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BIG INNOVATION CENTRE

The Purposeful Company

Interim Executive Remuneration Report

Purposeful Company - Interim Executive Remuneration Report

The Purposeful Company Taskforce is developing a range of policy recommendations to support the development of UK companies pursuing sustainable growth inspired by purpose. These will potentially include recommendations on company law, corporate form, purpose certification, commitment devices, takeover restraints, investment chain stewardship, intangible reporting and investment funding.

This is the Interim Executive Remuneration Report produced by the Steering Group of the Purposeful Company Task Force. The final recommendations will be published in January 2017 as part of the Final Policy Report, taking into account the Government's Green Paper on Executive Pay and Corporate Governance, and feedback from the Purposeful Company Taskforce Members and other stakeholders.

The Final Policy Report will be launched in January 2017. If you wish to attend the launch, please contact Alice Piterova at a.piterova@biginnovationcentre.com

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Further information on the Purposeful Company Task Force members can be found on the Interim Report.

Executive summary

Introduction

Executive Remuneration has become a signature issue in relation to public trust in business. As a result, policy-makers are considering reforms to address three perceived failings in current executive pay practices and governance:

- That executive pay encourages short-term behaviour that is to the detriment of the long- term growth and productive potential of the British economy;

- That executive pay has become disconnected from the pay of ordinary working people to an extent that is damaging social cohesion; and

- That shareholders do not have adequate control over executive pay practices, enabling companies to continue with practices against shareholder wishes.

Great companies need great leaders, motivated to act with purpose. It is vital that listed companies are able to attract talented CEOs, given that such people always have options about where they work. The commentary around executive pay can be so relentlessly negative that we are in danger of forgetting this important fact. Good CEOs remain good value.

However, reform is necessary along two main dimensions. First, pay structures need to be reformed better to support purpose. We want CEOs to act purposefully because of and not in spite of their incentives. Yet as shown in the Purposeful Company Interim Report[1], several aspects of prevalent practice in the UK act as in incentive against purposeful behaviour. Second, trust in business is at such a low ebb, and executive pay is such a signature issue in the minds of the public, that changes do need to be made to rebuild public confidence. For purposeful companies to flourish, the public needs to have confidence in the framework within which they operate. This is not currently the case, particularly in the area of executive pay.

In this paper we present a provocative challenge to the received wisdom on executive pay. We hope that all constituencies engage constructively in the debate, as we believe the status quo is not an option. To those who believe that all is bad with executive pay, and to those who believe that nothing needs to change, we say: look at the evidence. Our approach is distinctive in that, while recognising the political imperatives in this area, we are grounding our recommendations robustly within the context of high quality evidence, coupled with practitioner experience. This enables us to provide recommendations that have the best chance of addressing underlying root causes as opposed to responding ineffectively to symptoms[2, 3]. This is particularly important in an emotive area such as executive pay.

Policy Proposals

We put forward four proposals to help align executive incentives better with long-term purposeful behaviour and to help rebuild public confidence in executive pay.

A. Shareholder guidelines and the UK Corporate Governance Code should enable companies to adopt simpler pay structures for CEOs based on long-term equity and debt holdings to encourage long-term behaviour and to avoid the unintended consequences of over-reliance on performance-based incentives.

- Packages should be structured to ensure CEOs rapidly (e.g. within two years of appointment) build up shareholdings of at least 2x the value of a year's performance-based incentives, with a target to increase this to 2x total compensation over time.
- This should be achieved through appropriate combination of: reducing performance-based incentive plans in favour of long-term awards of equity; paying bonuses in shares; and making joining awards of equity to CEOs, vesting over long periods.
- Pay should be long-term, with shares released on a phased basis over periods of up to at least 5 to 7 years depending on industry with at least half of the shareholding requirement applying for at least two years after leaving the company.
- Cash bonuses should be limited to 25% of incentive pay and based on non-financial and strategic measures. Bonuses based on financial targets should be paid in shares, with board discretion to vary them up or down based on holistic judgement.
- Particularly in highly leveraged or volatile companies, boards should consider paying CEOs in unsecured debt (e.g. via deferred compensation plans) as well as equity.

Summary rationale

- Evidence shows that incentive plans based on performance targets over short periods of 1 to 3 years can cause short term behaviour to the detriment of purpose and long-term value.
- Evidence also shows that high levels of shareholding and greater long-term orientation of incentive pay have a positive impact on long term value, innovation, and long-term orientation of companies, consistent with greater purpose.
- De-emphasising annual bonuses and target-based long-term incentives, making long-term stock awards, and requiring large shareholdings helps align executives with truly long-term decision making and purposeful behaviour.
- Simpler packages, with less reliance on performance conditions, would also avoid the extreme difficulties that remuneration committees face in setting robust targets.

