BIS | Department for Business Innovation & Skills

A LONG-TERM FOCUS FOR CORPORATE BRITAIN
Call for Evidence Response Form

A copy of the consultation available at: http://www.bis.gov.uk/consultations.

Responses to the Consultation should be received by 14 January 2011.

Completed copies of the response form should be returned:

Via email to: clgconsultations@bis.gsi.gov.uk

Via post to:

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Please tick the box from the following list of options that best describes you:

	Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant
X	**Other (e.g. consultant or private individual) - academic**

Please note that my comments are restricted to the following consultation questions:

Shareholders: questions 4, 5, 6 and 10
Directors' remuneration: questions 11-14

To shorten the response form, I have therefore deleted the other questions.

My primary area of research interest is in relation to the regulation of executive remuneration via 'say on pay' regimes, such as in the UK and Australia. My comments on engagement and voting need to be understood in this particular context.

In particular, I want to draw the Department's attention to a different way of thinking about the regulation of executive remuneration: the regulated remuneration cycle. I present this at the end of the submission form.

Please feel free to contact me for clarification or any further information on my submission. I noted the material included at the end of my submission is based on my research work, including research undertaken as part of my doctoral thesis at the Melbourne Law School, The University of Melbourne.

Yours sincerely

Kym Maree Sheehan
14 January 2011

Shareholders and their role in equity markets

<u>Question 4</u>: What are the most effective forms of engagement?

Comments
This question is best examined from two different perspectives: company management and shareholders. We should be careful to distinguish between engagement that leads to better business outcomes, as opposed to engagement that is essentially a form of gamesmanship between investors and company management. From the perspective of company management, effective engagement occurs when they successfully persuade shareholders to agree with the company's perspective. From the shareholders' perspective, engagement is effective when investors successfully persuade management to either not proceed with a particular course of action, or to undertake a certain course of action. For example, in relation to the remuneration report, turning shareholder sentiment from 'no' to 'yes' or 'abstain' can be achieved by intense one-on-one engagement, either in person or other the telephone, in that short period between release of the notice of meeting and the cut-off date for the lodgement of proxies (but in practice, over a shorter period of time). Company management (the board) will often seek to woo investors and proxy advisory firms outside the voting season. Such proactive engagement by the board of directors allows the board to set the agenda for the dialogue, rather than 'fire fighting' issues arising from the resolutions set out in the Notice of Meeting. This engagement might be kicked off by a detailed letter explaining proposed changes and inviting comments or the opportunity for discussions. The company representatives I spoke to made it clear that these were discussions, not negotiations. This is also true of proxy advisory firms who engage with company management as part of determining their voting recommendations, or are proactively engaged by management. As the discussion paper notes however, frequently the investment decisions and the engagement activities and decisions around corporate governance are separated within fund management teams. A further observed pattern is for an organisation to undertake engagement on behalf of a number of pension funds, without being delegated the task of investment decision making. This may mean that the corporate governance analysis and engagement is undertaken by (a) an investment manager; (b) a corporate governance person within the fund manager; (c) an investment manager within the pension fund; (d) a corporate governance manager within the pension fund; (e) a corporate governance consultant across several pension funds; and (f) one or more proxy advisory firms. However, the decision to vote for or against company management is usually reserved for the fund

manager (subject to the terms of the individual mandate between the pension fund and its investment managers). The activities of the persons identified in (b)-(f) above can come to nothing if the investment manager insists on voting in favour of management.

While corporate governance continues to be seen by some (many?) as separate to, and not an integral part of, the investment decision, the power of corporate governance to improve company performance is diminished. And ultimately, that should be the yardstick by which the effectiveness of engagement is measured: it leads to improved, if not superior, company performance.

Of course, such performance should be measured 'holistically' in keeping with the spirit of enlightened shareholder value. It is also reflected in movements such as the UN's Principles for Responsible Investment that encourage investors to consider environmental, social and governance issues as part of the investment decision.

Question 5: Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?

Comments

Ownership of the voting decision is a key issue not only within investment teams, but between the beneficial owners and their investment managers. The level of dialogue really depends on the way the investment firm sets up its corporate governance team, its proxy voting decision making processes, as well as on the personalities of those involved in these functions.

There might be a cultural issue that prevents closure dialogue from happening. Examining the level of responsible investment education given to those who enter the finance industry as well as ongoing exposure to the concepts might help to address this culture.

Proxy advisory firms (PAFs) are also relevant to this issue. Based on my interviews with several corporate governance personnel in UK investment firms, PAFs are routinely retained by the corporate governance function in the investment firm. The PAF's report effectively summarises the remuneration report and the corporate governance report, and the recommendation flags which remuneration reports and corporate governance reports are acceptable (a vote for recommendation) and those that are not (a vote against recommendation).

Where the PAFs recommend a vote for, the corporate governance personnel will accept that recommendation. Where the PAFs differ, or where they

recommend against, the corporate governance personnel will then read the remuneration report for themselves. This may trigger a round of telephone calls with colleagues in other investment houses, as well as direct contacts with company management. The result of that is a recommendation from the corporate governance manager as to how the firm should vote.
That recommendation is then scrutinised by either, a committee of fund managers and the corporate governance manager within the fund, or else the individual fund manager who makes the voting decision.

<u>Question 6</u>: How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publically how they have voted?

Comments

It is important to recognise that, aside from the advisory vote on the Directors' Remuneration Report required under the *Companies Act 2006* (UK) c 46, s 439(1), resolutions at general meetings of the company, where passed by the requisite majorities, are binding decisions of the company. Therefore, ***voting is not engagement***. The resolution may form the basis for engagement prior to the general meeting, or, in the case of the remuneration report, pro-active engagement of shareholders by company management well in advance of the AGM. However, the legal status of shareholder voting should not be overlooked.

