

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[75] PwC, If executive pay is broken, making it more complex is not the answer: The psychology of incentives, March 2011, Available at: http://www.pwc.co.uk/eng/publications/if-executive-pay-is-broken-making-it-more-complex-is-not-the-answer.html

[76] Main, B., Thiess, R. & Wright, V., Do career shares improve CEO performance? Evidence from the FTSE350, 2011. Journal of General Management, Vol. 36, No. 4 (Summer), pp. 37–51

[77] A performance adjustment technique that allows firms to demand payback of all or part of an individual's bonus that has already vested with the individual, to take account of developments after vesting.

[78] FSA Remuneration Code, http://www.fsa.gov.uk/Pages/About/What/International/remuneration/index.shtml

117. In 2010, the UK Corporate Governance Code was amended to include the proposal that 'consideration is given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct'. Estimates have suggested that around one fifth of FTSE100 firms already operate claw-back, though what this means in practice varies.[79] In the United States, new legislation under the Dodd-Frank Act will make it a requirement for all public companies to put in place a claw-back policy to recover long-term incentives paid on the basis of 'flawed information'. We invite views on whether all UK quoted companies should be required to introduce a claw-back policy, what this would mean in practice and what impact it would have.

Question 14:

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

[79] Deloitte, Your Guide to Executive Directors' Remuneration, September 2010. Available at: http://www.deloitte.com/view/en_GB/uk/services/tax/employers/ef41969db86d9210VgnVCM200000bb42f00aRCRD.htm

6. Promoting good practice

Background

118. Executive remuneration is an issue that has attracted attention for almost three decades. Shining a spotlight on this issue can put pressure on companies to ensure that exceptional pay is a reward for exceptional performance.

119. Institutional investors and proxy voting advisors already play a valuable role in bringing shareholders' attention to remuneration proposals that give cause for concern. Remuneration consultants have also been active in highlighting the issues with current reward structures and exploring ways in which they might be reformed.

120. Academics have looked at the international trends in pay quantum, structure and the links to firm performance, to consider how pay can be used most effectively to attract, retain and motivate executives. The results of this research are diverse and often inconclusive, and more research in this area is required. Where companies can demonstrate a strong link between pay and performance or have shown good governance in remuneration practices, it is important to highlight these examples, and we welcome the efforts of some organisations to do just this, through guidance and awards for good reporting.[80]

Options for change

A body to coordinate research and promote good practice

121. Some stakeholders have suggested that a body, with a remit to promote good practice on pay structure and reporting, could provide a helpful, continued focus on the issue of executive remuneration. Although there are a number of organisations that track and comment on executive pay – such as consultants, proxy voting advisors and the media – there may be value in bringing this together through a body charged with coordinating the existing data and knowledge.

122. We welcome further views on whether there is a role for an independent body to take on responsibility for improving the quality of information on and practice in respect of executive pay and if so, what the precise remit of this body should be. For example, as well as coordinating research and developing our knowledge base in this area, it could produce an annual report on trends and draw attention to leading good practice. The Government does not believe in setting limits on pay and does not see any such body as having a role in advising on levels of remuneration or becoming a counterpart to the Low Pay Commission.

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[80] Report Leadership, Executive Remuneration: Simple, practical proposals for better practice in reporting executive reward, 2007. Available at: www.reportleadership.org
PwC, Remuneration Reporting: Who's doing it well? 2010. Available at: www.corporatereporting.com
PwC, Building Public Trust Awards 2010: People Reporting & Executive Remuneration Reporting. Available at: www.bptawards.com

Question 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?

7. Next steps

How to respond

123. This discussion paper is designed to stimulate debate and help the Government build its evidence base and understanding of the issues and potential measures discussed. We welcome views from all stakeholders, including companies, shareholders and investors, employees, governance experts, academics and anyone with an interest in this issue. Respondents are invited to comment on some or all of the questions posed in the paper, a summary of which is attached at Annex B.

124. Responses can be submitted electronically to executivepaydiscussionpaper@bis.gsi.gov.uk or in hard copy to:

Executive Pay Discussion Paper
Business Environment
Department of Business, Innovation and Skills
1 Victoria Street
London
SW1H 0ET

125. When responding please state whether you are an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents by selecting the appropriate interest group on the consultation response form and, where applicable, how the views of members were assembled.

