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Executive remuneration discussion paper: summary of responses

Introduction

There has been a lot of discussion recently about the growth in executive pay. Median total remuneration of FTSE100 CEOs rose from an average of £1m to £4.2m for the period 2008-10. This is more than a fourfold increase; significantly greater than the increase in the FTSE100 index, retail prices or average pay over the same period. This comes at a time where growth is strained across the rest of the economy.

In 2010 the Department for Business published A Long-Term Focus for Corporate Britain\(^1\), which, among other questions, asked why executive remuneration in our largest companies has increased so dramatically whilst the returns made for shareholders and average pay have grown at a much slower rate. The responses showed that the perceived failure to link pay to performance has important implications, both for companies and their shareholders and for wider public confidence in the business environment. Shareholders and institutional investors, business leaders, remuneration consultants and chairmen of remuneration committees have made it clear that this is unsustainable and have called for action. In September 2011 the department published the Executive Pay Discussion Paper\(^2\).

Building on the Long Term Focus paper, the existing body of research on executive remuneration and conversations with a range of stakeholders, the discussion paper put forward a variety of measures to promote a clearer and stronger link between executive remuneration and company performance and empower shareholders to hold companies to account.

At the same time as publishing the discussion paper on pay the department published a consultation paper\(^3\) setting out a simplified model for company annual reports. This proposed changes to the way information about remuneration is disclosed. The discussion paper on pay looked more broadly at how remuneration is structured and the role of remuneration committees and shareholders in the process of setting pay. This sets out a summary of responses we received to the discussion paper. Ministers and officials have also been meeting a wide range of stakeholders in the last six months to hear their views on these issues directly.

164 responses were received to the discussion paper. A full list of those who responded can be found at annex A. The following chart below shows a breakdown by type.

\(^1\) This can be found at: http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

\(^2\) The discussion paper can be found at: http://www.bis.gov.uk/Consultations/executive-remuneration-discussion-paper

\(^3\) This can be found at http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation
Responses to consultation

- Company: 38%
- Investor or investment manager: 25%
- Business representative organisation: 11%
- Investor representative organisation: 10%
- Non government organisation: 8%
- Trade Union: 5%
- Lawyer/ Accountant: 5%
- Other (i.e. Consultant or private individual): 2%
Overall themes arising from responses

Overall respondees agreed that the current remuneration landscape needed to be improved, but views were mixed on the best way of achieving this. This included some scepticism that more regulation was needed when greater clarity and good shareholder and company practice would be most effective.

Clarity

There was general support for increasing the clarity about how decisions are made on pay. Many people supported making the link between pay and performance clearer. Over half of respondees agreed that remuneration packages should be simplified, possibly through share incentive schemes but particularly by simplifying the structure of remuneration and perhaps reducing the number of schemes or the frequency with which they are reviewed. A majority also felt there should be more transparency about the role of remuneration consultants.

Shareholder or employee engagement

Respondees supported encouraging more engagement, but were mixed about how this should be achieved. Although a majority were against a binding vote on the remuneration report as it is currently structured, some of those who opposed the vote pointed out that a binding vote on the future looking element of the report would be more practical. Many felt that a shareholder vote on contractual terms is the best way to prevent payments for failure.

Remuneration Committees

A majority opposed having shareholders or employees on the remuneration committee. They felt it was important that the committee was made up of board members, with the breadth of knowledge and company overview that this would bring, and that going against this would be going against a central tenet of corporate governance. Several responses pointed out that there is already a great deal of guidance on how the committee should operate.

Although respondees supported the notion of a diverse remuneration committee, most felt that the way to achieve this was through a diverse board.
Summaries of Responses

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?**

At the moment shareholders have an advisory vote on the annual directors’ remuneration report (DRR). This report considers information about remuneration that has already been paid, and information about future remuneration and remuneration policy. Remuneration reports have failed to receive the support of a majority of shareholders in only a handful of cases since this advisory vote was introduced 9 years ago. Given the accelerating growth in pay, some have suggested that this advisory vote has had little impact.

