Executive Compensation: is there a right answer?

Dr Ruth Bender
29th October 2012
Banta Lecture Series

“Divided by a common language”
Possibly originally said by George Bernard Shaw.
Or maybe by Winston Churchill.
Or possibly Oscar Wilde.

Different approaches to governance
UK approach to governance is shareholder-led
EU approach to governance reflects very different underlying systems in the different member countries. EU regulation is close to the UK regulation, but allows wider variation
US approach to governance is regulator-led, and shareholders have limited protection compared to the UK position

“Comply or explain”
Comply-or-go-to-jail

Principles versus Rules
UK system: We’d quite like it if you did this, or explained why it is not appropriate for you ...

Principles versus Rules
US system: you can do anything that we don’t actually ban...
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Goverance in the United Kingdom

The UK Stewardship Code is the companion document for institutional investors.


The Financial Reporting Council operates with delegated powers from the Secretary of State for Business, Innovation and Skills.

http://www.frc.org.uk

A brief history of UK ‘soft’ governance

This relates just to codes with some effect on directors’ remuneration. Other codes exist, such as “Turnbull” on internal controls.

But is this approach still relevant…?

The type of shareholder in the UK has changed considerably since 1992.

Some relevant aspects of UK governance
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UK boards contain executives and non-executives

There are only three board committees required for listed companies

Committees comprise independent NEDs.
The Company Chair is allowed to be a member.
Executives can be invited to attend.

And they’re all called ‘Director’

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Definition of ‘Independence’ for NEDs

"Independent in character and judgement"

Tests include not being:

- Employee < 5 years
- Material business relationship < 3 years
- Remunerated other than director’s fee
- Close family ties
- Cross-directorships
- Represents a significant shareholder
- Been on board > 9 years

UK Corporate Governance Code 2012

CEO/Chair duality is generally not acceptable

Non-executives are not granted share options

Directors’ Remuneration in the UK: the current situation
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Who decides what?

- The remuneration committee has delegated responsibility for setting pay for executive directors and the chairman.
- It should also monitor the pay of ‘senior management’.
- The Board determines the pay of the non-executive directors.
- Shareholders must be consulted re all new long-term schemes, or major changes to existing ones.

Decisions on structuring pay

How much pay for on-target performance?
How much of that should be performance-related?
- Long term?
- Short term?
What performance measures?
What targets?
How should it be paid?

Total pay
Fixed
Variable
Short term
Long term
Plus pensions and perks, and intangibles

UK Corporate Governance Code 2012
Main provisions on Executive remuneration

D1. Sufficient to attract, retain and motivate... avoid paying more than necessary
D1. A significant proportion should be structured so as to link rewards to corporate and individual performance.
D1. Performance-related elements should be stretching and designed to promote the long-term success of the company.
D1. Judge where to position the company relative to other companies
D1. Sensitive to pay and employment conditions elsewhere in the group.
D2. Formal and transparent process for developing policy and fixing packages. No director involved in deciding his/her own pay.
D2.1 Remn Co of at least 3 independent directors, or 2 for smaller company. Chairman can be a member but not chair it.
D2.2 Delegated responsibility for setting pay (inc pensions and compensation) for all executive directors and the chairman. Remn co should also recommend and monitor the level and structure of remuneration for senior management.
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The pay-performance link?

www.dilbert.com

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UK Corporate Governance Code 2012

Schedule A: Provisions on the design of performance related remuneration

1. Performance conditions should be relevant, stretching and designed to promote the long-term success of the company. Upper limits should be set and disclosed.

2. Long term schemes should not vest within 3 years. Directors should be encouraged to hold shares after vesting.

3. New ltip schemes should be approved by shareholders, and total potential award should not be ‘excessive’.

4. Payouts under incentive schemes should be subject to challenging performance criteria reflecting the company’s objectives, including non-financial measures.

5. Remuneration incentives should be compatible with risk policies and systems.

6. Option grants should be phased rather than one large block.

7. Consideration should be given to provisions for clawback in the event of misstatement or misconduct.

8. Only basic salary should be pensionable.

9. Committee should consider the pension implications of salary increases.

Directors’ Remuneration Report Regulations 2002

Every person who was a director is responsible (not just those on the remuneration committee)

Partly audited

Members vote (advisory)

NOT SUBJECT TO AUDIT
- Names of committee members
- Names of advisors (inc internal): nature of work, who appointed them
- Statement of policy for this and future years
- Summary of Long Term performance conditions, with explanation
- Details of internal comparators
- Contract details
- Performance graph (3 years; index)

SUBJECT TO AUDIT
- Total salary and fees, bonuses, allowances, compensation for loss of office, benefits; and for previous years
- Shares subject to options, with prices and details of awarded/exercised/lapsed, etc
- Stop details at start and end of year, and vesting
- Pension details

Legislation currently in process

The Enterprise and Regulatory Reform Bill

Disclosure

Voting

New disclosures for directors’ remuneration, from 2013

- Two-part remuneration report, setting out Policy separately from Implementation
  - Policy section to discuss all facts taken into account in determining that policy
  - Policy in full, to include policy on payments for loss of office
- Full details of all awards, including the link between pay and performance
  - With details of how calculated
- Sums paid on loss of office to be disclosed immediately
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New voting arrangements on directors’ remuneration

POLICY
Binding vote

IMPLEMENTATION
Annual advisory vote, as now

- On passing the legislation (2013), and every 3 years
- On changes to policy
- If the previous year’s advisory vote was not carried

What didn’t happen (but might yet...)

- No requirement for employees to sit on Remco
- No publication of the ratio between highest and lowest/average pay
- No employee vote on directors’ pay
- No shareholder representation on the Nomination committee
- No disclosure of pay below board-level

Accountability

“Accountability, to strengthen the hand of shareholders so that they feel they are taking responsibility for remuneration in the boardroom.”
David Cameron, 28th October 2011

What formal accountability is there already?

UK Corporate Governance Code.

“The company must, prior to the meeting, give to the members of the company entitled to be sent notice of the meeting notice of the intention to move at the meeting, as an ordinary resolution, a resolution approving the directors’ remuneration report for the financial year”

DRRR 2002, section 241A(3)

How useful has this vote been...?

We find that less than 10 per cent of shareholders abstain or vote against the mandated Directors’ Remuneration Report (DRR) resolution.

Currently, we find limited evidence that, on average, “say on pay” materially alters the subsequent level and design of CEO compensation.

Conyon & Sadler, 2010

Source:
Voting against directors’ pay in 2012

Data from Manifest, The Proxy Voting Agency
www.manifest.co.uk

Represents all UK-listed companies from all indices with ‘Total Dissent’ > 40%, since 1 Jan 2012

Total dissent is the sum of ‘Against’ and ‘Abstain’

19 companies in all, of which 7 lost the vote.

Written by legal specialists and financiers, and deals with all aspects of UK corporate governance, including a comparison with other regulatory regimes

A series of publications exploring the differences between UK and US governance

The full survey is only available for a fee, but the blog sets out a summary. This also explains the ‘Total remuneration’ figure which is to be adopted for disclosure.

Manifest Blog summarises the results at:
http://blog.manifest.co.uk/2012/06/5739.html
Many of my publications, including my PhD thesis, can be downloaded from my LinkedIn page.

Regular updates on corporate governance on Twitter @Ruth999