Indeed, given the advisory vote on the remuneration report has been successful in encouraging engagement, albeit on a very narrow set of issues, consideration should be given as to how a different advisory vote could be deployed on broader issues.

If anything, a significant vote against management will reflect a failure of engagement to resolve the issue.

<u>Question 10</u>: What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?

Comments

I asked several remuneration committee chairman and company secretaries the last question in relation to disclosure of fund manager pay. Almost all of them said 'no', as they did not believe it would suit any purpose.

However, given the angst over bankers' pay in the UK in the prevailing economic climate in Britain, the general knowledge that fund managers are

indeed well paid, the fact that the source of large amounts of investment funds are compulsory savings in the form of pensions, and that a number of UK defined benefit pension funds are underfunded, I believe there is a general interest in understanding how this vital sector of the economy functions. That should not, however, be focused solely on pay issues.

There appears to be an ever growing gap between the wages of ordinary workers and the salaries of the fund managers who are investing the pension monies of these workers. It is not possible to begin to address that gap via government policies or private sector initiatives unless the system that sustains it is understood.

Directors' Remuneration

<u>Question 11</u>: What are the main reasons for the increase in directors' remuneration? Are these appropriate?

Comments

Firstly, ***there is no effective external control on the quantum of directors' remuneration***. To understand why this is, it is important to see how the advisory vote on the remuneration report functions within the regulated remuneration cycle. This is discussed further below at *.

Institutional investors are able to hold listed company management to investor-preferred remuneration structures. This is because such investors typically screen for the structural features in remuneration packages, not overall quantum. Where there is a quantum issue, for example, a bonus payment out of line with company performance, or a termination payment that seems inappropriate, given the reasons for departure, shareholders are able to respond because they can clearly see it is a problem. Typically a proxy advisory firm's report will flag the bonus as being out of line as against other companies in the FTSE 100 (for example). Shareholders can vote after the payment has been made by voting down the report but cannot usually stop the payment being made.

In part better disclosure of remuneration will improve shareholders' ability to spot the potential problems but the difficulty lies in commercial-in-confidence carve outs and a willingness to tackle remuneration problems in the good times, as well as the bad.

Secondly, the ***widespread and accepted practice of benchmarking executive remuneration*** against a basket of companies ***and the policy position of paying at the median of the market for 'on target' performance*** means that there is a systemic annual ratchet of executive

remuneration that occurs independently of any increases in inflation or other economic indicators. This is likely to prevail despite new guidance in the UK Corporate Governance Code (FRC 2010a, Schedule A) and the ABI Guidelines that both seek to de-emphasise the use of comparator groups.

An important issue is therefore the selection of the comparator group. While self-regulatory efforts by remuneration consultants to date have focused on addressing conflicts of interest, I believe a remuneration consulting standard, akin to an accounting standard, is required. Such a standard would explain, among other things:

- The purpose of the comparator group
- Parameters for selecting a comparator group: industry specific or based on size (and how measured, eg market capitalisation) country, and number
- Number of comparator companies
- International or domestic comparators
- Pros and cons of different choices (eg a small, industry specific group might be most appropriate because it best reflects the market for executive human capital for that company, but makes statistical analyses less robust)
- Need to adjust historic earnings to current values (because comparisons done on prior year's reported remuneration data)
- How data is reported
- Decisions on company remuneration policy and market positioning
- Comparator group for setting performance benchmarks.

Remuneration can increase by choosing a different peer group from one year to the next for benchmarking purposes. The comparator group for overall benchmarking and the comparator group for performance measurement may well be different.

Thirdly, ***greedy executives and weak boards*** make a heady combination. I am less inclined to accept that named disclosure has driven increases in executive remuneration because prior to the remuneration report and Combined Code guidance on the role of the remuneration committee, the executive directors have most likely always had access to the remuneration consultant reports, and may have had a role in directly commissioned them. In other words, they know their value in the marketplace and named disclosure only changes the game by showing up companies outside the remuneration consultant's report (eg different comparator companies).

It is not so much getting remuneration right as not getting it wrong, so that the executive team feels that it is not valued by the board, and looks elsewhere.

Fourthly, ***that past performance is frequently also rewarded through increases to base salary***, rather than through variable remuneration, with the

result that the bonus potential and long term incentive grants, based on multiples of base salary, also increase.

Fifthly, a ***difficulty in maintaining consistent contractual provisions when hiring in new executives***. By the time a senior executive is offered a position with the company, he or she has been through several interviews and meetings. The balance of power shifts towards this individual, away from the board of directors of the hiring company. This can be addressed by developing and applying a consistent remuneration policy on issues such as guaranteed bonus payments, buy-outs of existing share based payments, starting salary compared with the existing executive team. However, the remuneration committee and the board will always be making a decision based on the individual and, unsurprisingly, good senior executives are very effective negotiators.

<u>Question 12</u>: What would be the effect of widening the membership of the remuneration committee on directors' remuneration?

Comments

The problems identified in the discussion paper at paragraphs [5.11] and [5.12] are

1. the independence of the remuneration committee;
2. whether they are able to set remuneration policy and practice to effectively align the interests of directors with the long-term interests of the company;
3. whether the remuneration committee members are sufficiently sensitive to wider factors related to company performance, including pay relativities and employment conditions elsewhere in the group; and
4. the influence of remuneration consultants over the remuneration policy.

Issues 1 & 4: Independence of remuneration committees and remuneration consultants.

