Executive Pay Discussion Paper
Business Environment
Department for Business Innovation and Skills
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By Email: executivepaydiscussionpaper@bis.gsi.gov.uk

Wednesday 23rd November, 2011

Dear Sir,

GC100 response to the Discussion Paper on Executive Remuneration

I am writing on behalf of the GC100 in response to the above discussion paper. As you may be aware, GC100 is the association for the general counsel and company secretaries of companies in the UK FTSE 100. There are currently over 120 members of the group, representing some 80 companies. Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

The GC100 welcomes the opportunity to respond to this consultation and wishes to make the following response, comments and observations:

If you would like to discuss any of these points further, we would be happy to do so.

Overall Points

Before considering individual questions, we have a number of overarching comments to make:

- Remuneration is essentially a matter between companies and their shareholders. Ahead of each Annual General Meeting, there is usually active engagement between companies and their major shareholders around governance matters as a whole and remuneration matters in particular. There are a sizeable number of shareholders who participate in active and constructive dialogue around levels of pay, structure of packages and the setting of targets. This may not be visible externally, but does take place throughout the year as well as ahead of the AGM. It is largely as a result of these discussions rather than the vote on remuneration that companies amend and update their remuneration practices. We therefore believe that there should be more focus on improving engagement on both sides rather than on the vote itself.

- We believe that all members of the Remuneration Committee should be drawn from the Board. Remuneration should be linked to the strategy and business objectives of the particular company in order that there is alignment between performance and pay. All members of the Remuneration Committee responsible for determining remuneration policy structure and the level of reward should therefore be a party to Boardroom discussions on business strategy. The inclusion of non-Board members on Board Committees undermines the concept of a unitary Board and potentially hampers the alignment of pay and performance.

- We believe that an effective framework is already in place for the governance of remuneration matters through the 2006 Companies Act and the UK Code on Corporate Governance. Under UK Company law, shareholders own shares in a company and delegate the management of the company to a Board, consisting of a balance of Executive and Non-Executive (usually independent) Directors. The Board in turn delegates the day to day running of the company's business to the CEO and executive team and the determination of remuneration matters to a Remuneration Committee, comprised of independent Non-Executive Directors. Ss 172- 177 of the Companies Act 2006 set out the duties of directors, including obligations to have regard to the interests of the company's employees, to exercise independent judgment and to avoid conflicts of interest. Section A.4 of the UK Corporate Governance Code states that the Remuneration Committee should be responsible for determining appropriate levels of remuneration, whilst Section D and Schedule A go into more detail about remuneration practices and deal with topics such as pay for performance, appropriate performance targets, termination payments and regard for pay levels elsewhere within the company. From our perspective, many of the proposals in the Discussion paper are already addressed by the existing law and the recent changes to the Code.

- We are concerned that a number of the proposals could have unintended consequences. For example, the reduction in certainty for an executive director around what he or she is paid (arising out of issues such as longer vesting periods, and extended clawbacks, and especially if payment is subject to an annual shareholder vote) could potentially lead to expectations for higher base pay. This could have the consequence of increasing overall pay and overall costs.

- Some of our members have concerns that increasing prescription placed on remuneration practices could put UK listed companies at a disadvantage to those in other countries in the market for talented executives. It could possibly lead to Boards having fewer executive members, as in the US and thus reduce the pool of talent with Boardroom experience from which to select the CEOs of the future.

- A number of the proposals, including the employee vote and the additional non Board member representatives would cost companies considerably more for little perceived benefit.

Turning now to the specific questions raised in the discussion paper, we have the following comments to make:

Q1 - 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?

