May 2018

BIG INNOVATION CENTRE

Evidence to BEIS Committee Inquiry on Executive Pay

The Purposeful Company Steering Group

1. Submission Context

The Purposeful Company Taskforce was convened by the Big Innovation Centre in 2015 with the support of the Bank of England, and is guided by a Steering Group, co-chaired by Clare Chapman, remuneration committee chair at three major companies and a Low Pay Commissioner, and Will Hutton, economist, political commentator, and Principal of Hertford College, Oxford. The other members of the Steering Group are:

- Birgitte Andersen, Chief Executive of the Big Innovation Centre
- Alex Edmans, Professor of Finance, London Business School
- Tom Gosling, Partner at PwC and Executive Fellow at London Business School
- Professor Colin Mayer, Professor of Management Studies, Saïd Business School

The Task Force is a consortium of leading companies, investment houses, business schools, and business consultancy firms. It has been examining how the governance and capital markets environment in the UK could be enhanced to support the development of value generating companies, acting with purpose to the long-term benefit of all stakeholders.

A wide-ranging set of policy recommendations were set out in The Purposeful Company Policy Report published in February 2017. A subset of these related to Executive Remuneration, and were expanded upon in a detailed Executive Remuneration Report, which was also published by the Steering Group in February 2017. This report was drawn upon by the BEIS Committee in its deliberations and is referenced in the BEIS Committee Report published in April 2017. Two of the Steering Group members appeared in person to give evidence to the Committee, also supported by written submissions.

As well as commenting on research and policy, the Steering Group participants are active in the debate on pay reform. Members of the steering committee have variously: worked actively on real-life examples of enacted pay reform at leading companies; engaged actively with the investor community, drawing on the findings from the Executive Remuneration Report to advise on governance policies; published original research on matters relevant to the Committee's Inquiry. They have also been working extensively on The Purposeful Company submission to the Financial Reporting Council (FRC) on Stewardship, and have researched the role of proxy voting agencies, and commented on the research methodologies of those bodies.

The Steering Group is therefore well placed to comment on the state of play for executive pay in the UK, both from the perspective of the best academic evidence and also the realities of current practice.

This report is authored by the Steering Group. The authors are acting in their personal capacity in collaborating on this project and the views expressed here may not be taken to represent the views of their organisation. Nor does membership of the Purposeful Company Task Force by an organisation represent an endorsement of this submission.

2. Introductory Comments

Before commenting on the specific questions raised by the Committee, we would like to emphasise the importance of rigour in evidence in the executive pay area. It is possible to take a selective cut of data or a particular case in order to "prove" almost any viewpoint. Greater weight should therefore be placed on the conclusions of peer-reviewed studies published in the top academic journals, which may accept fewer than 5% of papers, representing a stringent quality standard.

Practitioner insight is required to interpret research findings and apply them to current problems. It is also vital to identifying real-life impediments to change, and practical ways to over-come these. It is through actions of practitioners that change will come about. The most powerful results can be obtained when practitioner insight is combined with robust academic evidence. This enables conclusions to be drawn that are most likely to be correct and insightful, and therefore for policy remedies to be developed that solve (a) a problem that actually exists; and (b) solve it in a way that is likely to be effective.

In brief summary, notwithstanding particular counter examples, we believe the evidence shows that significant progress has been and continues to be made on the seriousness with which the UK boards and remuneration committees take their responsibilities on executive pay, investor willingness to intervene, rigorous challenge on quantum of pay, and disclosure of pay. In terms of potential dimensions to reform:

- *Voting*. We do not see a case for further change to the voting regime; indeed some interventions to date are proving counterproductive (for example the Investment Association Public Register), reducing appetite for pay reform and increasing the influence of proxy voting agencies.
- *Disclosure*. There are changes that would enable better understanding of the link between pay and performance by reporting changes in the value of existing executive shareholdings.
- *Level.* While excessive pay should be challenged, there is a danger in basing policy on a small number of notable examples, when the broader trend is towards responsible oversight of pay. Instead the focus should be on fairness of pay for employees throughout organisations.
- *Design.* By far the most pressing need in executive pay is to make more progress on the design of pay, in particular enabling companies, where appropriate, to adopt simpler pay plans that de-emphasise complex bonuses based on multiple targets and instead emphasise long-term shareholding. Greater simplicity would avoid incentives to take short-term actions to hit targets and instead reward executives for investing in their businesses for the long term. At the same time, it increases the transparency in pay practices, in turn, rebuilding trust.

Ultimately the goal of executive pay reform should be to create incentives that encourage business leaders to fulfil the long-term purposes of the companies they lead, and in so doing create sustainable long-term value for shareholders and society. While no-one would support excessive executive pay, focussing just on reducing pay at the top is unlikely to solve the public's concerns about fairness in society. Data from the Office for National Statistics show that inequality after tax and benefits has fallen since the financial crisis, yet the failure of average living standards to improve means this is of little comfort to most citizens. Reducing executive pay does not of itself create material additional resources to redistribute. This is not to deny the societal challenges created by inequality, but we believe it is more fruitful to place greater focus on ensuring oversight of policies relating to pay fairness throughout the business as opposed simply to focussing on executive pay. Workers should be treated fairly regardless of how executives are paid.

3. Response to BEIS Committee Questions

a. What progress has been made on implementing the recommendations on executive pay by the previous Committee in its 2017 report on Corporate Governance?

We respond to this question by reference to the Conclusions and Recommendations on pay set out on pages 62-64 of the BEIS Committee Third Report of Session 2016-17.