The strong emphasis on independence is to remove the perceived conflicts of interest. However, it also reflects a belief that the right process will deliver the right outcomes (Conyon 1997, pp. 103, 103-104, 115; Huse 2005, p. 66). The insistence on independent remuneration committees likewise reflects a belief that board structure is an appropriate proxy for board success (Roberts, McNulty and Stiles 2005, p. 19). In other words, there is emphasis on the formal aspects of independence rather than on the substantive aspects (or what Matsumura and Yong Shin (2005, p. 109) describe as a broader concept of independence: that the directors bring an independent mind to the remuneration committee decisions they make).

As a sub-committee of the board of directors, the remuneration committee

plays the all important role, like other board committees, of working through the details of the remuneration decisions to be made by the board, both policy decisions and ad-hoc decisions. The membership of the committee may not need to be widened: rather it may be more important to ensure that the remuneration committee has pertinent information on the matters relevant to them.

My research has identified several information sources for the remuneration committee. These are summarised below in **Figure 3.** Information on the group's remuneration could be supplied by HR management or, if the TUC and other interested groups have information, they could ensure it is supplied to the remuneration committee. They need to make sure that the information is supplied in a timely fashion by understanding the cycle of remuneration committee meetings: based on a 31 December end of financial year, many remuneration committee decisions will be settled in January-February of the following year and backdated to 1 January. However the deliberations and information inputs into these decisions may come in November/December.

If the remuneration committee's membership is widened, and that committee has delegated decision-making powers, the persons who are not directors of the company risk being classified as de facto directors (see Davies 2008 [16-8]) and subject to all of the directors' duties as found in the *Companies Act 2006*, unless their involvement in the committee is by way of invitation only, and not to be part of the decision-making process.

In respect of remuneration consultants: the Remuneration Consultants Group has devised a voluntary code of conduct in relation on executive remuneration consulting (Remuneration Consultants Group 2009). As noted above in my answer to question 11, a remuneration consultants' standard that addresses the technical aspects of remuneration advice, might better help boards and shareholders to understand the parameters of the advice given.

Issue 2: Effective alignment of directors' interests with the long-term interests of the company.

The practices of share-based remuneration and the deferral of annual bonus payments (whereby only a portion is paid in cash in the current year, with the rest retained and paid in future only if performance conditions are achieved) both attempt to achieve this alignment. Share-based remuneration also potentially confers substantial wealth on the executive directors, especially if grants are made after a market correction at reduced prices.

In terms of the regulated remuneration cycle, this is a remuneration practice problem. However, having a differently constituted remuneration committee won't solve the problem, if the rules that shareholders use to determine whether the company's remuneration practices are well structured are not the ones that best measure sustainable long-term performance. While

performance periods in excess of three years attempt to achieve a longer-term focus, this alone will not change the outcome if the wrong performance measures are used. In short, the performance criteria used (relative TSR and EPS growth) may not be the most suitable choices of metric if 'performance' is to be viewed more holistically as including environmental, governance and social concerns. In other words, it's not only that the company achieves certain financial performance, but how it achieves it, that should be factored into the performance criteria allocated to variable remuneration.

Issue 3: Awareness of, and sensitivity to, pay and conditions elsewhere in the group.

There are two issues: awareness of remuneration elsewhere in the group, and use of that awareness in setting levels of executive remuneration within the group.

With the *Remuneration Principles* (FSF 2009, Principle 1), and more particular the *Implementation Guidance* released by the Financial Stability Board (FSB 2009, p.2), the FSA's *Remuneration Code* (SYSC 19A.3.12R) and, more recently, the Basel Committee on Banking Supervision in its proposed *Pillar 3 remuneration disclosure requirements* (Basel Committee 2010a, pp. 6-9); Basel Committee 2010b, p. 3), and CEBS (2010, p. 32-33), there is a general move towards giving the remuneration committee a broader remit that senior executive remuneration. However, a part-time committee of non-executive directors will be challenged by taking more than a high level overview of the policy in place in the rest of the group.

Awareness of pay levels can be achieved by information. Papers and presentations from HR management can be provided to the Remuneration Committee such that it is aware of pay. However, this information will need to be clear. Average pay across the rest of the company/group is potentially very misleading, because it could fail to convey to the remuneration committee the wages of the lowest level of employees. It will need some thought as to how best to communicate the range of wages and conditions that the non-executive employees of the company work under. Some kind of banded disclosure for salaries, with the number of employees on a particular band, might be useful.

The TUC and other external organisations can provide information on the overall level of wages and conditions for non-executive employees across industries. As remuneration consultants frequently provide remuneration committees with their general remuneration surveys (eg FTSE 100), as well as holding update briefings, these groups can reconsider their communications strategy to ensure it cannot be said that the directors couldn't possibly know.

<u>Question 13</u>: Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval?

Comments
Shareholders are effective in holding companies to standards of best practice remuneration in terms of structure, but less able to hold them to anything other than market rates of executive remuneration. Using the regulated remuneration cycle presented below, it is the synergy between shareholders rule-making on executive remuneration practice (via guidance), their engagement of remuneration committees and their voting practices that enables 'say on pay' to achieve good remuneration practices. To understand the enforcement options for poor remuneration practice, see further below for a discussion of the enforcement pyramid for remuneration practice. It is clear that there are few sanctions for poor remuneration decisions. With the change to the UK Corporate Governance Code providing for annual re-election of directors for FTSE 350 companies (Code Provision B.7.1), it is possible that shareholders frustrated with poor remuneration decisions will opt to not re-elect these directors. This would present a major shift in the voting practices of shareholders to date. There are two further areas of pay that could be subject to shareholder approval: shareholder approval of issues of securities (rather than plans) and termination payments. The Australian experience on both provides some useful comparative data. [1] ***Issues of securities***: Under the ASX Listing Rule 10.14, shareholder approval is required for an issue of securities (broadly defined) to a director, with the director and his or her associates unable to vote on the. Securities bought on market are already issued, and thus not subject to the requirement for approval. Shareholder approval can often be sought at the same time on the basis that the remuneration to be paid by this method is not 'reasonable remuneration' and hence the payment is giving a financial benefit to a related party of the public company: CA 2001, s 208(1). This listing rule is well regarded by shareholders as it provides an effective way of stopping what looks like an overly generous issue of securities being made. There have been instances of the resolution being withdrawn from the AGM: thus unless the company can get around the rule by buying the securities on market, the issue of securities cannot be made. Efforts to have this rule enshrined in legislation have, to date, proved unsuccessful.

