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
La	wyer or accountant
✓	Other (e.g. consultant or private individual)

Opening comments

Hay Group is a management consultancy which – amongst other activities – gives advice to remuneration committees and/or executive management on senior executive remuneration.

We have limited our comments to areas where we have professional expertise, primarily in the area of director remuneration.

The Board of Directors

Question 1: Do UK boards have a long-term focus – if not, why not?

Comments

Our experience of working with boards and executives on the issue of remuneration indicates that their focus in this area is not always long term. We have seen that remuneration is greatly weighted towards short term targets. This could be symptomatic of a wider short-termism, partly driven by:

- **short term investors (the average shareholding period in the UK has reduced from a couple of years in the 1980s to 7 months in 2010)**
- **increasing investor focus on short-term financial performance.**

Question 2: Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

Comments

No comment on this question

Shareholders and their role in equity markets

Question 3: What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

Comments
As the percentage ownership of UK plcs by UK based funds (life insurers and pension funds) has fallen, the views of actual shareholders (as opposed to trade bodies and proxy voting agencies) have become ever more diverse. **However, the tendency of some non-UK funds to automatically follow the advice of proxy voting agencies has frustrated a number of our clients who wish to engage directly with their shareholders. If this trend continues, it could risk undermining the 'comply or explain' principle.**

Question 4: What are the most effective forms of engagement?

Comments
Our experience in the area of executive remuneration shows that direct dialogue between companies and actual shareholders can be a powerful basis for engagement. **Less effective are:** • **investor attempts to outsource engagement to third-parties or their governance departments (without active involvement from investment teams)** • **attempts to engage with a large number of investee companies without having the necessary resources or a deep enough understanding of each business.**

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

Comments
Some investors claim that fund management and corporate governance teams are joined up in their institutions. Whilst this might be true in some instances, our experience suggests it is not always how it appears to companies engaged in shareholder consultations around remuneration issues: we are aware of companies who have discussed and received positive comments on their proposals from fund managers only to then receive a vote against by the proxy voting team when the proposals are tabled at the AGM. **That said, it appears to us that organisations with strong Boards who have won the trust of fund managers are sometimes given more 'rope' by the governance community, which may imply a degree of joined-up thinking in investor firms.**

Question 6: **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
The main benefit of voting transparency is that it allows policyholders and unit-holders to see how 'their' shares have been voted. **The main cost is that fund managers may feel reluctant to support something they agree with if they perceive that to do so may court controversy.**

Question 7: **Is short-termism in equity markets a problem and, if so, how should it be addressed?**

Comments

No comment on this question

<u>Question 8</u>: What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?

Comments
No comment on this question

<u>Question 9</u>: Are there agency problems in the investment chain and, if so, how should they be addressed?

Comments
We see a degree of misalignment between the interests of institutional investors and their clients. **In general, institutional investor firms win more business and their managers are paid more when they outperform their peers for a given level of risk. As such, their focus is often on relative rather than absolute performance. To some degree this is misaligned to the interests of the pension scheme members and life insurance company policyholders whose funds are being managed and who – as a rule – are more interested in absolute returns, for a given level of risk, than in relative performance.** **This focus on relative performance can be seen in our own field of executive remuneration. Institutional investors prefer rewards for executives in investee firms to be based on relative rather than absolute share price performance, even in firms which are not mature and cyclical.**

By contrast, in the private equity field the long term remuneration of both the PE firms themselves and the executives of investee firms tends to be based on absolute performance.

This presents a problem for Remuneration Committees and managers who should focus on the absolute return they can generate from shareholders' capital rather than return relative to other companies.

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

Comments
We believe greater transparency would make it easier for individuals and corporate bodies seeking to find the right fund manager. This transparency would also enhance the dialogue between fund managers and investee companies. Finally, such transparency would remove the current concern of investee companies that the pay standards fund managers expect of them do not apply within the fund management companies themselves. **Our concern is that the regulations would almost certainly become heavy handed, leading to long, complex and expensive disclosures. Such disclosures would risk baffling the non-specialist reader and/or lead to long, meaningless 'boiler plate' text. Both these outcomes have arisen in respect of the remuneration disclosures required from listed companies.**

Directors' Remuneration

Question 11 : What are the main reasons for the i ncrease in di rectors' remuneration? Are these appropriate?

