



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

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Dear Sir / Madam,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultative document, published in September 2011. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views in respect of your discussion paper on executive pay.

About the IoD

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of 40,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

Overall perspective

The IoD has noted, with growing concern, the rapid growth of executive remuneration at the largest listed UK companies. As stated in your discussion paper, the median total remuneration of FTSE 100 CEOs has risen much faster than the increase in the FTSE100 index, retail prices, average remuneration levels, or executive remuneration levels at smaller companies over the last ten years. Such a tenuous link between executive pay, company performance, and the performance of the wider economy is hard to justify.

The IoD is also aware of the difficult challenges that are experienced by the remuneration committees of larger companies. They are often faced with the dilemma of either responding to globally-driven pressures for higher executive pay or suffering the loss of a key member of the executive team, with significant implications for the execution of company strategy.

However, notwithstanding these pressures, we do not see the current pace of increase in executive pay as sustainable. The legitimacy of UK business in the eyes of wider society is significantly damaged by pay packages that are not clearly linked to company performance. For that reason, we feel that the effectiveness of individual remuneration committees could be assisted by some changes to the overall framework of UK remuneration governance.

Our most significant proposal is to argue for more professional diversity amongst independent non-executive directors. In our view, board members from diverse professional background are more

likely to exhibit “objective scepticism” in respect of remuneration policy than current or former CEOs. However, greater professional diversity is best promoted by changes to the UK Corporate Governance Code and associated best practice rather than by means of “one size fits all” regulatory change.

Answers to specific questions

Role of shareholders

1. Would a binding vote on remuneration improve shareholders’ ability to hold companies to account on pay and performance? If so, how could this work in practice?

We believe that shareholders should play a more active role in engaging with listed companies in respect of executive remuneration. However, we continue to have doubts about the willingness of many investors to play such an enhanced role. Shareholders already have significant mechanisms by which they can exert leverage over executive pay, including an annual vote on the remuneration report and an annual (or EGM) vote on director re-election. However, these mechanisms are inadequately utilised.

We have doubts about the practicalities of converting the existing advisory vote on the remuneration report to a binding vote. A binding shareholder vote on actual remuneration would be difficult to implement due to the difficulties of unwinding or negotiating contractual commitments. The need for a further series of votes after a negative vote would also create significant cost and uncertainty. In our view, once a remuneration award has been announced by a board, it is too late for shareholders to intervene with an absolute veto.

However, we do see the merits of shareholders being involved at an earlier stage of the remuneration-setting process. Investors could more feasibly cast a binding vote on the proposed remuneration policy – including the associated performance criteria - rather than the actual remuneration outcome.

Such an *ex ante* vote on remuneration policy would ensure that there was forward-looking rather than backward-looking shareholder oversight of executive remuneration. This would result in fewer nasty surprises after the event and provide an opportunity for shareholders to help define the drivers of executive pay. Actual pay awards would be viewed as more legitimate, as their calculation basis would have been approved in advance by shareholders.

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

Not by Government. However, companies should exercise more care in the shaping of executive employment contracts. Contracts should not extend beyond 12 months. Notice payments should ideally be made on a monthly basis so that if the person finds new employment, the payments may be stopped or reduced.

Although shareholders have no role in approving employment contracts, they can subsequently hold remuneration committee members to account for poor decision-making, e.g. by voting them off the board. They should seek to use these powers in a more active manner.

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

Despite its theoretical attractions, we do not view this model of nomination committee composition as compatible with the structure of UK share ownership. Most shareholders of UK-listed companies are institutional investors with highly diversified share portfolios. A significant and growing proportion of shareholders are non-UK investors. Many have a relatively short-term investment time-frame. There is little evidence that such investors have the time, resources or inclination to assume an “insider” role within an individual company, e.g. sitting on a board or a nomination committee.

Another problem with shareholder representatives is that they are representative of one particular stakeholder and shareholder constituency. The concept of the board of directors which has developed in the UK over the last couple of decades – which we support – is one of an independent body that is able to define the interests of the company in an objective and unconflicted manner, and which considers the interests of all shareholders and other relevant stakeholders.

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

We would like to see greater professional diversity on boards and remuneration committees. In particular, there should be a higher proportion of independent non-executive directors from non-executive backgrounds. In contrast to NEDs whose viewpoints on remuneration may have been shaped by their own personal experience as CEOs, board members from more diverse professional background are likely to exhibit a greater degree of “objective scepticism” in respect of remuneration policy. In our view, their greater presence on boards would exert a beneficial influence over boardroom decision-making in general, and the workings of the remuneration committee in particular.

However, we would not support the membership of “non-directors”, e.g. external experts or other individuals who are not main board members, on remuneration committees. The board of directors is the governing body with direct legal liability for the performance of the company. Directors are also accountable on an individual basis to shareholders. It would not be appropriate for individuals that are not board members to exert power over a key strategic area of the company’s activities, such as executive remuneration.

Such a situation would create power without proper accountability. It could also encourage executive remuneration policy to be determined in isolation from other components of business strategy. This would be highly undesirable.

It is perfectly reasonable for independent experts – or any other stakeholder – to provide input and guidance to boards or remuneration committees on an advisory basis. However, the final decision of the remuneration committee should ultimately be a matter for legally-accountable directors.

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

This issue is best addressed by increasing the professional diversity of boards. In particular, independent non-executive directors should be drawn from a wider gene pool than that of current and former senior executives.