In our opinion the current advisory vote works well. Although there is a requirement for a majority to pass this vote, in practice, any company receiving votes in favour below 75%, or a material level of abstentions takes the matter very seriously as a clear message of discontent from shareholders

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and will seek to work with shareholders to understand their concerns and make adjustments to their remuneration practices. Since the introduction of the advisory vote, very few resolutions have received below majority support (no FTSE100 companies in 2011 for example), but the discontent expressed by shareholders even with votes in favour above 75% has had a powerful impact on the way companies have behaved. Shareholders therefore have significant influence through effective engagement with investee companies, supported by the current advisory vote, which we would argue is fit for purpose. We do not believe that the introduction of a binding vote will improve the ability of shareholders to hold companies to account.

We foresee a number of practical difficulties in introducing a binding vote on the Directors' Remuneration Report. Aside from the practical difficulties of requiring executives to pay back amounts they have already received, and the knock on effect on the legal position of director contracts, it is hard to see how a vote "against" should be interpreted. There will also be a number of practical difficulties in unwinding tax and social security payments paid on amounts, which subsequently are be clawed back.

It is possible and probably likely that different shareholders may have objected to different aspects of the remuneration policy. In which case, it would be impossible to decide whether the will of the shareholders was for example that salaries should be reduced, bonuses repaid or LTIP performance measures altered. We also have concerns that a binding vote could be abused by an activist shareholder.

One solution could be to have a separate vote on each element of the remuneration package, but remuneration packages are structured as balanced packages combining a number of elements, to deliver a blended outcome designed to meet the needs of both executives and shareholders. A process where some elements, but not others, would be approved could in practical terms be very difficult to manage.

It should also be noted that shareholders currently do have the opportunity to vote on long term incentive plans, which often seem to be the most controversial element of the remuneration package, either when they are introduced or when substantial changes are made. In practice, companies frequently consult major shareholders in advance before proposing new or material changes to long term incentive. Following the changes introduced last year by the new UK Corporate Governance Code, shareholders now also have the ability to vote against the re-appointment of the Chairman of the Remuneration Committee and other directors on an annual basis.

We feel that there should be more focus on engagement between companies and their shareholders rather than solely on the vote. Positive engagement is, in our experience, far more effective and does bring about change.

Q2 - Are there further measures that could be taken to prevent payments for failure?

Practice has evolved considerably in this area in recent years. For example, whilst 3 year contracts used to be acceptable, the maximum notice period is now 1 year and usually termination payments will be based purely on salary and benefits and will not include bonus. Shareholders have long been pressing companies to align remuneration packages with the strategy of the company and therefore link pay more closely to performance.

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Typically contracts are negotiated with executives on appointment, when no one is expecting failure. When things go wrong, there is usually a desire on both sides to act swiftly and have a controlled exit which causes the least damage or disruption possible, particularly reputational, to the ongoing business and the share price.

Shareholders have the right to view directors' service contracts and in our experience, this right is exercised and shareholders regularly discuss the terms of service contracts and termination payments with companies.

A number of measures are already used by various companies to prevent payments for failure. The most appropriate measures will differ from company to company depending on differing circumstances, for example whether the company is in steady state or a period of change, the size of the company and the long or short term nature of the business cycle. We have heard it suggested that the following measures might be used although we would caution against over-prescription in this area, as we believe that the most appropriate form of remuneration package will differ from company to company.

- Use of a US style restricted stock, under which participants are required to keep shares in the company until retirement and beyond. If an executive's bad performance continues to impact the company negatively after their departure, it may be appropriate that they are required to retain their shares in the downturn rather than selling before the impact hits. (This however would not work if the shares have already fallen in value and conversely may negatively impact someone who left the company following a disagreement regarding the future direction of the company, who then suffered from the actions of their successors.) Provision would need to be made within plan rules to cover the exceptional circumstances such as a pressing need to sell shares in emergency situations.

- The use of clawbacks could be considered although see our comments below on question 14.

- A closer link to shareholders' interests in the form of a requirement to hold a substantial number of shares for a long period of time would also ensure greater focus by executives on the impact on shareholders.

- Measures that are currently in place in the financial services industry, such as malus provisions, could be considered for extension beyond the financial services sector although we would prefer to see how effective such measures were in the financial services sector before adopting them more widely.