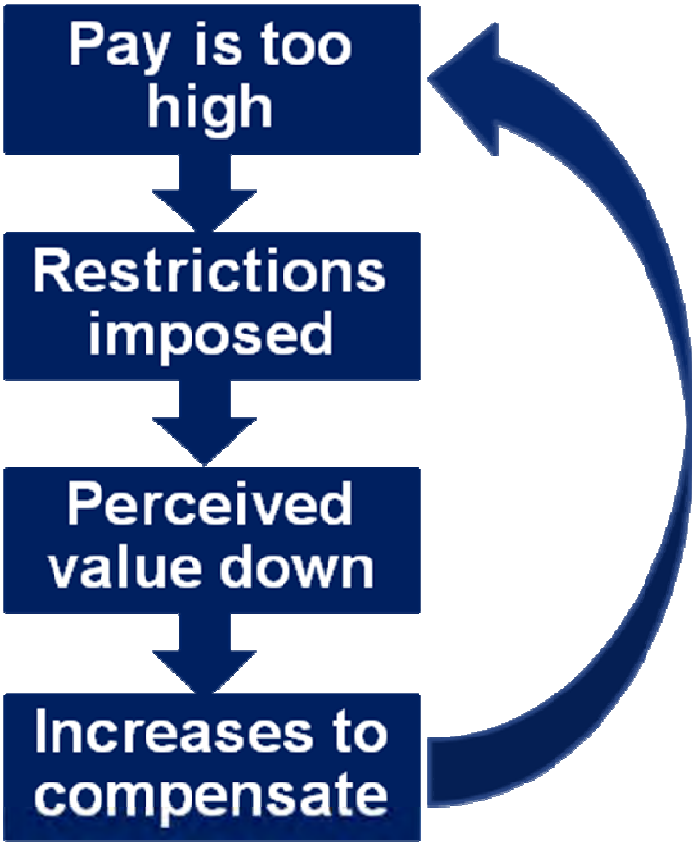
Comments
We see the reasons for executive pay growth as follows. ***Benchmarking.*** **There is no doubt that market benchmarking has contributed to the growth in executive pay. However, we do not think the very large increases that have occurred over the last 10 years or so can be explained by benchmarking alone (which has been around for considerably longer). We would also note that companies that do not benchmark pay tend – on average – to pay more than those who carry out sophisticated benchmarking.**

Disclosure. **Pay transparency has undoubtedly made senior executives more aware of what their peers earn which in turn has put pressure on remuneration committees to increase pay. However, we would note that:**

- **elsewhere in Europe, countries where remuneration disclosure is limited (e.g. Russia) or has been limited in the past (e.g. Switzerland) are often among the highest payers – the same is true in firms and industries within the UK where there is no pay transparency (e.g. hedge funds)**
- **pay disclosure often provides an incentive for Remuneration Committees to take action on hard-to-justify pay arrangements (for example the recent reduction in the provision of executive perquisites in the US followed new disclosure requirements)**
- **the same transparency gives non-executive directors the ammunition to make an informed response to executives whose claims to be behind the market are based on selective or inappropriate comparisons.**

Governance 1. **Until the recession, the governance community had an explicit focus on pay design rather than pay quantum. It also used to consider pay on an element-by-element basis rather than reviewing the package as a whole. Today there is far more focus on the absolute level of total pay.**

Governance 2. **The formal and informal guidance produced by the Association of British Insurers, the National Association of Pension Funds and other parts of the governance community has – to some extent – had unintended consequences. The requirements to make incentive pay more long term and to ensure that share plans have stretching performance conditions has reduced the perceived value of incentive plans. At least part of the significant growth in pay between 1997 and 2007 was implicit 'compensation' for this, as illustrated in the diagram below.**



Pay dysfunction. **The tendency of remuneration committees to follow 'market practice' and investor guidance has led to a situation where the pay of executives is often imperfectly aligned to business strategy (and to the legitimate preferences of the executives themselves). If pay had been better aligned to business strategy, we believe that this would have mitigated some of the significant growth in pay between 1997 and 2007.**

Consultancies. **We believe that some practitioners in our own industry have contributed to pay growth. Endorsing pay restraint is not always in the adviser's commercial interests and last year we lost a client in part because our recommendations fell short of the CEO's own pay expectations.**

We also see three other possible causes of executive pay growth, though to our knowledge comprehensive hard evidence for these is limited.