Around two thirds of those who responded were against introducing a binding vote, and just over a fifth supported the proposal. Most of those who opposed the proposal represented larger companies (who were almost unanimously against it), investors or business. Some investor or business representatives did support it, but individuals, NGOs and Trades Unions gave the proposal the most support.

Many who opposed the binding vote felt that shareholders already had the necessary tools to show dissatisfaction, including the advisory vote and the annual re-election of directors. The British Banker’s Association said that although a majority of shareholders don’t vote against the report very often, a vote of only 75 percent for the report can have “a powerful impact on the way companies have behaved”.

Many of those who opposed the vote said it would be impractical to vote on pay already received (tax would have been paid, and recouping the money would be difficult without claw-back provisions). It was also unclear what would happen after a no vote – would there be repeated votes until there was agreement? Some of those who opposed it pointed out that it would be more appropriate to vote only on the future element of the report.

Those in favour of a binding vote said that there should be more consultation with shareholders on all aspects of remuneration policy but were aware that it was important to ensure the costs of this did not create an unreasonable burden.

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

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 Corporate Governance Code, companies are advised to adopt one
year contracts for directors. However, there are still a number of high profile cases where directors have left failing companies with large exit packages.

Over a third of those who responded said there are further measures that could be taken to avoid payments for failure, while a quarter thought there were not. The most popular suggestion from those who felt that further measures should be taken was that there should be upfront shareholder approval of the contractual terms for executive directors when they are hired. Generally respondents felt that there should be greater transparency about directors’ contracts. There was also support for more disclosure about bonus schemes, vesting periods and exit payments.

A significant number said that it would be useful for shareholders to vote on termination payments, particularly if these related to pay of more than one year’s salary, although there would be practical difficulties in implementing this. There was strong support for the deferral of incentive payments until the performance measures used to grant those payments had been proven.

Around a quarter of respondees indicated that there was no need for further government involvement in regard to payments for failure. One company said that “I do not believe that the unfortunate actions of a few errant companies should lead to broad-brush measures to prevent ‘payments for failure’”.

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

The nominations committee makes recommendations to the board for board appointments. The Corporate Governance Code requires committees to have a majority of non-executive directors. Some have suggested that one or more shareholder representatives should sit on the nominations committee.

Over half of those who responded said that there were no advantages to having shareholder representation on nominations committees. Around a tenth indicated that they felt there were advantages to including them.

Advantages put forward were that it would foster closer working relationships between shareholders and the management of companies and that it would improve the scrutiny of appointments.

However, over half of respondents indicated that directors, appointed by shareholders, are best placed to make decisions and should be responsible for nominations. One investor representative organisation said that the “most important objection is that it would undermine the unitary board”. One company pointed out that “shareholders currently influence board membership through the election of non-executive directors”. Over a quarter of those who responded felt there it would be difficult to find a person to represent shareholders, given the international and diverse make-up of shareholders and the time the role might take-up.
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?

The remuneration committee oversees the design of remuneration packages for directors and senior management and oversees the appointment of remuneration consultants. Depending on the size of the company, the committee should be made up of at least two or three independent non-executive directors.

Just under half of those who responded said that there would be no benefits from having independent remuneration committee members from a more diverse range of professional backgrounds. A third said that there would be benefits from this. They said this would help challenge the status quo.

Some said that the focus should not be on diversity of the committee, but of the board itself, which would automatically lead to a more diverse committee. Many said that it was not clear how independent advisers to the committee would improve decision-making if they were not privy to wider discussions about company strategy as would be the case with full board members.

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

It is common for individual directors to have a role in several companies, either in a non-executive or executive capacity. There is potential for this cross-pollination of directorships to create a conflict of interest, for instance where an executive is involved in setting the pay of someone who, in another company, may have a role in setting theirs.

Half of those who responded did not feel there was a need for stronger guidance to prevent conflicts of interest. However around a quarter indicated that there was a need for stronger guidance.

Just over a quarter said there was little evidence that executives are involved in cross directorships. One company said “we have not seen any evidence of [this] type of conflict”. An investor representative organisation said that “in practice, the incidence of such [conflicts] is extremely low”. Around a quarter of people indicated that directors are required to avoid such conflicts of interest through the Companies Act 2006. A similar proportion indicated that the UK Corporate Governance Code provides enough guidance on this.