This does not obviate the need for boards to appoint individuals with outstanding personal capabilities. It is also likely to increase the need for appropriate director-level training that will facilitate the cross-over of potential board members from other professional activities.

However, an excessive focus on former or current CEOs when appointing NEDs –although offering significant benefits to the board in terms of business expertise – can give rise to conflict of interest problems in respect of executive remuneration policy. To counter this risk, there needs to be an appropriate balance and diversity in board composition.

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

As discussed above, we do not believe that it makes sense to include “non-directors” on remuneration committees, either in the form of employees or independent experts. Decisions about executive remuneration should ultimately be made by legally-accountable board members as part of their responsibility for the company’s overall strategy and performance.

However, we would encourage remuneration committees, on a voluntary basis, to engage with employee representatives in an informal dialogue on the topic of executive remuneration. Such engagement would assist the board in fulfilling its obligation under the UK Corporate Governance Code to be “sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases”¹. It is also likely to increase employee “buy-in” to the executive remuneration-setting process

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

We would not support a formal requirement for an employee vote on executive remuneration. However, as discussed above, we believe that the board should identify an appropriate mechanism for engaging with employees and other stakeholders on the topic of executive pay. This is important in order to increase the legitimacy of executive remuneration in the eyes of wider society.

A related idea – which extends beyond executive remuneration - has recently been proposed by Bob Tricker². He writes as follows: “Increasingly, the added-value stakeholders, including employees, entities in the up and downstream added-value chains, and suppliers of debt finance are recognized as inherently part of corporate governance. Sound corporate governance recognizes their legitimate, long-term interests in relations with the company.”

Tricker proposes the creation of so-called stakeholder liaison groups. Such groups “would work with both the executive management and the governing body (i.e. the board of directors) providing three-way communication on matters of mutual interest.”

However, he also emphasizes that such stakeholder bodies should not have any formal decision-making power vis-à-vis the board or executive management. They would fulfil a purely advisory role.

Our view is that individual companies may find it beneficial – both from the perspectives of increased efficiency and increased legitimacy – to develop appropriate means of engaging with wider stakeholder groups (including employees) on issues such as executive remuneration. However, this should not be mandated by regulation; it should be a matter for each individual 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?

We agree that there should be greater transparency concerning the potential conflicts of interest of remuneration consultants. Companies should be required to disclose any fees paid to remuneration consultants. They should include full disclosure of their services to the remuneration committee and to management.

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

Yes. Remuneration reports are currently too complex and too focused on financial performance. Boards should define a relatively small number of easily understandable and robust performance criteria for the CEO and the senior executive team. These criteria should consist of both financial and non-financial measures of performance (consisting of KPIs and the achievement of strategic milestones), and should be chosen to reflect the time horizon of the company’s business strategy (e.g. long-term performance). In

¹ UK Corporate Governance Code. Supporting Principle D.1.

² Bob Tricker. “Re-inventing the Limited Liability Company”. Corporate Governance: An International Review. 2011.

most instances, it should be possible to publish these performance criteria and discuss their relevance with shareholders and other interested stakeholders.

Boards should avoid using performance criteria which can be significantly influenced by factors unrelated to the actions or performance of senior management, e.g. absolute movements in the share price which may occur due to fluctuations in the overall stockmarket. In addition, performance metrics that are potentially vulnerable to internal manipulation, e.g. short-term earnings growth or internal surveys, should be treated with care.

However, it is not desirable for regulators or regulation to pre-define the specific measures of performance that should be adopted by all companies. Measures of performance must be tailored to an organisation's specific objectives and circumstances. The appropriateness of performance criteria must be considered on a case-by-case basis by directors and shareholders.

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

We believe that a three year deferral period is appropriate in most instances. However, it is difficult to pre-judge the desirability of a deferral period without understanding the circumstances of individual companies. For this reason, such a decision should be a matter for the remuneration committee and the shareholders.

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?

The exact details of executive remuneration packages – including their frequency of adjustment - should be left to the judgement of individual remuneration committees. However, remuneration committees should be encouraged to significantly reduce the complexity of executive remuneration arrangements. Complex long-term incentive plans should be avoided. The emphasis should be on basic pay and a variable performance payment that is directly linked to success in fulfilling pre-defined and easily understandable performance criteria.

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

We believe that executive remuneration policies would benefit from substantial simplification. However, we are not convinced that significant share awards are the answer in all circumstances. The remuneration committee should be responsible for evaluating the desirability of this approach in specific circumstances.

One disadvantage of share-based awards is that share prices move upwards and downwards in response to fluctuations in the overall equity market or equity market sector. These fluctuations may have nothing to do with the actions of company executives. In general, we believe that performance-related pay should be based on performance criteria that directly reflect the efforts and success of senior management.

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

As stated above, we would like to see a simpler remuneration structure based on fixed salary and an annual performance award. The annual performance award should be determined by a simple formula based on pre-defined performance criteria. A significant proportion of this bonus should be deferred and

subject to clawback provisions. Although the final decision should be left up to individual remuneration committees, we would encourage boards to avoid more complex remuneration structures.

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

We support this proposal. It should always be possible for a company to recover performance related pay components in circumstances of financial misstatement or misconduct.

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?

We would see value in a body such as the ONS producing periodic statistics on executive pay alongside other economic data. This would then provide a firm basis for research by academics and other research bodies.

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

A handwritten signature in black ink that reads "R. Barker". The signature is written in a cursive style and is underlined with a single horizontal stroke.

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