> **Excerpt from BEIS Committee report**
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> We agree with the Prime Minister that high and unwarranted executive pay is an issue that needs to be addressed for the benefit of society as a whole. It is hardly consistent with her vision of an economy that works for everyone to see levels of pay for those at the top increasing at a rate that vastly exceeds increases for ordinary employees and which seemingly is at odds with the value created in the company. (Paragraph 81)
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> *We recommend that companies make it their policy to align bonuses with broader corporate responsibilities and company objectives and take steps to ensure that they are genuinely stretching. Policy in this respect would be considered by the FRC in their corporate governance rating system.* (Paragraph 86)

While we agree that the issue of executive pay needs to be addressed, we disagree with the implication that pay for those at the top is increasing at a rate that vastly exceeds increases for ordinary employees and is at odds with the value created in the company. As we show on page 28 of our Executive Remuneration Report, median pay levels in the FTSE-100 for CEOs have declined in real terms since the financial crisis, broadly in line with average wages.

Table 1 shows the development of pay levels for the current constituents of the FTSE-350 since the year before the binding vote on executive remuneration was introduced (which was 2014 for most companies). This data includes all of those companies in the FTSE-350 (excluding investment trusts) that have existed for five years and so provides a consistent, continuous dataset. It should be noted that because of the different year ends and reporting timescales, this is not a perfectly date-matched sample. We take the end of March 2018 as our base point, using latest disclosed data for all companies as at that date, and then track back to prior years. So, for example, the latest current data for a March year-end company will be 2016/17. The advantage of this approach is that it ensures a consistent set of companies in each year of the data set, which is the most important factor when looking at multi-year trends.

The data shows that the general level of executive pay (represented by the median) has increased by 6% over the last four years, which is in line with the increase in Consumer Prices Index (CPI) over the period, and slightly behind the 9% increase in UK average earnings. There has been an element of compression in CEO pay, with the gap between the lowest and highest payers closing. The significant reduction in the upper quartile and upper decile of pay in the FTSE-350 reflects pressure shareholders have brought to bear on companies that they see as being outliers on pay, a number of whom have enacted voluntary reductions in incentive levels. We have not fully analysed the causes of the increase in lower quartile and lower decile levels of pay, which will typically be associated with companies at the smaller end of the FTSE-350. One hypothesis is that management teams at companies in this size bracket are particularly attractive to investors in private companies (such as private equity and venture capital). Given recent increases in private investment activity, the data may reflect the impact of these competitive pressures on pay in the listed market.

Table 1: FTSE-350 pay trends since the introduction of the binding vote

FTSE-350 CEO pay	Financial years ending in					Change 2013-2017
	2013	2014	2015	2016	2017	
Lower Decile	756	770	851	829	894	18%
Lower Quartile	1,103	1,247	1,202	1,316	1,344	22%
Median	2,103	2,216	2,185	2,281	2,230	6%
Upper Quartile	3,992	3,912	4,148	3,632	3,627	(9%)
Upper Decile	6,776	6,901	6,706	5,398	5,575	(18%)

Source: CEO single figure of remuneration, PwC survey database. Data based on 249 current FTSE-350 companies (excluding Investment Trusts) with a continuous 5 year history. Data may be for different CEOs over the period. Where more than one CEO served in a year, the total single figure for all CEOs in the year was aggregated and used in the analysis.

Therefore, the data does not support the contention that executive pay continues to increase (in real terms) or to outstrip employee wage increases. Our Executive Remuneration Report shows that even the increase in pay prior to the financial crisis needs to be viewed as part of much longer trends. Since the early 1980s, pay levels have increased at a rate that is much more justifiable economically than is commonly believed, even if it is problematic from the point of view of public perception.

Bonuses do increasingly reflect a range of non-financial measures, which may reflect specific strategic objectives of the company or objectives reflecting wider corporate responsibilities. Frequently, objectives relating to wider corporate responsibilities are incorporated into executives' individual objectives and so the weight prevalence of such objectives is not always easy to identify. However, customer satisfaction is explicitly identified as a separately weighted bonus objective in 15% of FTSE-100 companies. Employee engagement, health and safety, and environment and community goals are found as separate categories in around one in ten companies for each measure. The typical weighting is around 10% of the bonus.

It should never be expected that such measures would form a majority of bonuses, given that bonuses are used to align executive to the performance of the business in financial and strategic terms. However, our practical experience is that such measures are becoming more widely used.

There has been a greater focus on the stretch in performance metrics as a result of toughened disclosure requirements. In around 2015, investors started using the threat of voting action against companies not disclosing bonus targets. Now, it is normal market practice to disclose bonus targets in full at the end of the year to which they applied. It is now the case that more than four in five FTSE-350 companies give retrospective disclosure of bonus targets. Investors are continuing to put pressure on this area, requiring better disclosure of non-financial and personal targets, as well as the financial targets which are now typically fully disclosed. This information is allowing investors to engage with companies on the toughness of targets, and we are starting to see this happen.

We expect this process to lead to greater stretch in bonus targets, and while it is too early to be conclusive, there is some indication that this is starting to happen. Table 2 below shows the distribution of bonus outcomes for the FTSE-350 in the last three years since investor pressure on this issue started to build up. The median and upper quartile bonus pay-outs as a percentage of maximum has fallen slightly, and the lower quartile pay-out has fallen markedly, suggesting that investors are being particularly tough on cases of poor performance.

Table 2: FTSE-350 CEO bonus pay-out as % of maximum

FTSE-350 CEO bonus as % of maximum	Financial years ending in		
	2015	2016	2017
Lower Quartile	57%	46%	43%
Median	76%	74%	71%
Upper Quartile	94%	88%	89%

Source: PwC survey database, companies with continuous history over the period

We see the question of bonus targets as a matter for the market to resolve since it is clearly in investors' interests for targets to be sufficiently stretching, and they now have the information and tools available to exert pressure on this issue, as discussed later in this submission.