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?

Around two thirds of those who responded said that they did not think there would be benefits in having employee representatives on remuneration committees. One sixth said that such representation would be beneficial.

Those who supported it suggested that employees could bring useful insight and that they have an interest in the long-term success of the organisation, as their career is linked to the success of the company.

But around a third of those who made submissions indicated that members of the remuneration committee need to be full board members to be aware of the overall strategy of the company. One said that “executive remuneration demands deep understanding of the broader business issues and the economic context that the business is operating in over a long period”. Some said there may be a conflict of interest, and others said it might undermine the status of the unitary board. It might also be difficult to find an employee representative that would be truly representative of the interests of the whole workforce, particularly in companies with a large workforce spread over different countries. It may also be difficult to find a willing representative since one company suggested that “it is well established in business that going against those further up the chain of command will make any thoughts of progression […] evaporate instantly”.

A small proportion indicated that there was little need for employee representatives on remuneration committees as the UK Corporate Governance Code requires remuneration committees to be sensitive to the pay and employee conditions throughout the whole of the company.

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

Some have suggested that giving employees a right to vote on executive remuneration proposals before shareholders do would be a simple way of getting employee input to the remuneration process.

The majority of respondents considered that the benefits of an employee vote on executive pay would be outweighed by the costs. Many of them said it was not clear what the benefits of an employee vote would be. Around a tenth felt the opposite. One response said that “a FTSE 100 company with several hundred thousand employees in dozens of locations could incur significant costs”. Another said that “the costs are difficult to assess accurately but the provision of training and awareness on the wider issues to enable employees to make a judgement would be time consuming and costly”.

A small proportion pointed out that in many organisations employees already have a vote because they are a member of share schemes, allowing them to have a voice as shareholders in the company.
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?

Almost all remuneration committees of large companies use 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.

Over half of respondents said that greater transparency over the use of remuneration consultants would be beneficial. Just over a quarter felt that there was no need for greater transparency.

Around a quarter of respondents felt that there should be greater disclosure about how remuneration consultants are appointed, what advice they give, fees paid to them and how any conflicts of interests are managed. A few suggested that there should be disclosure confirming the independence of consultants.

Around a fifth were supportive of the Remuneration Consultants Group Code of Conduct used in the financial sector, with some suggesting that consultants should indicate whether they agreed with and worked within the Code of Conduct.

A few suggested that remuneration consultants should be appointed by shareholders in the same way that auditors are, but on the recommendation of the remuneration committee. Furthermore, some suggested that shareholders should be able to see advice provided by remuneration consultants if they wish.

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

The Corporate Governance Code requires a significant proportion of executive directors’ remuneration to be linked to performance. In the past companies have typically used total shareholder return (TSR) and earnings per share (EPS) as performance measures. We have been told that this is unhelpful\(^4\) not least because

\(^4\) 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](http://www.bis.gov.uk/assets/biscore/business-law/docs/s/11-797-summary-responses-long-term-focus-corporate-britain.pdf)
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\(^5\).

Two thirds of responses agreed that the link between pay and performance could be strengthened by moving away from TSR and EPS as measures of performance.

Around a fifth of respondents said these measures do not align executives with the long-term interests of shareholders. A smaller proportion suggested that other financial measures such as cash flow could be used. One individual said that TSR and EPS are used “because of the strong support for these measures by some major institutional shareholders and institutional shareholder bodies, and not because individual companies think that such measures are necessarily good ideas”.

Many felt that remuneration committees need the flexibility to pick measures that were right for the company. They should also be flexible, so companies could change them when they needed to. This means that they should not be fixed by law. A small proportion said there was no need for further legislation in this area.

However, around a fifth supported TSR and EPS as satisfactory measures given their long-term nature and that they are broadly understood. Several felt that companies could be more transparent in explaining which performance measures they use. A small proportion said that it was more important that each company had the right measures in place for them, than that all companies used the same comparable measures.

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

Directors’ pay is often deferred, to encourage directors to work for the long-term success of a company. The Corporate Governance Code suggests a three year minimum vesting period. The proportion of pay that is deferred has increased, but most companies use the minimum period of three years.