[1] 'ASX' means the Australian Securities Exchange, and 'CA 2001' refers to the *Corporations Act 2001* (Cth).

Termination payments: Under CA 2001, s 200B(1), an entity[2] must not give a person a benefit in connection with a person's retirement[3] from an office or position of employment in a company or a related body corporate if the office or position is a managerial or executive office (or had such a position during the last three years before his or her retirement) unless there is member approval under s 200E for the giving of the benefit. There is a threshold of 12 months' base salary under which shareholder approval is not required, as well as some other carve outs.

The Australian termination payment provisions are very technical and complex, and have been so for some time. It is also the case that approval has been successfully obtained for various termination payments in exceess of the thresholds since the legislative amendments (eg Macarthur Coal Ltd in 2010).

However, legislation alone is not the only route to achieve changes to this particular aspect of remuneration practice. Evidence presented to the Productivity Commission in 2009 by the Hay Group (submission 84, p. 15) shows the effect this provision has had on remuneration practice in terms of termination payments (Productivity Commission 2009, p. 235). While in 2003, 70% of CEO contracts (for companies contributing to the Hay Group database) had a termination payment in excess of 16 months, in 2008, this figure had been reduced to zero. This pre-empts the change to legislation, flagged in late 2008 but not implemented until late 2009. It is likely that shareholder engagement, proxy advisor analysis, and mounting public criticism via the media of overly generous termination payments has been the reason for this change.

The UK should not forget the first years of the advisory vote on the remuneration report (2003-2005) where shareholders were able to effect change to the contractual termination provisions in a number of FTSE 100 companies. While the contemporaneous DTI inquiry into *Rewards for Failure* (which contemplated legislation to address this issue) helped shareholders to persuade companies to change. However, it was the preparedness of many shareholders to either vote against or abstain from voting on the remuneration report, together with engagement to communicate the reasons why that led to changes.

Whether shareholders need to be given further explicit voting rights in relation to particular remuneration practices is therefore a moot point.

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[2] Defined in section 200B(1AA) as the company, an associate of the company (other than a body corporate related to the company and itself a company) and a prescribed superannuation fund in relation to the company.

[3] Retirement includes loss of office or position, resignation from office, death while in office: s 200A(1)(e).

The advantage of having an explicit voting right that binds the company (eg by requiring shareholder approval of golden parachute payments) means that if the resolution does not pass with the requisite majorities, the company cannot make the payment. Having an explicit voting right does not, of course, obligate shareholders to use that right.

The difficulty for shareholders in approving in advance golden parachute provisions is that they do not know ultimately whether that payment will be reasonable when the termination ultimately occurs. It could be as a result of M&A activity, it could be as a result of 'a mutual agreement' for the executive to step down. They could have performed poorly, but not engaged in misconduct.

<u>Question 14</u>: What would be the impact of greater transparency of directors' pay on the:

- **linkage between pay and meeting corporate objectives**
- **performance criteria for annual bonus schemes**
- **relationship between directors' pay and employees' pay?**

Comments

The issues here are all remuneration practice issues: namely that variable pay is linked to long term performance, broadly defined; that the annual bonus scheme incentives are targeting the right behaviours and thus resulting in the right performance and are not too 'soft'; and that there is some restraint on executives' pay in times of restraint in employee pay.

Regulating remuneration practices via disclosure is at best an indirect way of achieving improvements in remuneration practice.

It can bring about change because, in having to disclose what the company does, it has to do something (assuming that the disclosures are an accurate reflection of what the company does).

Designing effective disclosure regulation for executive remuneration is difficult, in part because company's treat it as a compliance exercise, using engagement, proactive and reactive, to communicate to 'those that matter'. There is a lot of standard reporting and boilerplate phrasing of remuneration practices in remuneration report and care must be taken in writing the relevant 'rules' to ensure they are sufficiently flexible to accommodate a variety of practices.

However, achieving change in remuneration practice turns on the rules that shareholders write via their guidance and enforce through their engagement and voting activities. Shareholders can undermine company disclosures by

taking a formulaic approach and when companies work out the formula or 'magic phrase' that will attract a 'tick', it will be vigorously deployed. Shareholders and the proxy advisors who undertake analysis of company practices that informs shareholder voting must be sensitive to how their own practices shape company disclosure. Being more flexible in applying their 'principles' to allow for greater variation in company practice would be helpful.

Turning to the question of disclosure of the three particular issues:

Disclosure of link between pay and the achievement of corporate objectives: Assuming there is a link between the corporate objectives and the variable remuneration awarded (because the performance criteria for the variable components of remuneration are those that reflect the corporate objectives. As noted by the FRC (2011, p. 8), many companies are not adequately disclosing their strategy, risks, performance and position.

Disclosure of performance criteria for annual bonus payments: Disclosure of the criteria and disclosure of the targets in advance (for the year ahead) and historically (for the year reported) should be analysed separately.

Historical data: The performance criteria should link with the stated strategy of the business, reported elsewhere in the annual report. If the company can report how it achieved the key performance indicators used to determine its success in achieving the stated strategy, there appears little justification for not disclosing how an annual bonus payment based on the financial year reported (ie historical data) reflects these criteria. In essence, it is whether the performance is perceived by the board as excellent, good or poor that should be reflected in the size of the bonus payment made.