- Other measures, like rolling one year contracts and moving away from the defined benefits retirement arrangements should be given time to embed into companies' practice and tested for their effectiveness before different and/or additional measures are introduced.

Q3 - What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

We fail to see the advantages of this proposal as an appropriate framework is already in place:

- We foresee a number of difficulties with a requirement that a shareholder representative sit on the Nominations Committee. No one shareholder can represent the views of all the shareholders as investors tend, in our experience, to hold differing views. There is also a danger that the shareholder representative could have access to price sensitive information and be made an insider, which would impact their ability to make investment decisions. Nomination decisions cannot be made in isolation from setting the company's strategy. In addition, investment managers have fiduciary duties to their clients, whose own views and interests may diverge.

- In relation to the appointment of Executive Directors, we do not feel that it is appropriate for someone who has not been privy to the full Board discussions on say the future strategy of the company to sit on a committee to decide who would be the most appropriate person to implement that strategy. We believe that the nomination committee (and other Board committees) should consist only of Board members, who have been party to and have collective responsibility for all Board discussions.

- In most large companies, directors stand for re-election at each AGM in accordance with the UK Code on Corporate Governance. Shareholders can and do already vote against the re-election of directors if they do not believe they are properly representing their views, particularly on matters relating to Remuneration.

- We would also point out that the role of the independent non-executive director is to represent the interests of all shareholders. This is exactly what it means to be an "independent" director.

- There would also be complexity around the choice of which shareholder nominated the representative, and whether they would cease to hold office if the underlying fund sold part or all of its holding. Again, this power could be abused by an activist shareholder.

- Shareholder representatives might also find themselves in a difficult position, should an executive whose appointment they have approved through the nominations process, subsequently fail. The line between management and owners, and the mechanisms for accountability (managers accountable to shareholders through votes at general meetings), may become blurred.

Q4 - 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?

As mentioned in our preamble, we believe that remuneration committees should consist only of Board members who have been party to all Board discussions. For example, it would not make sense for a Remuneration Committee member to discuss appropriate performance measures, without also having been party to discussions about the company's strategy, key drivers and targets.

It is a great benefit to have a wide range of skills, experience and strategic perspective in the boardroom. The Board's responsibility is to ensure that the most suitable individuals are appointed, regardless of their origin or geographical location. We do not see why the Board shouldn't consider candidates from different professional backgrounds and we think many Boards are already doing so. This is already a requirement under the UK Corporate Governance Code. As Boards as a whole become more diverse, it would be expected that Remuneration Committees will also.

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We suggest that Companies could include the skills and experience that directors bring to each of the Committees they serve on in the "Biographies of the Board" section of their Annual Report. We do recognize however that this would entail more disclosure in the Annual Report at a time, when all parties are calling for more concise reporting and we have some concern that this could just lead to boiler plate disclosures.

We note the potential benefits summarized in the consultation document, and would note that this is the role many remuneration committees expect their consultants to play. While the consultants are advisors, and not committee members, the independent perspective should be "in the room".

Q5 - Is there a need for stronger guidance on membership of remuneration committee, to prevent conflicts of interest from arising?

We believe that this question stems from a perception that directors set the pay for executive directors in one company who then reciprocate in their roles as non-executive directors in other companies (i.e. where there are cross-directorships.). In practice, the incidence of such executive / non-executive cross-directorships is extremely low. We do not think there is a need for stronger governance, but if there is a conflict of interest identified, we suggest that companies should explain in their Remuneration Report how this is being managed.

In addition, there are many checks and balances already in place which prevent such conflicts arising. Directors are required to avoid conflicts of interest under the Companies Act 2006 and such cross-directorships are one of the factors impeding independence under the UK Corporate Governance Code. Directorships are publicly available information and the Listing Rules requires notification of other directorships. In addition, executive directors may only hold one external directorship. All these factors limit the possibility of such conflicts of interest arising. In our experience, governance specialists soon draw attention to such cross-directorships where they exist.