B. **Companies should be required to publish a Fair Pay Charter explaining policy and outcomes for wider employee pay and fairness and to engage with employees on its content including specified disclosures on pay comparisons**

Boards should be required to produce a Fair Pay Charter covering their approach to wider employee pay and fairness. The Charter should be published on the Company's website at the same time as publication of the annual report, and an appropriate forum established for the Remuneration Committee Chair, together with appropriate members of management, to explain the report to, and obtain feedback from, at least UK-based employees. The Charter should cover, supported by data where appropriate:

- The company's philosophy and principles on pay fairness across the population (including how fairness is defined) and the approach taken to internal and external comparisons, covering the structure and level of pay.

- Disclosure and explanation of the relative movement in pay over the last five years (building to ten over time) for the CEO and the average for the UK workforce and total workforce, and explanation in the context of the company's performance – shown for base pay and for maximum and actual total remuneration, indexed to 100 at start of the period.

- Explanation of how the policy on pay for the wider UK workforce differs from that for the CEO and other senior executives in terms of the elements of pay offered, the quantum of opportunity under those pay elements, and the target positioning of pay against the market together with justification for such differences.

- Explanation of the extent to which it is the company's policy and practice to pay living wages in the territories in which it operates, and how these are established, statutory disclosures on Gender Pay and philosophy and approach to equal pay issues.

- Explanation of the approach by which employees are engaged on the Fair Pay Charter and a summary of any themes emerging from the feedback on the prior-year's Charter.

Summary rationale

- The evidence does not support the notion of widespread lack of control or market failures in listed companies.

- However, there is significant public disquiet about inequality and listed company CEO pay is a visible symbol of that inequality in the minds of many.

- A purposeful company should have a strong understanding of how its stance on pay relates to the broader societal debate about fairness, as this will build trust and also employee engagement, and is consistent with operating with purpose.

- A mandated disclosure and employee engagement requirement will elevate the priority of this discussion within boards.

- The disclosure should meet public demands for transparency, and explanation, of the disparity between CEO pay and worker pay, but this should focus on relative trends in actual pay and pay opportunity over time rather than on a snapshot ratio.

- Pay ratios do not lend themselves to valid comparisons between companies, even within the same industry, and would likely add to misunderstanding over executive pay as well as potentially creating perverse incentives – also would fuel excessive negativity over pay, when we need great leaders to create our great companies.

- Pay ratios may lead to pay being decoupled from performance, in favour of being linked to median worker pay.

- Any statistic about pay relativity must be set in the broader context of a company's approach to fairness, which may be defined by external as well as internal relativities, as well as by contribution, and so the Fair Pay Charter should be broader than statistics.

C. The Directors' Remuneration Reporting regulations should be updated to enable greater stakeholder understanding of a company's maximum pay and relationship between pay and performance

The Directors' Remuneration Report should include:

- Disclosure over each of the last five years of the change in "total company wealth" of the CEO, comprising remuneration for the year plus or minus changes to the value of unvested and vested share and debt based remuneration, compared with the change in market capitalisation of the business over those years, together with a justification for the relationship.

- Within the remuneration policy a clear monetary maximum should be stated and justified for each element of remuneration other than those linked to the value of shares, in which case the limit should be based on the initial value of shares awarded.

- The single figure table should show how much of the single figure of remuneration arises from the impact of growth in share price on share incentives between the date of grant and measurement of performance and should show a separate total single figure excluding this amount.

Summary rationale

- Current disclosures comparing pay and performance are extremely misleading and lead to widespread misunderstanding of whether executive pay is actually linked to performance, as they focus only on a single year's awards and not the incentive effect of holdings of previously granted equity.

- Changes in value of equity holdings are a major contributor to executive incentives and should be shown, compared against the aggregate value created over the period, to enable a much better and more complete analysis of executive pay.

- Boards should have to explain why they have chosen the level of maximum pay for the CEO, and that maximum should be clearly defined – in particular the practice of allowing certain elements, such as final salary pensions, to be in effect uncapped should end, with a clear monetary limit on these.

- Potential upside due to increase in share price flowing through into share awards should not be capped – however, this should be separately disclosed to enable stakeholders to assess where the single figure pay outcomes sits against the maximum disclosed in the policy, and to see the contribution to the single figure from share price growth. This will help minimise misunderstanding of how pay compares to policy and performance.

D. A binding vote regime should be triggered when companies lose, or repeatedly fail to achieve a threshold level of support on, the advisory remuneration vote

If a company loses the advisory remuneration vote in any year or receives 25% or more vote against the advisory vote two years in a row then:

- The company should be required to bring forward their remuneration policy for approval at the next AGM of the company as a Special Resolution requiring a 75% majority to pass; and

- At the same AGM a motion would be brought forward enabling shareholders to dis-apply, by simple majority, the requirement for a super-majority.