Year ahead data: The argument made by companies is that this is commercial-in-confidence information. The difficulty from a remuneration perspective is that it makes it difficult for shareholders to know whether the remuneration policy for the current year is appropriate and the targets rigorous. Engagement can fill some of this gap, but only for the chosen few institutional investors and, even then, it is unlikely the company will divulge the real targets.

Pay relativities. This might produce data that could be used by others via moral suasion to exercise restraint, but as noted above in question 12, it neither ensures nor guarantees that the remuneration committee will exercise restraint without some other lever that can pushed by shareholders.

Having to disclose in the remuneration report the relationship, in percentage terms, between the chief executive and the lowest paid employee/s (or some other carefully chosen representative of employees) requires the directors to firstly have that information and secondly, to report that to shareholders.

However, when the change desired is that these figures are taken into account in setting executive pay, not only do you need a different or additional rule[4] but also some disclosure of how the remuneration committee has reconciled the different information it has received.[5]

*** The regulated remuneration cycle**

The regulatory space for executive remuneration can be thought of as a cycle of four activities:

- *Remuneration practice*: the actual practices of firms and individual executives in relation to remuneration. Remuneration practice includes setting remuneration policy, writing the remuneration contract, execution of the contract (namely the executive performs and the company makes payments according to the contract), and termination of the contract;
- *Remuneration disclosure*: the disclosure of remuneration annually via the remuneration report together with ad hoc disclosures related to remuneration, such as share-transactions, margin loans, company loans;
- *Engagement on remuneration*: the engagement between the company and shareholders on remuneration, both proactive and reactive; and
- *Voting on remuneration*: the annual advisory vote on the remuneration report and any other remuneration-related resolutions.

It can be represented as the regulated remuneration cycle, shown below in **Figure 1**.

This figure explicitly illustrates two important aspects of the regulatory framework for executive remuneration. Firstly, there are four distinct activities in the remuneration cycle: practice, disclosure, engagement and voting. Secondly, a variety of organisations act as a regulator. There is an iterative process in the regulation of executive remuneration practice and thus the potential for evolution

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[4] For example, a Code Provision on how the remuneration committee should take pay in the wider group into consideration, combined with an 'if not, why not' disclosure obligation, not as currently found in the UK Corporate Governance Code as a supporting principle to the main principle on the level and components of remuneration found in D.1.

[5] Remuneration consultant data on executive pay in the comparator group of companies (which recommends paying more) and performance relativities within the company (which recommends, at best, no change).

in executive remuneration practice will be influenced by evolutions in the activities of disclosure, engagement and voting. Ideally, individual regulators will consider the other regulators, the whole cycle, and the time lags implicit within the cycle when making new rules or amending existing rules.[6]