Excerpt from BEIS Committee report

We conclude that long-term incentive plan (LTIPs) should be phased out as soon as possible. No new LTIPs should be agreed from the start of 2018, and existing agreements should not be renewed. (Paragraph 90)

We recommend that the FRC consults with stakeholders with a view to amending the Code to establish deferred stock rather than LTIPs as best practice in terms of incentivising long-term decision making. Overall, we recommend that this consultation should develop guidelines for the structure of executive pay with the following features:

A simpler structure based primarily on salary plus long-term equity, to divest over a genuinely "long-term" period, normally at least five years, without large steps;

Limited use of short-term performance-related cash bonuses, which should be aligned, where possible, to wider company objectives or corporate governance responsibilities;

Clear criteria for bonuses: they should be genuinely stretching and be aimed to provide incentives rather than just reward. (Paragraph 95)

These recommendations touch on the question of pay design. We do not support a one-size-fits-all model of pay design, and there are sectors, circumstances, and companies in which LTIPs can be effective. We, therefore, do not support the idea that LTIPs should be phased out entirely. Moreover, it should be noted that many UK companies operate globally, and in markets where pay expectations may differ from the UK. For example, US companies have only recently completed a move towards using LTIPs for the most senior executives. Therefore, it is not realistic to expect all companies to move away from the LTIP model.

However, our Executive Remuneration Report did find significant potential problems with target-based incentives, i.e. incentives where the pay-out depends on performance targets over, typically, a one or three year period, as opposed to awards of, say, deferred shares. We do therefore support the notion that the definition of best practice should include much simpler plans as outlined in the Committee's recommendations. We need to move away from the current presumption that target-based incentives, and in particular LTIPs, are the only acceptable pay model. The design principles outlined by the Committee above are very close to those we recommended in our Executive Remuneration Report. Indeed the Investment Association's Executive Remuneration Working Group did good work in this area, outlining three alternatives to LTIPs that should be considered acceptable where aligned to strategy: deferred bonuses, so-called 'performance-on-grant' schemes (similar to deferred bonuses), and restricted stock. All models shared the common insight that high and long-term shareholding can be a substitute for LTIPs in terms of aligning executives with performance. But the challenge has been embedding this into day-to-day institutional investor thinking.

Around 10% of FTSE-350 companies have adopted one might be termed "non-standard" pay arrangements. At one end of the spectrum are various types of one-off long-term incentive that mimic aspects of private equity pay. At the other end of the spectrum are simplified plans that seek to replace LTIPs with deferred share awards of various types. We spend most of this section commenting on simplified plans but comment on one-off plans first.

One-off plans

One-off long-term incentive plans are typically put in place in a transformation or turnaround situation, or in cases that mimic the investment style horizons of private equity. Typically a single plan will be put in place over a five year period that replaces three normal long-term incentive awards. Metrics will relate to shareholder returns (with management perhaps sharing in a percentage of the value created above a hurdle rate, as in private equity) or may be linked to targets that represent a financial transformation of the business. The purpose of such plans is to focus management on step change transformation of a business over a five year period. An example of such an innovative arrangement was introduce by Kingfisher in 2016 to support their business transformation. A reduced cash bonus based on strategic goals coupled with an annual Alignment Share award provided a simplified annual package, which is supplemented by a one-off plan incentivising transformation of the operating model, profitability and returns over the five year strategic time horizon.

One-off plans can give rise to comment because their one-off and leveraged nature can give rise to significant pay-outs in a single year. However, two important facts must be borne in mind:

- The plans typically replace multiple years of LTIP awards – typically three, and so should be seen in that context;
- This type of plan frequently pays out zero, due to the tough hurdle rates imposed, so for every case of a very large pay-out, there will be a case (or cases) of zero pay-out.

This type of plan should not be discounted. Indeed the view set out in our Executive Remuneration report was that LTIPs are most effective in situations of this type where there is a transformation goal and clarity of objective, timeframe, and measurement. A single plan operating for a defined period avoids some of the confusion and complexity of overlapping targets. Such scenarios are frequently monitored by strong anchor shareholders, investing on a value basis, which supports strong governance. Such plans can be particularly valuable in segments of the market where investors and management teams face choices between private and public ownership, and enable public companies to mimic the arrangements in private competitors.

It is beneficial to the investment ecosystem in the UK mid-market for investors to have choices about public versus private ownership. As such, investors in listed companies need to be able to retain management teams, who in this size bracket can be in high demand and have genuine choices about where they apply their skills. To date, listed company investors have been open to such plans, which are often simpler than traditional LTIP alternatives. Applying a vanilla one-size-fits-all approach could result in certain types of company simply not being available on listed markets, which would limit investment choice for retail investors.

Simplified replacements for LTIPs

In 2016 and 2017 momentum built in support of simplified plans as a replacement for LTIPs. In 2016, the Investment Association Executive Remuneration Working Group suggested that restricted stock or deferred bonus plans could replace LTIPs in certain circumstances. At around the time the BEIS Committee published their report in 2017. Norges, the fund manager for the Norwegian Sovereign Wealth Fund, issued a statement in favour of replacing LTIPs by awards of deferred shares. However, examples of companies seeking to discontinue their LTIP programmes entirely are few and far between. Norges publicly commended two companies for thinking differently about pay in line with their principles: The Royal Bank of Scotland (RBS) in 2017 and Weir Group in 2018. Although somewhat different in the details of implementation, both companies adopted some common principles:

- Traditional LTIPs replaced by awards of deferred shares
- Extended timeframes for the release of awards (up to 7 or 8 years)
- Increased shareholding requirements extending beyond retirement
- Underpinning business health metrics prior to vesting to avoid payment for failure
- Reduced quantum of awards in exchange for greater certainty

These were not the only cases of companies replacing LTIPs, but were the two most high profile examples in 2017 and 2018, and there were only a few other examples.

Of policies brought forward for approval in 2017 that included removal of a traditional LTIP, we believe that all received a vote against a recommendation from Institutional Shareholder Services (ISS), the influential shareholder advisory service. However, in a sign that underlying investors were willing to consider simplified designs in the right circumstances, RBS received the support of 85% of shareholders excluding UK Financial Investments (UKFI) (nearly 95% including UKFI), notwithstanding the ISS vote against recommendation.