It should also be noted that no remuneration decisions are made by single directors but by the entire Remuneration Committee as a whole. This weakens the impact of any conflict.

Q6 - 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?

We are not supportive of compulsory employee representatives on Remuneration Committees unless that person also sits on the full Board for the reasons explained earlier, namely that it is not appropriate for anyone to be involved in setting remuneration policy structures and levels, who has not participated in discussions relating to overall strategy.

Including employees on remuneration committees would potentially create a conflict of interest for the employees as they are not independent and, depending on the scope of the Remuneration Committee, may be participating in decisions that impact the structure of their own pay.

The UK Corporate Governance Code already requires Remuneration Committees to be sensitive to pay and employment conditions elsewhere in the company.

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We do not advocate employee representatives on Boards, although we recognise that this can work well for some companies and indeed is recognized in different legal systems, where companies have supervisory boards and management boards, with different responsibilities and accountabilities. In some circumstances, an effective employee representative can communicate employee issues to the rest of the Board and also explain the Board's thinking and reasoning to employees. In many cases however, it may not be easy to find a suitable employee representative who can effectively represent the views of all employees, particularly in globally diverse companies. There is significant scope for the views of an employee representative to be driven by local issues relevant to the location where they work, rather than the global interests of the company and shareholders as a whole.

Q7 - What would be the costs and benefits of an employee vote on remuneration?

We believe it is appropriate that shareholders, rather than employees, vote on director remuneration given shareholders are in an economic sense the owners of the company and they elect the directors.

We foresee many practical difficulties in organising an employee vote on remuneration and no benefits. The logistics of organising an employee vote on any matter is challenging, particularly where a company operates in many countries. The cost for large multinational companies of organizing such a vote would be significant. Some of our members have employees overseas who are unable to read in their own language let alone English. Documents would need to be translated and employees would have to be educated on the basics of remuneration. Large multinational companies with 100,000s of employees would need to engage third parties to manage the voting process and there is a danger that employees dissatisfied with other local matters, would vote against board remuneration, which should be a group-wide issue.

The practicalities of running an employee vote ahead of sending documentation to shareholders would be challenging in that the remuneration report would be likely to contain price sensitive information derived from the as yet unpublished accounts.

Consideration would also have to be given to what message a vote from employees would mean? For example, if employees voted strongly in favour of executives' pay, what weight would external shareholders have to give that outcome if their view was different and they were minded to vote against the remuneration report. The same dilemma but in reverse may apply if employees were to vote against but shareholders were supportive of management action.

As an alternative, we note that some companies invite employees submit comments and feedback on directors' remuneration through some other mechanism for example employee opinion surveys. In many cases, this already happens, as published accounts are widely available and employees and their representatives, particularly if they are shareholders, typically raise questions at and ahead of the Annual General Meeting. We would however advise against prescription in this area as different methods will work best in different companies depending on existing methods of employee communication.

Q8 - Will an increase in transparency over the use of remuneration consultants help to prevent conflicts of interest or is there a need for stronger guidance or regulation in this area?

We would support a proposal for greater transparency on the use of remuneration consultants and if a conflict arises, that it should be disclosed in the annual report. We would suggest that Remuneration Committees could be required to explain in greater detail the extent to which they use remuneration consultants and in the event that the consultants also advise management, the measures they take to satisfy themselves that there is no risk of a conflict of interest. We are mindful however that this would mean further disclosure at a time when there are calls to cut back on the clutter in annual reports.

We note that remuneration consultants already sign up to a voluntary code of conduct which addresses these issues. Whilst the disclosure of fees paid to remuneration consultants may appear to lead to greater transparency in practice this detail gives little information about potential conflicts of interest, as the nature of possible work the consultant might undertake for a remuneration committee or the management team will vary vastly from company to company. For example, a remuneration committee consultant advising the CEO on a special package for a fellow executive director presents far more of a potential conflict than that same advisor advising on an all-employee share plan for overseas employees. Disclosure solely of the fees in these circumstances would give a misleading impression of where there might be a conflict.