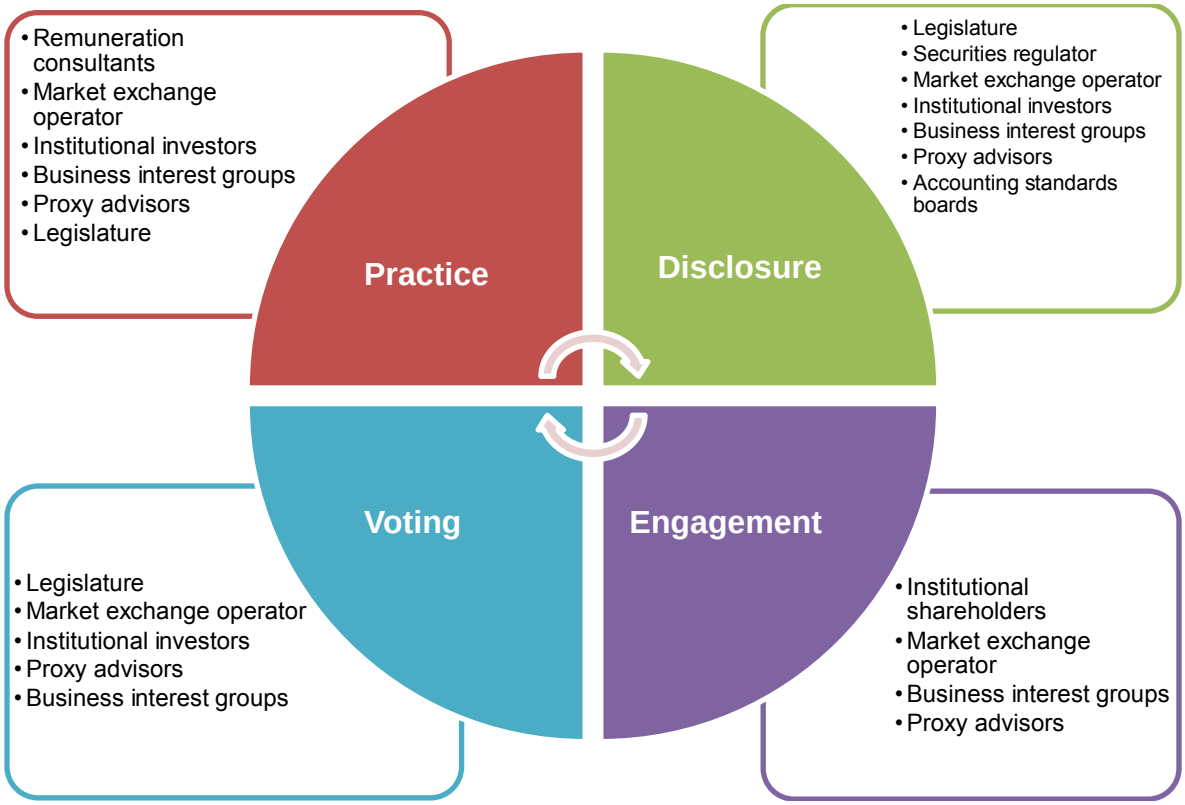

Figure 1: The regulated remuneration cycle

There are limits on the extent to which *legislation* can directly dictate *remuneration practice.* The list of 'regulators' attached to practice in Figure 1 includes the 'usual suspects' of the legislature and market exchange operator, as well as persons who are not traditionally regarded as 'regulators'. Legislatures have, to date, been persuaded that market mechanisms operate on executive remuneration practice and these should be left largely unhindered (Dine 2006, p. 82). In other words, governments should leave it up to 'the market' to regulate the social practice of executive remuneration with any formal regulation designed to ensure the efficiency of the market (Hill 1996, p. 233; Cheffins 1997, p. 211). Thus formal regulation by government is typically limited to disclosure initiatives and to prescribing voting rights which assign particular remuneration decisions to shareholders, such as the advisory vote on the remuneration report in the UK

[6] The time lags implicit in the cycle are those surrounding the company's ability to respond to evolving views of good practice.

and Australia which consists of legislation mandating *disclosure* via a remuneration report and an annual *vote* on that report.

Given limited government intervention in the area of remuneration practice, institutional investors are the primary regulators of good remuneration practices within listed companies.[7] The notion that shareholders 'regulate' executive remuneration may at first seem unsettling. Shareholders are, after all, participants in the company through share ownership. However they are not insiders in those large listed corporations that have a dispersed pattern of share ownership. Nor are they involved in making the primary decision on remuneration. This is a decision of the board of directors. Shareholders make rules in the form of practice guidance, about what a 'good' remuneration structure looks like. How they control the decisions of directors is through their engagement and voting activities. In doing so, they 'regulate' board conduct. The further notion that shareholders act in an enforcement role might appear to depart from more typical analyses of the relationship between shareholders and the company. John Armour notes that shareholder voting should not be thought of as 'governance' in this context, but as informal, private enforcement (Armour 2008).

The regulated remuneration cycle acknowledges that shareholders and boards deal with matters informally behind closed doors via engagement. Thus, the interpretations and negotiations of the remuneration practice rules can be thought of as regulatory 'conversations' (Black 2002). They can occur at the *micro-level* as conversations between a remuneration consultant and a remuneration committee, or a remuneration committee and an institutional investor; or at a more *formal level* as discussions about the formulation and reformulation of rules and policies. These regulatory conversations can involve a number of players both in one-on-one (remuneration committee and chief executive, remuneration committee and one shareholder) and in two- or three-way conversations (remuneration committee with remuneration consultants and chief executive and a number of institutional investors, proxy advisors and

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[7] While many writers view proxy advisors as driving the decisions of institutional investors (Larcker and Tayan 2010), their role may simply be boosting the *regulatory capacities of individual institutional shareholders* by providing resources such as information and expertise to facilitate shareholder actions to enforce their own guidance. As one well-known Australian proxy advisor says, 'We don't fire the bullets. We make them' (Chessell and Kitney 2010). My own interview research confirms that institutional investors are more likely to follow without question a recommendation to vote 'for' the remuneration report. A recommendation to vote 'against' the resolution will be flagged within the fund manager/ pension or superannuation fund (depending on who has the voting right per the terms of the mandate between the pension/superannuation fund), and the decision made internally.

perhaps even the media, if the firm's remuneration practices have attracted some notoriety).

Understanding the micro level at which much of the regulation of executive remuneration 'happens' is crucial to appreciating how executive remuneration decisions are regulated in practice. The quality of these micro-level regulatory conversations is therefore critical to the rules applied and hence the quality of the decision made. Poor conversations are likely to result in sub-optimal application where the principles, standards and guidance surrounding executive remuneration are narrowly interpreted as rules to be followed to the letter, irrespective of whether that practice is actually appropriate for the company, given its circumstances: the 'principles paradox' (Black 2008). Furthermore, that say on pay is acknowledged as leading to increased engagement (Gilshan and PIRC Ltd 2009, p. 14; Productivity Commission 2009, p. 385) does not mean better decisions are being made by boards of directors and their remuneration committees.

Regulatory conversations between parties to interpret what 'good' remuneration looks like are sources of ongoing rule-making not only to keep up with current practice but to regulate emerging practices. There is an iterative process of market practice, firm practices and statements of good practice that functions as an observational schema (Seidl 2007 pp. 711-715, 721). Companies watch how the market responds to practices in other companies before adopting the same practice. When the market response to a new practice is positive (a good outcome on the advisory vote), other companies adopt this practice and report that they have done so. This, in turn, encourages further companies to consider adopting the practice. However, by the time 'the follower' companies consider the practice, the statement of good practice has evolved further. **Figure 2** below illustrates this process for statements of good remuneration practice.

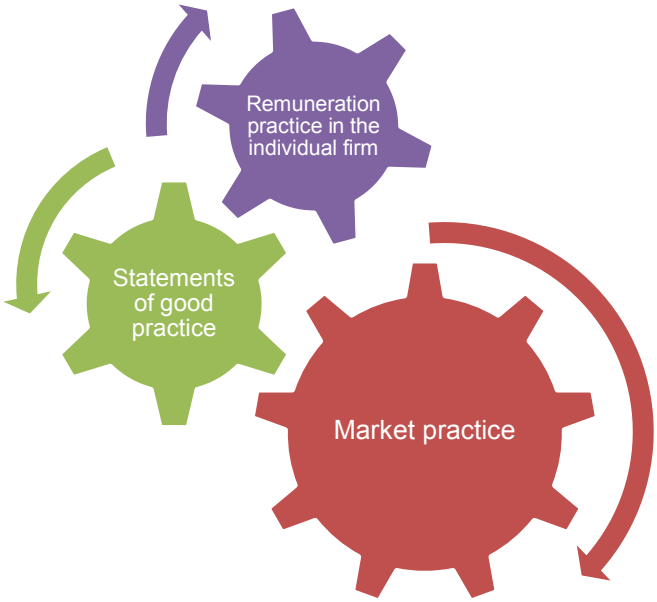

Figure 2: Iterative rule making (Sheehan 2010, p. 66).