In an important development, following a survey of members in 2017 that indicated greater willingness to consider restricted stock or equivalent arrangements, ISS recommended a vote in favour of the Weir plan. The plan was also supported by Glass Lewis, and simply highlighted for shareholder consideration by the Investment Association's IVIS shareholder advisory service. The proposal received the support of 92% of shareholders at the recent AGM.

The change of stance by ISS as reflected in the Weir recommendation is a positive sign. ISS surveyed its clients in 2017, which showed that over 60% would consider restricted stock proposals in the right circumstances. As a result of that, they appear to be prepared to take more of a case-by-case approach. This is also reflected in a number of investors publicly supporting restricted stock proposals. For example, Hermes introduced guidelines in favour of simplified plans in the autumn of 2016 and were followed by Norges, the Norwegian Sovereign Wealth Fund in 2017. Norges also publicly commended the boards of RBS and Weir in supporting their proposals, as did HSBC in the case of Weir. Old Mutual in their submission to the FRC's consultation on the UK Corporate Governance Code supported the use of restricted stock, and various other investors have been actively supportive.

Therefore, over the last year, there has been some progress, and there is certainly a different climate in relation to discussions about alternative pay models. Nevertheless change is very slow. We identify the following barriers to pay reform in the UK.

Diversity of investor views makes it challenging to build consensus around pay reform

Shareholders remain split on the merits of alternatives to LTIPs. Within UK institutional investors there are mixed views, and the UK companies also need to take account of the views of the US investors, who now make up a very significant proportion of the UK stock market. In the US, proxy agencies and investor groups have used say-on-pay to campaign for *more* use of LTIPs. The traditional pay model, therefore, tends to have majority support amongst US investors in UK companies. It is therefore challenging for companies to secure an investor consensus on pay reform.

A number of investors retain a strong commitment to the traditional performance pay model and worry that moving away from traditional LTIPs will result in loss of the performance dynamic if stretching targets are removed, leading to reduced management motivation and, as a consequence, coasting. A related concern is that some investors view deferred share awards as essentially fixed pay, and worry about too much pay being earned without merit – even if the share price halves, the shares are still worth something.

These are legitimate concerns that cannot simply be brushed aside. To date, the concerns about payment for failure have been addressed by introducing underpinning business health metrics to enable the board to exercise to reduce vesting of awards if required in cases of poor performance. However, a number of further avenues should be explored:

- *More radical package restructuring.* Frequently restricted stock or deferred bonuses are awarded as a like-for-like replacement for LTIPs. However, it may be that more effective solutions could be found to create greater leverage including: paying part of fixed pay in shares; making block awards of shares every five years that vest on a pro-rata basis in order to create immediate alignment. We explored some of these ideas in our Executive Remuneration Report (see pages 23 to 25).
- *Development of more leveraged alternatives to shares*. In response to the concern that even significant share price falls can leave executives holding a significant value from restricted share awards, leveraged share units could easily be created. Whereas a share increases or decreases in value by £1 for each £1 change in the share price, a leveraged share unit could increase or decrease by £2. In which case, for example, the unit would be worthless if the share price halved. These could be designed in a way that still enabled phased vesting, avoided complex

performance targets, and avoided the problems that arose with awards of share options in the past. If desired, these could be designed as relative leveraged units, where the value increased or decreased according to performance against a benchmark. These approaches differ importantly from traditional performance conditions, as they remove thresholds, kinks, and non-linearities in pay-out curves, which create perverse incentives and unintended consequences.

- *Continued use of performance testing to a moderated degree*. Performance testing could be continued, but to a lesser degree, and in a manner informed by board judgement or discretion. This could apply to awards either on grant, which could remain performance related, or on vesting. Board judgement against a set of long-term factors could be used as opposed to mechanical vesting targets. Alternatively, long-term incentive awards measured over five years could be made back to back or every three years alongside annual bonus and restricted stock awards. The key is to ensure that the build-up of long-term shareholdings is sufficient to provide the dominant incentive, outweighing the returns from hitting short-term performance targets (see pages 18-20 of our Executive Remuneration Report). This requires shareholding requirements to be 2x the value of a year's performance-based incentives. Development of non-financial reporting may also enable targets to be used that are aligned to strategic rather than financial goals, and the build up of long-term intangible value.

There will not be a single design that works in all circumstances. The Investment Association could helpfully convene an ongoing working group to explore alternative designs, supported by best evidence and analysis.

We do not advocate a one-size-fits-all model, but would hope that investors become more open to considering alternatives to the current norm. By contrast, a number of investors and their representatives will consider alternatives to LTIP such as restricted stock or deferred shares only if LTIPs are impossible to operate in the company, for example, because of extreme business volatility. However, the research evidence we presented in our Executive Remuneration Report, highlighting the dangers of target-based incentives, was not sector-specific. Alternative pay models can simply be a better option than LTIPs, even if it is possible to construct an LTIP.

There has been some movement on this front, and there is more acceptance of the legitimacy of discussions on pay reform than has been the case before. However, progress is slow, and the signalling power of Government and the FRC is needed to accelerate the pace of change. The divergence of shareholder views also creates a practical challenge, which is the amount of time required to put through a non-standard pay policy. One member of our Steering Group estimates a hundred hours of meetings for a Remuneration Committee chair seeking to guide through a non-standard pay policy. Many boards conclude the effort is not worth it.

The Investment Association Public Register risks discouraging reform

Because of the divergence of shareholder views, companies at the vanguard of reform are quite likely to trigger the 20% opposition that results in them appearing on the Public Register, particularly given proxy-agency views (although not certain, as the cases of RBS and Weir show). If this level of opposition is seen to be disreputable, then responsible remuneration committees face a significant disincentive to pursue reform. We fear that responsible remuneration committees, not wishing to appear on the register, may thereby be put off progressive pay reform. This classic example of the law of unintended consequences requires the Public Register, and the associated UK Corporate Governance Code Changes to be rethought.