Q9 - Could the link between pay and performance be improved by companies choosing more appropriate measures of performance?

The link between pay and performance could be improved in many cases if companies chose more appropriate measures. The performance measures should ensure delivery of a company's objectives and therefore they need to be tailored to the specific company's needs at a certain time in a balanced approach of financial and non-financial metrics. The measures will change over time as will a company's objectives. It is the ultimate responsibility of the Remuneration Committee to ensure that performance measures in place focus Executive Directors efforts in the right direction – achieving the specific objectives, thus linking pay to the corporate and the individual's performance. We would note that there has been a move in recent years away from relatively standard EPS and TSR performance measurements as investors have encouraged companies to use measurements more closely linked to specific aspects of the company's strategy. This is an imperfect science and the most appropriate measure will differ from company to company and may well change over time within a given company as strategy evolves.

We suggest however that finding the right measurement is more important than comparability, and this view is supported by shareholders' actions in encouraging and supporting company-specific performance metrics. It also means that appropriate measurements may evolve over time, which naturally increases complexity. The lack of comparability between differing company specific measures means that benchmarking becomes more difficult and this, in a positive way, could quell the ratcheting up of pay which has followed increased transparency in these areas.

We would note that with long term incentive plans, it necessarily takes time (typically three years) for the impact of any change in performance measurements used to filter through. The perceived disconnect between company performance and pay-outs under long term plans may well reflect the performance measurements of the past, whilst the greater alignment intended through the use of more sophisticated measurements which are designed to align more closely with strategy have not yet played out.

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Q10 - Should companies be encouraged to defer a larger proportion of pay over more than three years?

We recognise that deferment over a longer period of time maybe appropriate for some companies with longer term strategic horizons, but also recognise that this may not necessarily be appropriate for all companies. There is existing evidence that individuals naturally tend to discount the value of reward payable at a distant date, and excessive deferral may fuel increases in base pay. We note that the FSA Remuneration Code for financial service companies already requires longer periods of deferment and retention periods apply beyond the normal vesting date.

We would also note that many companies already require their executive directors and other senior employees to acquire and maintain a personally significant holding in the company's shares. Executive Directors should align their interests with those of shareholders by holding shares for the longer-term. The "longer-term" could be different for each company and will depend on industry, business cycle and other factors. Such holdings align directors' interests more closely with shareholders. This is a practice which could be more widely encouraged.

Q11 - 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?

Please see our response to question 9. As strategy evolves or following engagement with shareholders, it may be appropriate for companies to alter the type of plans and the performance measurements used. We believe that it is important that remuneration structures are regularly reviewed to ensure that they continue to support the corporate strategy and delivery of objectives and are amended as appropriate rather than leaving inappropriate measurements and targets in place which could well either fail to incentivise executives appropriately or encourage them to focus on the wrong areas of company performance. We do not see evidence of companies routinely reviewing remuneration structures for the sake of it, but companies need flexibility to adapt to changing economic and business conditions and mandating the frequency of remuneration reviews would not be in shareholders' interests.

Q12 - Would radically simpler models of remuneration which rely on a director's level of share ownership to incentivise them to boost share value, more effectively align directors with the interest of shareholders?

Global businesses are complex, and reducing remuneration to simple or simplistic measures will not necessarily be in the interests of shareholders, who expect (rightly) that management will manage complexity. Overall, we do agree that simpler is better and suggest that it might be useful to commission a study into the behavioural aspects of remuneration to examine the type of remuneration structure that really incentivises directors to perform.