Around two fifths agreed that vesting periods should be longer than three years. On the other hand, a similar proportion felt that the type of company should determine the period. For example, it might make sense to have longer vesting periods for pharmaceutical companies and shorter vesting periods for retail businesses.

A slightly smaller proportion, just over a third, did not think that vesting periods needed to be as long as three years. They pointed out that longer vesting periods might reduce the motivational impact of incentives as executives discount their value, particularly if the vesting period is longer than the business cycle for the company. Furthermore, the longer deferral of awards can lead to upward pressure on pay as people seek compensation for not being able to receive their bonuses immediately.

One individual said “executives already regard three years as a long time to wait to receive payment. If pay were to be deferred over longer periods recipients would heavily discount it, which would tend to push levels of pay higher”.

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?

Companies often have several long-term incentive plans with different terms running in parallel which makes it difficult to understand the value of an individual director’s package.

Just over a third of responses agreed that the frequency with which plans are reviewed should be reduced, whilst slightly more, around two fifths, disagreed. Over half indicated that companies needed to be able to review as necessary to make sure their remuneration policy is in line with corporate strategy.

Some said that there was no need for the frequency of reviews to be mandated, indicating that it was for companies themselves to decide the appropriate frequency of review. Few felt that companies reviewed incentive schemes just for the sake of it and that it was prudent to review incentive schemes to ensure they continue to work as intended. Reviewing the scheme did not mean that the scheme needed to be changed.

Those who argued that incentive schemes should be reviewed regularly said that stable, long-term remuneration schemes provide greater transparency on incentives.

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

Some people have argued that remuneration structures are now far too complex, making the link between pay and performance even more difficult for shareholders to assess, and that the schemes should be simplified. One way of doing this would be for directors to have a substantial proportion of their pay as shares, to be held for several years before their value could be released. This would create a direct and binding link between a company’s long-term performance and directors’ pay, and other less tangible links with performance would not be needed.

Over half of those who responded to the consultation agreed that these simpler models would align the interests of directors with shareholders. Just over a quarter did not think simpler models were necessary. One company suggested “it might be useful to consider the analogous position of football players and managers, few of whom are on purely performance-based contracts. Those with bargaining power do
not place themselves in a position where their financial security is largely dependent on their team’s performance”.

Just under a third indicated that companies should have a balanced package including short and long-term incentives, salary, pension and share ownership. A fifth said that companies should be able to tailor incentive arrangements to suit their needs, to attract and retain the best talent. Some said that executives need to be rewarded for their action (i.e. performance) rather than simply being rewarded because markets had risen.

Caution was expressed about the impact of share ownership. Specifically if directors had too great a shareholding they may be incentivised to stimulate unstable share prices (for their own benefit) rather than act in the interests of the company as a whole.

13. Are there other ways in which remuneration - including bonuses, long-term incentive plans, share options and pensions - could be simplified?

Over half agreed that aspects of remuneration could be simplified. A small proportion felt simplification would be difficult.

There was support for the view that remuneration committees should set pay packages that applied for a number of years, rather than having annual reviews of them. Almost a third indicated that the design of remuneration packages needed to take into account the business strategy of individual companies and strike a balance between simplicity and effectiveness.

A small proportion suggested that remuneration committees should publish a single figure for each director’s annual remuneration. One company said there would be “major benefits in condensing and simplifying the disclosure of total remuneration, ideally into a single table so that meaningful comparisons between companies and sectors can be made”.

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

The FSA’s Remuneration Code for financial institutions requires that provision is made for ‘claw-back’ (where firms can demand repayment) when performance turns out to have been miscalculated or misstated⁶. This is aimed at the financial services, but since 2010 the Corporate Governance Code has said that companies should consider having some type of claw-back.

Over half of those who made submissions to the consultation agreed that all UK quoted companies should be required to have claw-back mechanisms in place. Most of these did not make significant comments on why they thought claw-back should be mandatory.

Just under a third indicated that they did not think that it was necessary to require businesses to put in place claw-back. One company said that although it might be suitable for high-risk businesses, “legislating for such requirements to be put in place for all quoted companies may be unnecessary”.