It is unclear who is leading the development of good practice: particular firms acting on advice from their remuneration consultants or institutional investors enforcing their own guidance? The criteria by which these practices are deemed to be 'best' or 'good' are also unclear as they are not specified in the statements of practice issued by these investors. Human resource theories would argue the best practice for the individual firm is the one which will deliver the desired performance for that firm. In other words, 'best' is highly context specific. The regulatory conversations that interpret 'best' are an important feature of the regulatory framework for executive remuneration.

The information sources for the remuneration committee

Based on my research of remuneration practices in the UK and Australia, two 'say on pay' countries, the remuneration committee is challenged by the concept of strict independence from management, because it firstly relies on management for company information; and secondly, many directors believe it is the chief executive who should be setting remuneration policy, not the remuneration committee. This is because it is the chief executive who has the day-to-day management of the company, and remuneration can be deployed to achieve the company's strategic goals. These information sources are set out below in **Figure 3**.

Advisor	External	Internal	General information	Specific information
Remuneration consultants	✓		Market updates Trends One-on-one education of directors	Benchmarking of executives' remuneration Comparator group Salary recommendations Long term incentive schemes – vehicles, valuations Scenario modelling
Lawyers	✓		Legal updates, including bills, legislation and recent cases from the courts	Advice on contracts Tax structuring Share plan terms Terminations Advice on disclosures
Accountants	✓		Updates on tax and trends in reporting	Advice on tax structuring Advice on disclosure, reporting and valuations Advice on actual performance measures (calculation of TSR performance)
Actuaries	✓			Superannuation and pension modelling Modelling for share plans (eg binomial, Black Scholes)
Analysts/ stock brokers	✓		Market information	Reports on company's prospects (EPS forecasts, profit targets) to inform company's selection of STI targets
CEO		✓	Routine briefings on company matters	Strategy proposals Remuneration proposals for direct reports Reports on delivery against targets Performance appraisals of direct reports (to inform succession planning)
CFO		✓	Routine briefings on company matters Financial reports	Budgets Forecasts Performance against budget
HR Manager		✓	Routine briefings on human resource matters Updates on company policies and procedures	Executive remuneration policy proposals Information on current remuneration arrangements Advice on company procedures Advice on broader remuneration arrangements Performance management information
Company Secretary		✓	General information on meeting procedures and committee procedures	Continuous disclosure Director share dealings Notices of meeting and accompanying documents Proxy voting forms Proxy voting records (48 hour deadline) Meeting procedures

Figure 3: The Remuneration Committee's Information Sources (Sheehan, 2010, p 211).

The Enforcement Pyramid for Remuneration Practice

Enforcement in this regulatory space represented by the regulated remuneration cycle relies upon something other than legal sanction alone. Influencing board behaviour are market exchange operators and institutional shareholders in writing rules about remuneration process and practices. If those with the greatest incentives to monitor and detect breaches of the rules are the preferred enforcers (Stigler 1975, p. 176), then ultimately shareholders alone enforce these rules.

The enforcement pyramid devised by Ayres and Braithwaite in which a regulator has an array of mechanisms that can be deployed to achieve compliance or enforcement (Ayres and Braithwaite 1992) must be modified to explain the regulatory space for executive remuneration. It is, however, a useful tool to compare the variety of mechanisms that may be used in encouraging responsive regulation; that is enforcement that responds to the level of compliance or non-compliance exhibited by the regulatee. The advantage of the enforcement pyramid analysis[8] is that it emphasises 'a dialogic regulatory culture' (Gunningham 1998, p. 396) in which conversations between the regulator and the regulatee are pivotal. It is this aspect which makes this model particularly pertinent to an analysis of the regulation of executive remuneration because, as noted above, engagement is an important feature of how say on pay works within the regulated remuneration cycle.

In the regulatory space of executive remuneration there are a number of regulators each with different enforcement capacities that might lie at different points on Ayres and Braithwaite's enforcement pyramid. In other words, few regulators in the regulated remuneration cycle have a range of enforcement options. This lack of enforcement options, in particular, the lack of a 'peak' that sufficiently deters the remuneration committee from making poor remuneration decisions, may be an inherent weakness in the regulation of executive remuneration.

However, realising that shareholders reward or punish directors in a relationship without a planned ending means that both parties mutually benefit from co-operation (Meidinger 1987, p. 366). That is what 'say on pay' is trying to achieve by using an advisory only vote on the remuneration report: a public signal that the board is being unresponsive.

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[8] Of course, there are critiques of responsive regulation: see Baldwin and Black 2008), pp. 62-64. They note that some of these concerns can be addressed by Gunningham's adaptation of this model: 65.

If the overarching goal of regulating executive remuneration is improved remuneration practices, understanding how this is enforced within the regulated remuneration cycle reveals the heavy burden placed upon shareholders.

Figure 4 below illustrates the enforcement pyramid for executive remuneration practice. The enforcement strategies shown do not belong to any one regulator of remuneration practice. The main enforcers of good remuneration practice are shareholders, through their engagement with companies who undertake to change their remuneration practices and through voting. The media too has a role to play here in drawing attention to particular companies whose remuneration practices are likely to attract shareholder wrath.[9] Regulators have limited scope to take action in relation to actual remuneration practices, although they play a part in enforcing compliance with the mandatory rules for disclosure and voting.