A shareholding requirement is already in place in most large companies. The UK Corporate Governance Code requires directors to "promote the long-term success of the company" rather than just align their interest with the shareholders. Therefore, we believe there should be a balance in structuring directors' packages that would consist of elements that would promote the company's success together with shareholder value, risk alignment, sustainability and other stakeholder interests. Most of the complexity within Directors Remuneration Reports is as a result of differing plans, targets and measurements adopted over time, as new plans are devised to incentivise management to deliver against an evolving strategy or in response to engagement with shareholders. Generally speaking, the remuneration package for a given year is relatively straightforward (although in some cases, no doubt, the terms of certain bonus and share based plans could be simplified and/or better explained.) In any given year of reporting, the report discusses what happened in the previous year, as well as what will happen in the upcoming year. There is also a complication in that vestings of awards made in the previous 3 years (which may be under different plans or have differing targets) also need to be described. If plans were to operate over longer periods, this complexity will be increased further. In addition, companies with dual listings tend to have even longer Remuneration Reports due to the need to comply with the reporting obligations of two jurisdictions.

Alignment with wider remuneration regulation, such as CRD3 and the FSA Remuneration Code for financial service companies, would need to be considered in any attempts to simplify remuneration structures. There may also be a danger in an over-reliance on share ownership as the main, or only, tool to incentivise directors.

Q13 - Are there other ways in which remuneration – including bonuses, LTIPs, share options and pensions – could be simplified?

Please see our response to question 12. Whilst the performance targets for certain bonus and share based plans could be improved, we believe that a lot of the complexity in directors' remuneration structure and the Remuneration Report, arises from changes in plans and targets used from one year to the next as Remuneration Committees seek to find performance plans and measures which more appropriately match an evolving strategy or in response to investors' concerns. It would be far simpler if all companies adopted the same plans with the same targets, but such plans would not necessarily provide any alignment with the interests of the shareholders in particular companies. Complexity is a necessary by-product of better alignment with shareholders and link to the corporate strategy.

Q14 - Should all companies be required to put in place claw-back mechanisms?

We would welcome the opportunity to discuss further what is meant by "clawback". We would support the principle that in cases of fraud, misrepresentation etc, it would be desirable to have some mechanism for clawing back payments made which should not have been. However, there are practical difficulties in doing this particularly with cash payments already made in the form of cash bonuses or shares which have already vested. This would be even more difficult to implement in the case of employees who have left the company.

We would however support the forfeiture of deferred payments or shares that have not yet vested (commonly known as "malus"). It is possible that longer retention periods may be appropriate, as fraud or restatements may take some years to come to light. We would suggest however that even though a malus provision may be written into bonus and share plans, it is likely that the application of these provisions will differ depending on the circumstances. There is likely to be debate around the extent deferred payments or shares should be forfeited and whether forfeiture should apply across the board or only to those involved in the fraud or malpractice concerned. We believe that over prescription in this area at this point could well lead to unintended outcomes in practice in the future

We will be interested to see how these provisions work in practice in the financial services industry.

Q15 - 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 are not really clear what it is envisaged that the role of this new body would be or who the research would be intended for. There are already a number of shareholder and governance bodies who undertake research in this area (some of which represent the views of groups of shareholders) and we are not convinced of the need for a further body, which could just add an additional layer with which we need to comply and engage. Remuneration consultants also routinely produce analysis and information on market practice in the UK and around the world, especially in the USA, and remuneration committees typically have access to these analyses, either generically or on a bespoke basis. There is a lot of information which is in fact already publicly available. Companies already have the challenge of trying to find remuneration solutions which will be accepted by a range of shareholders with differing views and opinions. We could however see some benefit, if this new body could act in an over-arching co-coordinating role. We suspect however that this is unlikely to happen as individual shareholders will still have their own view on specific topics.

We would also have concerns that any pronouncements by this body would be seen as statements of best practice, and therefore pressurise companies into making changes to their pay arrangements. As we have noted, it is change which causes the complexity in pay reporting.

We would be delighted to continue the debate on these topics further with you.

Yours faithfully

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