Proxy agencies can encourage a one-size-fits-all model

Proxy agencies such as ISS and Glass Lewis perform an important role in helping shareholders fulfil their governance responsibilities in an efficient manner. However, by committing to give voting recommendations on all resolutions, such agencies create a risk of outsourced governance. Research suggests that a vote AGAINST recommendation from ISS, the dominant provider in the UK market, can causally add 10%-15% opposition to the AGM vote[1]. Given the reputational concern about being on the Public Register, this makes the role of proxy agencies, and particularly ISS, especially critical. In 2017 ISS generally recommended a vote against proposals to remove an LTIP in the FTSE-350. It is encouraging that they have supported Weir Group in 2018, and appear to be adapting their position. However, pay reform inevitably demands greater alignment to specific company strategies, and as we have highlighted above. This may require a fundamental restructuring of remuneration packages. Proxy agencies will inevitably struggle to apply the necessary strategic context to their recommendations.

Trade-offs required for acceptance may limit take-up

It is understandable that investors have wanted to avoid 'opening the floodgates' to a new pay model until they have had time to test it and get comfortable with appropriate guidelines for the new construct. The general principles of the trade-offs required for simpler plans based on long-term share ownership are becoming well established:

- Reduced maximum pay in exchange for greater certainty
- Increased deferral term
- An underpinning requirement to allow deferred shares to be forfeit in extremis to avoid payment for failure
- Increased shareholding requirements including beyond retirement.

These are all reasonable principles, which we would support. However, we fear that they are being enacted too severely by investors. For example, it is generally required that the reduction in the maximum award by at least 50% in order to exchange an LTIP for restricted stock. Once lengthened deferral and underpinning conditions are added, this can make the trade-off impossibly unfavourable for executives to accept. In many cases, they would rather take their chances with a traditional LTIP.

This is unfortunate, as pay reform should not be viewed as a pay reduction exercise (although that is likely to be a consequence). Rather, the evidence suggests that a move to longer-term, simpler plans based on delivery in deferred share awards can in the right circumstances encourage more long-term thinking, innovation, and ultimately shareholder and stakeholder benefits than a traditional LTIP. These are important benefits, and companies should not be dissuaded from exploring whether they apply to them by a requirement for excessive pay reductions to adopt such models. There clearly

[1] An ISS vote against resolution is typically correlated with a c. 30%-35% vote against However, some of this arises because shareholders often agree with ISS; 10%-15% is the impact *caused* by the ISS recommendation, which would not arise in its absence.

should be a reduction in maximum quantum for moving from an LTIP to a deferred bonus or restricted stock model. However, for restricted stock, we believe that requiring a reduction of 50% will unnecessarily limit adoption and that a reduction of 35% to 40% is much more likely to strike the right balance between shareholder and executive interests.

Disclosure

Current disclosure rules are biased against deferred share awards versus LTIPs. This is because for restricted stock or deferred bonus plans the award value is disclosed in the single figure of total remuneration for the Executive Directors at the point it is awarded. The impact of subsequent share price appreciation or depreciation is ignored in the disclosure. By contrast, LTIP values are disclosed at vesting, when performance conditions are measured, and the impact of any share price movement over the period also affects the disclosed value. This makes LTIPs appear more performance-related than deferred share awards (which may lead to a similar disclosed value every year, and so appear "fixed" in nature). Of course, this is entirely misleading, as it is the impact of the change in share price on deferred share awards and other shareholdings that creates the performance incentive that academic evidence suggests is so powerful. Yet this is entirely missed both in disclosed pay amounts but also in methodologies that derive from these (such as proxy adviser pay-performance models).

Further actions to support pay reform are discussed in the final section of this submission.

Excerpt from BEIS Committee report

We recognise that the job of leading a major company is extremely taxing and requires great skill and commitment. These roles, given their importance, should be appropriately rewarded. But overall pay levels have now been ratcheted up to levels so high that it is impossible to observe a credible link between pay and performance. At a time when average pay has remained relatively stable, these increases have served to undermine public trust in business. (Paragraph 99)

Deeper engagement alone may not be a powerful driver of pay restraint. We believe that the most effective remedy lies in the combined impact of the various measures we have outlined in this Report, including driving better stewardship through more transparency, better reporting, more employee involvement and tougher enforcement. If these measures and more responsible shareholder engagement does not have the desired effect, Government may have to consider more direct intervention. (Paragraph 103)

In our view, the current scale of opposition to remuneration reports and policies does not, at present, justify annual binding votes on pay levels. (Paragraph 105)

To incentivise the engagement of the otherwise uninterested, and to force effective action, we favour a strict approach to implementing this principle. Our preference is for the threshold for triggering a binding vote should be low and that companies should have one chance to resolve concerns, not two. A 25 percent threshold would be consistent with the threshold for votes on a special resolution and would strike a reasonable balance in terms of the degree of leverage given to a single minority shareholder. It is reasonable to expect companies to address any serious and widespread concerns on remuneration by the following year. *We recommend that the FRC revises the Code to include a requirement for a binding vote on executive pay awards the following year in the event of there being a vote against such a vote of over 25 percent of votes cast s a requirement should* be included in legislation *at the next opportunity.* (Paragraph 106)

This recommendation has been partially enacted through the Investment Association's launch of the Public Register, which records all instances of votes against in excess of 20%, for any resolution, and also the proposed toughening of requirements under the UK Corporate Governance Code for companies receiving 20% or more vote against.