The only legal sanctions that will prevent a particular practice occurring are those associated with termination payments or disguised returns of capital,[10] related party transactions[11] or approval of an employee incentive scheme[12] which require prior shareholder approval on a resolution that is binding on the company/ board. The top enforcement option shown in the pyramid will require the executive director to return a payment/s received in breach of some, but not all, of these particular resolution rules.[13] Should a company pay excessive remuneration, the available enforcement options lie towards the middle to lower end of the pyramid: engagement, publicity and advisory voting. The *legal sanctions* for errant remuneration practices are thus very limited.

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[9] Core, Guay and Larcker (2008, p. 23), suggest excess remuneration and poor company performance are likely to motivate negative media coverage of the CEO's compensation in the USA, although their regression studies did not find that this coverage had an impact on subsequent remuneration.

[10] *Companies Act 2006* (UK) c 46, ss 217-219, noting the exceptions in ss 220-221. On disguised returns of capital, *Companies Act 2006* (UK) c 46 ss 847(2),(3).

[11] *Companies Act 2006* (UK) c 46, ss 197(1), 198(1), 200(2), 201(2) and 203(1).

[12] FSA Handbook, *Listing Rules*, LR 9.4.1(2)R.

[13] *Companies Act 2006* (UK) c 46, ss 213(3), (4) arising from breach of s 197(1), 198(1), s200(2). S 201(2) and s 203(1); ss 222(1)-(5).

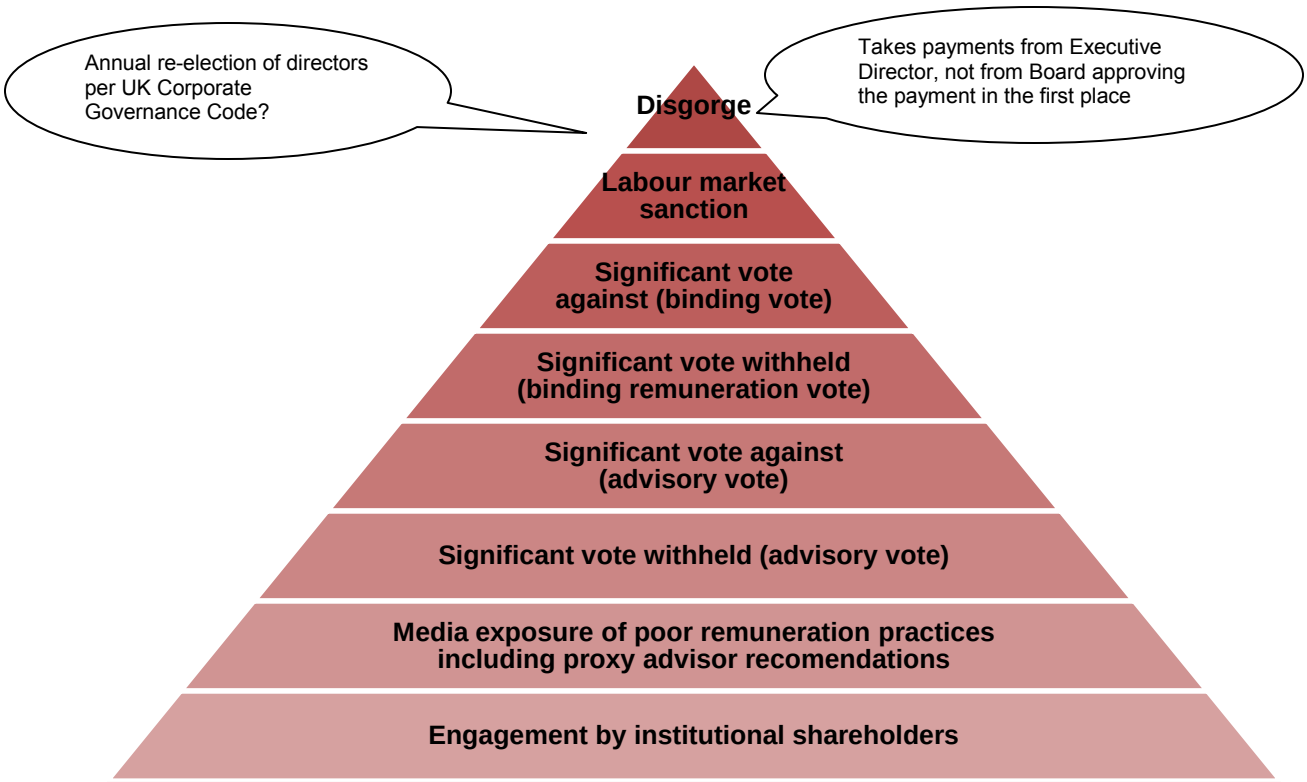

Figure 4: The enforcement pyramid for executive remuneration practice (Sheehan 2010, p. 104).

The change to annual re-election of directors could be used by shareholders to provide an incentive for members of the remuneration committee to be responsive to shareholders' concerns on remuneration. However, as noted earlier in this consultation response, institutional shareholders are not typically concerned about the quantum of remuneration when company performance is good, and are only able to detect high levels of remuneration for bonus payments and termination payments, both of which have usually be paid by the company at the time of disclosure in the remuneration report. Any votes cast do not prevent the payment being made. It remains to be seen whether annual re-election presents a credible threat that directors respond to in their decision-making.

For some in the wider community, even strong company performance does not justify the levels of remuneration received by executives in FTSE 100 companies. It is not clear that government can, by legislation, directly address this impasse.

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