Corporate restructuring. **As companies have sought leaner operating models they have systematically stripped out tiers of management from their organisation. This has left the management in situ with more responsibility and accountability than was the case prior to**

restructuring. This additional responsibility and accountability needs to be paid for and as a consequence senior management pay has increased although overall costs should have come down.

Real and perceived talent shortages. **Both real and perceived talent shortages – in particular at the levels of management one or two levels below the Board – reflecting the demographic change in our population, has led to pay inflation at these levels as companies compete for talent. This pay inflation has lifted pay levels at the levels above – i.e. executive directors – as companies seek to maintain a gap in pay between the executive directors and talent below them.**

The importance of human capital/the superstar CEO. **Once companies have chosen their strategy, made their operations as efficient as possible and ensured their finance is as efficient as possible, the only remaining source of competitive advantage is the quality and capability of their leadership and employees. Consequently companies will/should seek out the best talent – who invariably command a premium. The cost of a more expensive executive is negligible compared to that of the organisation's entire cost base and so the investment is considered worthwhile by Remuneration Committees. Companies who do not pay or aim to pay at a minimum of market rate are effectively sending a signal to the market that they do not have the best possible talent in place to run the organisation – arguably a sell signal.**

It is the combination and co-incidence of all the factors above which has, in our view, led to executive pay growth. However, the most significant of these is 'pay dysfunction' - the tendency of remuneration committees to automatically follow 'market practice' and investor guidance.

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

Comments
One of the key problems with remuneration committees is that their members lack expertise in remuneration design. By contrast, most other Board activities and committees (e.g. audit, nomination, risk) are a better fit with the experience non executives have gained from their current or previous full time roles. **As a result, committees often focus on the market and compliance (i.e. with actual or perceived investor requirements) rather than on designing pay arrangements that are fit-for-purpose. This has led to stagnation**

and – in too many cases – a situation where remuneration packages don't satisfy any set of stakeholders.

This implies that there may be value in adding members who have HR and reward experience but who perhaps lack the all-round business experience perceived to be required for a full non executive role in a listed company. We have a large but non-listed client which has recently engaged a retired reward consultant in this role and – on the evidence of his first few months – he is adding value to the process.

Employee representation has – in principle – some advantages. In particular, it would lead to the 'reasonable man in the street test' becoming part of the remuneration landscape. However there is a significant risk that such representation would become politicised in some companies and thereby increase tensions in what is already a "difficult" committee. Moreover, there is no evidence that executive pay is lower in other European countries where employee representation is common. We therefore do not believe that such an approach should be mandatory although it might be encouraged.

Question 13: 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 have been effective in enforcing compliance in their key areas of focus. Their impact has been far wider than the evidence of 'no' votes might suggest, since controversial proposals are often modified or abandoned long before any formal vote. Shareholders have made a particularly positive contribution to the reduction in contract terms (golden parachutes) – see below. **On the negative side, shareholders tended – until recently – to focus on compliance rather than effectiveness.** **However, we believe that investors have 'upped their game' in the last two years. They are now more sophisticated in considering the pay package as a whole, in encouraging pay that is fit-for-purpose rather than just market-typical and in tracking pay quantum as well as design.** **We have a concern about investors that automatically follow advice from proxy voting agencies, which has made it difficult for companies to provide bespoke rather than market-driven pay. The business model employed by most proxy voting agencies requires the use of bright but inexperienced analysts who follow a check-list, which makes it hard to**

assess new or unusual pay designs. The same model makes it difficult for these analysts to develop a deep business knowledge of the companies whose pay designs they are assessing, therefore resorting to 'market practice' as the de facto reference point.

We do not believe that it would be helpful to expand voting on remuneration issues. On the specific issue of termination payments, these are now lower (as a percentage of salary) than in the past or than in many other countries. (It should be remembered that 10-15 years ago three year contracts were the norm.) Whilst lower payments might be desirable in principle, in practice this would be hard for remuneration committees to achieve. This is because:

- **employment legislation and the need to manage the Company's reputation make it difficult to dismiss an executive unilaterally for poor performance**
- **at the time of exit, the Company generally wishes to avoid any legal problems that would be an unwelcome distraction and could lead to revelations that might damage its reputation**
- **at the time of appointment the new executive is in a strong negotiating position.**

<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

We have a general concern about further regulation in the area of disclosure. At present, disclosures are long and complex and further regulation would risk making this worse. Our comments on the specific questions raised above are as follows.