However, we disagree with the premise of this recommendation. As outlined in the introduction, it is not true to say that there is no credible link between pay and performance. In our Executive Remuneration Report, and also highlighted in the PwC publication *Paying for performance*, most studies purporting to show the link between pay and performance are quite misleading. This is because they ignore the impact on executive wealth and incentives of the change in the value of their shareholdings, which have a major impact on the overall pay-performance link. Ignoring this important factor, PwC finds a correlation of just 19%. Including it the correlation increases to 79%. This is not to say that all is perfect in relation to performance pay. We have highlighted above and in our previous research the problems with target-based pay plans. But the contention that there is no link between pay and performance is too sweeping.

Executive pay has indeed increased much faster than average employee pay over the last four decades (although not over the last decade), but so too has the size and complexity of companies being led. The uncomfortable truth is that high pay for scarce skills is a feature of an increasingly international and intangibles-based economy, and is far from restricted to pay for senior executives in listed companies. The rise in pay of public company executives has been no faster than in other high-skill professions, such as private company executives, law, finance, media, and even professions outside of business such as music, sports, and acting which are not considered to have lost the public's trust. Executive pay at large companies therefore needs to be viewed as part of wider economic phenomenon of pay dispersion in an economy increasingly focussed on intangible value and with large returns to scale.

While work can continue to drive out the remaining examples of excess, there is no easy fix that will create both greater economic efficiency and lower general levels of executive pay within the current model of our economy. The market for executive pay, like any market for scarce skills, is far from perfect, but it would be a mistake to assume that there is major market failure that, if solved, will result in executive pay falling dramatically. Indeed there is a danger of unintended consequences if the environment for listed company CEOs is made particularly unattractive relative to private sectors of the economy. This is not to deny the social and political concerns relating to inequality, but rather to point out that policies focussed just on listed company executive pay are unlikely to be successful in addressing them. At the same time such policies could have counterproductive impact on liste companies. Issues of inequality in society are more likely to be tackled through traditional policy areas of taxation, education and skills, social mobility, housing provision and so on.

The global evidence is that say-on-pay regimes have been effective in enabling shareholders to have their views heard on pay. Indeed in the UK the pressure arising from investor engagement around say on pay has led over the last decade to pay reducing slightly in real terms, and reducing substantially amongst the highest payers, and also becoming harder to earn through: tougher performance conditions, longer vesting and holding periods; higher shareholding requirements; introduction of malus and clawback arrangements; reduction in contract terms; toughening leaver and change of control provisions; and greater transparency. Our Executive Remuneration Report showed that the three-quarters of companies receiving a vote against of 20% or more in a given year had increased that vote to an average of 94% a year later, showing the most companies do respond to shareholder concerns immediately: the feedback loop largely works. Moreover, a number of investors have now adopted formal escalation mechanisms where failure to address concerns on remuneration leads in subsequent years to votes against directors. This is an appropriate and effective mechanism, which can be adopted under current rules.

Another problem of using such a low threshold as 25% to trigger consequences is that it assumes that the shareholder voting against are acting as the 'canary in the coal mine' and that this is representative of the latent concerns of other investors. This is frequently not the case, particularly in smaller companies where views of different types of investor may be quite different. We are aware of situations where a resolution has had relatively low levels of support, but in the majority, but where the opposition to the resolution was mirrored by strong, active support on the other side. In such a situation it cannot be legitimate for the minority to hold the majority hostage.

We have highlighted above the problems being created by the Public Register, which is inhibiting pay reform. The Committee's recommendation above would have the perverse consequence of undermining its own objectives in this regard. The Public Register is problematic on two counts:

- The Register is acting as a disincentive for responsible companies to undertake progressive pay reform, because of the reputational concerns, for them, of being on the Register
- Conversely, for companies who are dismissive of shareholder concerns, the fact that the threshold has resulted in around 200 companies already being on the register means that it is no longer an effective sanction.

We are not persuaded that the solution to current problems in executive pay resides in changes to the voting regime, and on the contrary, fear that it would undermine pay reform.

Excerpt from BEIS Committee report

Employee representation on remuneration committees would represent a powerful signal on company culture and commitment to fair pay. This option should be included in the Code and we expect leading companies to adopt this approach. (Paragraph 108)

Chairs should also be responsible for driving discussions aimed at delivering simpler structures and just able levels of remuneration and shareholders should be prepared to hold them to account if they have not engaged sufficiently to secure support for pay policies and annual reports. *We recommend that any Chair of a remuneration committee should normally have served on the committee for at least one year previously. To further incentivise strong engagement, we recommend that the Chair of a remuneration committee be expected to resign if their proposals do not receive the backing of 75 per cent of voting shareholders.* (Paragraph 109)

We recommend that companies should set out clearly their people policy, including the rationale for the employment model used, their overall approach to investing in and rewarding employees at all levels throughout the company, as well as reporting clearly on remuneration levels on a consistent basis. e FRC should consult with relevant bodies to work up guidance on implementing this recommendation for inclusion in the Code. (Paragraph 112)

We recommend that the FRC works with other relevant stakeholders on the detail and amends the Code to require the publication of pay ratios between the CEO and both senior executives and all UK employees. We further recommend that the Government requires that equivalent pay ratios should be published by public sector and third sector bodies above a specified size. (Paragraph 115)

The FRC has included employee directors as one option for supporting employee voice in the draft UK Corporate Governance Code.

The proposal that the Chair of a Remuneration Committee should be forced to resign if the remuneration vote receives more than 25% opposition has not been enacted. This proposal is problematic for a number of reasons:

- Similar to the reasoning outlined above for the Public Register, this proposal would risk stopping pay reform in its tracks, with no remuneration committee prepared to take the risk to do anything out of the ordinary.
- The Chair of the committee is not Chief Executive of the Committee, and cannot be personally held responsible for all of its decisions.
- The idea that a Committee Chair should be forced to resign through the votes of just a quarter of investors when a large majority has supported the proposal seems difficult to justify when a simple majority can approve a takeover, for example.
- Investors already have the opportunity to register their opposition to the actions of directors through the vote on annual re-election, and are showing greater willingness to use this vote.