The reasons given for this were various. Some indicated that there would be legal and practical difficulties in trying to claw back money already paid to executives, particularly in cases where tax and national insurance have been paid. Just under a quarter indicated that whilst claw-back mechanisms would be useful, there was little appetite for them to be mandatory. Some suggested that longer retention periods would be a better solution as they would remove the need for claw-back mechanisms in many cases. A small proportion said that claw-back mechanisms were increasingly being written into the individual service contracts for directors.

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?

A quarter indicated that it would be useful to have a body, such as the High Pay Commission, to disseminate information, provide further research and promote good practice. A fifth said that there is already advice and information available from bodies such as the Association of British Insurers, PIRC and via the Corporate Governance Code. Some suggested that collecting and managing information via a common body would encourage ‘group think’ and would restrict independent thought.

A quarter said there was no need for further research as there is a large body of existing information. A small proportion said that there was a need for further research.
Annex A: list of 164 responses

Alistair Blair
Alithos Limited
Amlin PLC
Andrew Dalkin
Anthony Reading
Association of British Insurers
AstraZeneca PLC
Aviva
BAE Systems
Barclays Bank PLC
Ben Tyler
BHP Billiton
BlackRock
BP
British American Tobacco
British Bankers' Association
BT Group plc
Cable&Wireless Worldwide
Capital & Counties Properties
Carillion
Centre for Economic Performance, London School of Economics
Centrica plc
Chartered Financial Analyst Society of the UK
Chartered Institute of Management Accountants
Chartered Institute of Personnel and Development
Chartered Secretaries Australia Ltd
Church of England Ethical Investment Advisory Group
Clifford Chance LLP
Cobham plc
Confederation of British Industry
Co-operative Investment Management
David Brown
David J E Knight
David Thornber
David Wright
Deloitte
Diageo
Douglas Dryden
Drax Group plc
Duncan Alexander
Edinburgh University Business School
Employment Lawyers Association
Ernst & Young
Eumedion
F&C Management Ltd.
FairPensions
Financial Reporting Council
Freshfields Bruckhaus Deringer LLP
Friends Life Group plc
GC 100
Geraldine Pamphlett
Giles Dixon
GKN plc
GlaxoSmithKline plc
Glenn Murray
Governance For Owners
Graham Philips
Hargreaves Lansdown plc
Hay Group
Headlam Group plc
Henderson Global Investors
Hermes Equity Ownership Services
Hikma Pharmaceuticals
Howden Joinery Group
ICSA
Institute of Directors
Institute of Economic Affairs
Integrity by Design
Joint response from Church Action on Poverty, Ekklesia, LVSC and One Society.
Obermatt Inc
OIS Consulting
One Society
Patterson Associates LLP
Peninsula Business Services Ltd
Peter Bonniniga
Petrofac Limited
Phil Sheppard
PIRC
Premier Farnell plc
Premier Foods plc
PricewaterhouseCoopers LLP
Professor Ian Tonks
Railpen Investments
Richard H. Rowley
Rio Tinto
Robin Bailey
Roger Morton
Rolls Royce
Ross Graham
Royal Dutch Shell plc
Royal London Asset Management
Rupert Robson
Ryszard Filipiak
SABMiller plc
Share Plan Lawyers Group
ShareSoc
Shire plc
Smith and Nephew
SSE plc
Standard Chartered Bank
Standard Life Investments
Standard Life Remuneration Committee
SVM Asset Management Ltd
Tate & Lyle plc
Terradev Limited
Tesco PLC
The Association of Chartered Certified Accountants
The Co-operative Asset Management
The Institute for Chartered Accountants in England and Wales
The Institute of Chartered Accountants of Scotland
The Law Society
The Quoted Companies Alliance
The Royal Bank of Scotland Group plc
Toby Keynes
Tony Scrace
Tony Ward OBE
Towers Watson
Traidcraft
Travis Perkins plc
TUC
UK Shareholders Association
Unilever plc
Unite
United Utilities Group
Universities Superannuation Scheme
VBDO
Vitec Group
Vodafone Remuneration Committee
Whitbread
Xstrata