***Linkage between pay and meeting corporate objectives.* We believe that most companies are very poor at explaining these links. This is partly because the Directors' Remuneration Report is treated as a technical 'disclosure' document prepared by HR and legal specialists and which therefore, does not join-up with the rest of the annual report.**

More significantly, we would also note that many companies' incentive plans are not particularly well aligned to their own, unique corporate objectives, instead following market-typical models which may not be

suitable.

Finally, we have carried out research into annual bonus performance criteria to assess their link to shareholder returns. When looking at the FTSE All Share Index, we found that most of one year, backward-looking financial measures used in company bonus plans have little to no correlation to long term shareholder returns.

Performance criteria for annual bonus schemes. **Most companies are far too vague about disclosing performance criteria. Whilst disclosing the targets themselves would raise confidentiality and other issues, there is no reason why all or most of the metrics used should not be disclosed since these ought to align to the strategy and objectives set out elsewhere in the Annual Report.**

Having said all the above, there is a problem with disclosing more about the annual bonus. The problem occurs when payments are based in part on qualitative and lead indicators rather than purely on lagging financial metrics and where disclosing poor performance may cause problems for the company. (For example, a Company might be reluctant to disclose that the CFO did not receive the "leadership/behavioural" element of his/her bonus).

Relationship between directors' pay and employees' pay. **We believe that it is important for Remuneration Committees to ensure that the relationship between directors' pay and employees' pay is appropriate and defensible. We do not endorse the publication of ratios between top pay and that of the average or lowest paid worker as these are distorted by: 1) company size (larger companies have bigger ratios); 2) sector (employee pay is inevitably higher in sectors that employ highly skilled workers); and 3) by business shape including the extent to which the business operates in developing markets, uses outsourcing etc. We would also note that our research finds no statistically valid correlation between the pay ratio (highest to average) and company performance, even when adjusting for sector.**

Takeovers

<u>Question 15</u>: Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

Comments

No comment on this question

<u>Question 16</u>: Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

Comments
No comment on this question

<u>Question 17:</u> Do you have any further comments on issues related to this consultation?

Comments
We have three main concerns about our own field of executive remuneration, as follows. ***Fit-for-purpose pay.*** **We believe that too many companies have blindly copied one another instead of designing fit-for-purpose pay arrangements. However, this problem is starting to be fixed by the market as: 1) Remuneration Committees try to achieve better value for money from pay by better design and 2) institutional investors require business-based rather than market-based justifications for changes to executive pay.** ***Long term remuneration.*** **We believe that the pay of executive directors (including CEOs) is too closely aligned to annual, backward-looking financial measures of performance at the expense of long-term value creation. Backward-looking financial performance is – in many companies – significantly influenced by cyclical and other external factors and the metrics used are often poorly aligned to long term value. We would prefer to see pay more strongly linked to long term value creation and to effective execution of strategy.**

Absolute performance. **We believe that alignment to ultimate investors (i.e. pension fund members, life insurance policyholders etc.) has diminished. Long term executive pay tends to be linked to relative performance and/or for three year earnings growth and is quite insensitive to absolute share price growth. Rather, payment is in full value shares which retain value even when the share price falls significantly. (Although the executive receives less when the share price falls, this is an opportunity rather than a real cost as the shares are free).**

We see the above problem as more serious than pay growth. Investors are currently being very effective in holding down pay increases. (The '55% increase' recently reported by Incomes Data Services was extremely misleading).

However, whilst we have concerns, our long and international experience tells us that regulatory and other interventions in executive pay often leads to dysfunctional outcomes – this is occurring in financial services at the present time. Another example is the attempt in the United States to curb executive pay by limiting the deductibility of salaries to $1 million, which was introduced as a measure in 1993. This led to significant increases in CEO salaries below that limit, as the $1 million was seen as an aspirational and acceptable target rather than an absolute limit. It also led to a portion of essentially fixed compensation being transferred to bonus payments that paid out regardless of performance as a way of evading the limit.

We therefore believe that – despite the problems that currently exist – direct government intervention would risk making things worse.