Although we did not support the introduction of pay ratios (see our Executive Remuneration Report), regulation is pending that will require their disclosure from 2018 or 2019 reporting years.

The draft UK Corporate Governance Code does include a requirement for boards to oversee people policies throughout the company and to report on these. We believe that this Board oversight accountability, which has been introduced as a new Principle P in the draft Code, is an important addition, which emphasises the Board's responsibility for ensuring governance relating to the fair treatment of employees throughout the company. We are already seeing leading companies react positive to this. More details on our views on how the FRC should be implementing this provision can be found in our submission to the consultation on the UK Corporate Governance Code.

b. What improvements have been made to reporting on executive pay in the last 12 months?

Levels of transparency in pay disclosure continue to improve. The proportion of companies disclosing annual bonus targets retrospectively has now increased to nearly 90% of the FTSE-350.

BEIS has consulted on and will be introducing various changes to remuneration disclosure including:

- Pay ratios and associated narrative reporting
- A scenario showing the impact of share price growth on pay-outs from policy
- A disclosure showing the impact of share price growth on the single figure of pay
- Disclosure in relation to exercises of discretion.

These are generally improvements, and levels of transparency, and explanation in executive pay reporting are generally increasing. However, in our view, these proposals leave a significant gap in current executive remuneration reporting, which is proper disclosure of the impact of share price changes on executive wealth through previously granted equity and deferred share awards.

Any approach to analysing pay for performance that is based only on the single figure is fundamentally flawed, and would not stand up to scrutiny in any high-quality peer-reviewed academic journal. This is because the impact of share price changes on previously granted equity is fundamental to executive incentives and to the link between pay and performance. In practice, these changes are very material compared with the single figure of pay. For example, a 10% fall in the stock price reduces the equity holdings of an average FTSE-100 CEO by nearly £1m after tax. Assessing the pay-for-performance relationships based on the single figure only makes as much sense as reviewing investment performance based on dividends but ignoring capital gains – i.e. no sense at all.

Although this sounds like a technical issue, failure to make this amendment to disclosure regulations has material consequences, which will inhibit achievement of the Committee's objectives. Research shows that including the impact of share price movements on previously granted equity transforms the assessment of the strength of the link between pay and performance in UK companies. In addition, such disclosure may have a substantial impact in improving public perceptions of fairness and accountability. At present, there is the widespread concern that executives are unaccountable for poor performance because their salaries and bonuses are relatively insensitive to performance. However, in reality, they are severely punished for poor performance through the reduction in the value of their previously-granted equity, which can in many cases exceed any newly-granted salaries and bonuses and mean that their overall change in wealth is negative.

In particular, simplified plans based on awards of long-dated equity will generally, under current reporting rules, quite falsely suggest a very weak relationship between pay and performance. This is because they are included in the single figure when they are awarded, with no recognition of the long-term share price exposure they engender. Furthermore, proxy agencies generally base their quantitative analysis of pay-for-performance entirely on disclosed items – namely the single figure disclosure. Given the influence that such agencies can have on voting outcomes, the current weakness in the disclosure regime is a significant barrier to necessary reform of pay design, which the BEIS Committee has highlighted in its report (and the Government in its response to the Green Paper) as a desirable aim.

c. What steps have been taken by remuneration committees and institutional investors to combat excessive executive pay in the last 12 months?

As shown in our introductory remarks, a notable feature of recent pay that the upper quartile of total pay in the FTSE-350 has fallen significantly. This reflects pressure that investors have brought to bear on companies that are considered to be paying outside market norms, to which remuneration committees have responded through voluntary action.

There are, of course, always cases of companies bringing forward proposals that are deemed by investors or the public to be excessive, and these are being addressed through investors voting against both remuneration proposals, but also increasingly the accountable directors.

Moreover, and anticipating the UK Corporate Governance Code requirements for a minimum five-year total term for LTIPs, most companies bringing policies for renewal in 2017 and 2018 have introduced a holding period on LTIPs to meet this requirement. This means that the overwhelming majority of FTSE-350 companies now have a total LTIP term of at least five years.

Although there will always be one-off cases and exceptions, our view is that the vast majority of remuneration committees act responsibly, taking into account investor views. Investors themselves are developing clear policies on vote escalation (from remuneration votes to vote for re-election of directors). For this reason we see the pressing issue being the design and structure of pay, rather than its level. Although in addressing structure, the level will also be affected somewhat as a consequence, with simpler designs typically allowing lower headline pay levels.

d. What further measures should be considered?

Pay reform

Creating more momentum behind pay reform is in our view the critical task for the BEIS Committee to focus on. We believe that there are four ways in which this can be done:

- Government signalling that they expect investors and proxy voting agencies to treat with open mind pay proposals that make use of simplified plans based on long-term deferred share awards in place of LTIPs. The Government cannot mandate pay design but could provide a stronger endorsement, for example, for the work of the Investment Association's Executive Remuneration Working Group.

- The UK Corporate Governance Code could be strengthened, as originally recommended by the BEIS Committee. A radical approach would be to reverse the 'burden of proof' so that simple deferred share awards became the best practice norm, with explanation required if more complex target-based incentives were adopted. However, while the academic evidence would support such a stance, in practice this would go too far for current investor sentiment. We have suggested to the FRC a softer approach to the issue by amending their Provision 40 in the draft Code to:

  'Executive remuneration should support long-term company performance and value generation. Remuneration committees should consider the behavioural risks that can arise from target-based plans, and how these are mitigated. In certain circumstances, simpler arrangements based on long-term stock awards may be more effective than target-based long-term incentives.'