126. The deadline for responses is 25 November 2011.

Confidentiality & Data Protection

127. Information provided in response to this discussion paper, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want information, including personal data that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.

128. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

Help with queries

129. Questions about the policy issues raised in the document can be addressed to:

Gemma Peck
Executive Pay Discussion Paper
Business Environment
Department of Business, Innovation and Skills
1 Victoria Street
London
SW1H 0ET
executivepaydiscussionpaper@bis.gsi.gov.uk

Annex A: Summary of existing regulation on executive pay

Current UK and European regulations on pay

Legislation	Requirement	UK registered companies	UK registered and listed	UK listed but not registered	UK registered and listed companies that are also financial institutions
Companies Act 2006	Shareholder resolution on directors' employment terms longer than two years	X	X		X
	Shareholder resolution on non-contractual payments for loss of office	X	X		X
	Companies to include certain information concerning directors' remuneration by way of notes to the company's accounts	X	X		X
	Companies to publish a report on directors' remuneration as part of the annual reporting cycle		X		X
	Companies to put the report to a shareholder vote		X		X
Financial Services & Markets Act 2000	Listing Rules require shareholder resolution on directors' share schemes and long-term incentive plans		X	X	X

	UK Corporate Governance Code requires companies to comply or explain with guidance on the role and membership of remuneration committees and the structure of remuneration. States that: *'levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully'.*		X	X	X
European Commission Capital Requirements Directive 3	Implemented in the UK through the FSA Remuneration Code, which makes recommendations on structure of remuneration for risk-taking staff and requires aggregate disclosure of amounts paid to these staff.				X

Summary of the evolution of company law reporting requirements on directors' remuneration

Section 148 of the **1929** Companies (Consolidation Act) required companies to furnish information on remuneration of directors to shareholders 'on demand'.

Section 196 of the Companies Act **1948** required a company's accounts to show:-

(a) the aggregate amount of the directors' emoluments;

(b) the aggregate amount of directors' or past directors' pensions; and

(c) the aggregate amount of any compensation to directors or past directors in respect of loss of office.

The Companies Act **1967** section 6 required the accounts to show the emoluments of the chairman, and in respect of the directors, in bands of £2.500, the numbers whose emoluments fell within those bands.

The Companies Act **1985** consolidated and reformed company legislation. The provisions on directors' pay were set out in Schedule 5 paragraph 22 and 25. The provisions for the chairman were at paragraph 24. The bands for directors' pay were uprated to commence at £5,000, and bands of £5,000.

The 1985 Act was amended shortly afterwards by the Companies Act **1989**, and the provisions on directors' pay were moved to Schedule 6 (as given effect by section 232 of that Act).

In **2002** the Directors' Remuneration Report Regulations 2002 (SI 2002/1986) (made under section 257 of the 1985 Act), revised section 232 and provided that the provisions of Schedule 6 on disclosure would only apply to companies that were not quoted companies.

For quoted companies a new section 234B was inserted into the 1985 Act which gave effect to a new Schedule 7A. That schedule required quoted companies to produce a directors' remuneration report for each financial year. The schedule set out the details of the report. The regulations also provided for a new section 241A of the Companies Act 1985 which gave the members the right to an advisory vote on the remuneration report.

The latest consolidation and reform of company legislation was the Companies Act **2006**. The provisions for all companies other than quoted companies now appear in section 412. The provisions on quoted companies are in section 420 – 422 and section 439 (members' vote). The details of the remuneration report, formerly in Schedule 7A, are now set out in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), Schedule 8.

Annex B: Summary of 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?

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

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

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?

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

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

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

8. Will an increase in transparency over the use of remuneration consultants help to prevent conflict of interest or is there a need for stronger guidance or regulation in this area?

Structure of remuneration

9. Could the link between pay and performance be strengthened by companies choosing more appropriate measures of performance?

10. Should companies be encouraged to defer a larger proportion of pay over more than three years?

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?

12. Would radically simpler models of remuneration which rely on a directors' level of share ownership to incentivise them to boost share value, more effectively align directors with the interests of shareholders?

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

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

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?

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London SW1H 0ET
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