  The Guidance could then reference the final report of the Investment Association Executive Remuneration Working Group and the range of alternatives considered there, including restricted stock and performance-on grant schemes, which promote long shareholding through simple structures.

- BEIS should request that the Investment Association convene a follow-up to the Executive Remuneration Working Group to establish lessons learned over the two years since their report was published, including barriers to adoption. The Investment Association as part of this should work with investors to make more rapid progress on pay reform, including influencing the position of proxy voting agencies.

- There is a connection between pay governance issues and broader stewardship, which is dealt with extensively in our paper Thoughts for Change, submitted to the FRC ahead of their review of the Stewardship Code. A particular one we highlight here is the role of proxy voting agencies and how investors use them . Because of the commitment by some firms to give voting recommendations on every resolution, we are seeing proxy voting agencies stray into areas of decision making where they do not have the methodologies, capability, or resources to comment authoritatively, and yet their recommendations are very influential. This includes pay reform, where non-standard pay designs are really a matter of strategic judgement and not amenable to high-volume analysis techniques. The FRC should be requested to review this issue as part of their review of the Stewardship Code. A three-pronged approach is likely to be required covering: (a) proxy agencies agreeing to independent review of their quantitative analysis methodologies on pay versus performance; (b) requirements for proxy agencies to mark 'for strategic judgement' those voting recommendations that are not purely a matter of fact in relation to voting policy; and (c) set an expectation on Stewardship Code signatories that they undertake their own analysis on such proposals rather than simply following the proxy agency recommendation. We note that the use of proxy agencies is a wider stewardship issue, which is why we are suggesting it is dealt with holistically by the FRC rather than as an isolated pay issue.

Disclosure

We recommend creating a new requirement to disclose the change in the value of previously granted equity to show alongside the ten-year history of the single figure that has to be disclosed under existing regulations in the annual remuneration report

We would recommend a simple disclosure requiring three additional rows to be disclosed in the same table that discloses the ten-year history of the single figure. These additional rows would be under a subtitle of 'Changes in the value of accumulated share exposure':

i. Change in value of vested shares over the year due to share price movements, taking into account the timing of any sales or purchases of shares (note that only the change in the value of shares acquired would be recorded, not the value of shares themselves)
ii. Change in value of unvested deferred awards of shares that have already appeared in the single figure for a prior year (this will typically be an unvested deferred bonus or restricted stock)
iii. Dividends paid in the year on vested shares

It can be seen how these additional disclosures level the playing field between deferred equity awards and LTIPs. LTIPs vary significantly under the single figure basis because their reported value is impacted by both performance conditions and share price movement over the performance period. Deferred equity is valued for the single figure based on its value at grant, and will therefore typically show very little variation in the single figure year on year. However, a large build-up of exposure to deferred equity would come through strongly in the variation of the deferred share awards line of the table of changes in value of accumulated share exposure. This disclosure would, therefore, enable investors and proxy agencies to analyse the incentives within different pay structures on a consistent and robust basis, which they are currently unable to do.

Investment Association Public Register

Care needs to be taken in assuming that minority opposition to a resolution represents the "tip of the iceberg" of wider opposition. In some cases it simply represents a difference in view among different groups of investors. Assuming it is retained, the Public Register should be reformulated in two ways:

- The threshold for appearing on the Public Register should be a 25% vote against rather than 20%. Although this is a small difference, it aligns with the level of opposition that can defeat a special resolution. It seems extraordinary that a company can withstand greater opposition when changing its articles of association or waiving pre-emption rights than it can before appearing on the Public Register.

- The Public Register should focus on repeat offenders. We would suggest either:
    - Companies where the opposition of 25% or more is received two years in a row on the same matter (suggesting that the company may not respond to investor concerns);
    - Companies where opposition of 25% or more is received across more than one category of resolution in a given year (suggesting that the company may have problems across a range of areas – here votes against directors would be a category, as would remuneration, so that, for example, a vote of 25% against both remuneration report and policy would not result in appearance on the Register – given the possibility that the issues are linked).

Pay fairness

The UK Corporate Governance Code has introduced a new principle that emphasises the board's role in overseeing people policies across the Group. This is a positive development and should be retained in the final Code. As we outlined in our paper on Strengthening Board Accountability for Pay Policy, we believe that ensuring boards take greater ownership of ensuring fair pay practices throughout their organisation will have at least as much positive impact on pay fairness as focussing just on executive pay. This oversight needs to be strategic rather than operational in nature, but also meaningfully connected to the FRC's proposals on employee voice. We encourage the FRC to continue to be bold in its aspiration on this point in the final UK Corporate Governance Code.

Incentives through the investment chain

The BEIS Committee's inquiry focussed on executive pay in the listed sector. Incentives through the investment chain are also very important, as these determine the approach that investors take to stewardship, which in turn profoundly affects how companies enact corporate governance. This includes remuneration, but also the structure of mandates and fees. There is an opportunity to consider some of these matters as part of the FRC's review of the Stewardship Code, due to take place through 2018. Stewardship behaviour across the investment chain is a matter the Committee could usefully take up as part of its 2018 work programme, in order to provide input to the Stewardship Code review. This should include the mechanisms by which asset owner views (both retail and institutional) are reflected in asset manager stewardship approaches.

The Purposeful Company Steering Group
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Contact details

Big Innovation Centre
8th-Floor Penthouse, 20 Victoria Street
London SW1H 0NF
email: info@biginnovationcentre.com

Launched in September 2011, Big Innovation Centre is a hub of innovative companies and organisations, thought leaders, universities and 'what works' open innovators. Together we test and realise our commercial and public-purpose ideas to promote company and national innovative capabilities in a non-competitive and neutral environment. We act as catalysts in co-shaping innovation and business model strategies that are both practical and intellectually grounded. Our vision is to help make the UK a Global Open Innovation and Investment Hub by 2025, and to build similar initiatives internationally. For further details, please visit www.biginnovationcentre.com