Proxy voting agencies should:

- Give clear guidance during consultation with companies if proposals are likely to attract a negative voting recommendation; and

- Take into account the views of major shareholders in a company when issuing voting recommendations.

Summary rationale

- Evidence shows that the current UK voting regime, combining triennial binding policy vote and annual advisory vote on implementation of policy, is effective.

- However, a small proportion of companies (c. 3%) either lose the advisory vote or repeatedly secure only lower than normal levels of majority support on the advisory vote.

- Introducing a binding vote for all companies every year is a disproportionate response to this problem, and would be likely to have many negative unintended consequences.

- Therefore, it would be better to design an escalation approach such that only those companies showing an inability to sustain high levels of shareholder support would trigger a binding regime.

- The requirement to bring back the policy to a vote with a super-majority imposes a higher bar for approval for companies that have not maintained high shareholder support in the past. This provides a disincentive against companies either having their report voted down or consistently get opposition above 25%, and a sanction if they do.

- Having the vote on policy rather than outcome enables shareholders to bring pressure to bear in relation to any problematic area of policy.

- The parallel motion enabling disapplication of the super-majority ensures that, in the rare cases where a disruptive minority group of shareholders exists, they cannot hold a company to ransom on a binding basis against the wishes of the majority.

- The existing of a 25% threshold condition will give greater influence to proxy voting agencies. It is therefore important that they engage fully with companies, provide clear guidance, and take into account the views of the company’s major shareholders, to avoid unintended consequences of the escalation mechanism.

Detailed policy, rationale, and evidence

Policy Proposition

A. Remuneration Structure

Table 1: Recommendation A

Our recommendations primarily focus on CEO pay. The CEO holds a distinctive position in the company as the most senior executive. This gives them a particular accountability for balancing the performance and long-term health of the business. CEOs also do not suffer from the information asymmetry faced by boards, and so may be in a better position to govern performance-based incentives for their executive teams. While companies may well wish to have a degree of alignment in pay design across those executive teams, the recommendations here particularly have the CEO in mind.

Recommendation	Description
Shareholder guidelines and the UK Corporate Governance Code should enable companies to adopt simpler pay structures for CEOs based on long-term equity and debt holdings to encourage long-term behaviour and to avoid the unintended consequences of performance-based incentives	• Packages should be structured to ensure CEOs rapidly (e.g. within two years of appointment) build up shareholdings of at least 2x the value of a year's performance-based incentives, with a target to increase this to 2x total compensation over time. • This should be achieved through appropriate combination of: reducing performance-based incentive plans in favour of long-term awards of equity; paying bonuses in shares; and making joining awards of equity to CEOs, vesting over long periods. • Pay should be long-term, with shares released on a phased basis over periods of up to at least 5 to 7 years depending on industry with at least half of the shareholding requirement applying for at least two years after leaving the company. • Cash bonuses should be limited to 25% of incentive pay and based on non-financial and strategic measures. Bonuses based on financial targets should be paid in shares, with board discretion to vary them up or down based on holistic judgement. • Particularly in highly leveraged or volatile companies, boards should consider paying CEOs in unsecured debt (e.g. via deferred compensation plans) as well as equity.

Problems with current CEO incentives

Current incentive plan designs, in particular performance-based vesting over relatively short timeframes of 1 to 3 years, act to undermine long-term and purposeful leadership of companies. There are several strands of evidence for this, a number of which were discussed in detail in the Purposeful Company Interim Report[1]. In summary:

- Executive behaviour (for example in relation to R&D expenditure, capital expenditure, news releases, and other short-term controllable executive action) can be distorted by upcoming incentive vesting events and by equity vesting patterns, with the effect being most extreme when performance conditions are close to being triggered[4-8]. This suggests that so-called "long term" incentives with performance-based vesting actually encourage short-term behaviour as vesting dates and triggers approach.

- Executives discount complex performance-based long-term incentive plans to an excessive degree, thereby reducing any positive impact on long-term behaviour[9,10].

- Short-term or poorly designed financial incentives can crowd out creativity and intrinsic motivation and thereby act to inhibit purposeful behaviour, can be ineffective in incentivising performance in relation to complex multidimensional jobs, and can lead to excessive risk-taking and even unethical behaviour[11-16].

- Research and experience shows that CEOs can have significant influence over target setting and partly as a result of information asymmetry, remuneration committees struggle to set consistently challenging targets as shown by the fact that incentive pay-outs are consistently biased towards "above-target" levels[17,18].

Collectively this evidence suggests that some elements of the "performance pay model" promoted over the last 20 years by investor bodies and governance guidelines are faulty. This model, which is based on bonuses and "long-term" incentive plans with performance targets over relatively short periods of 1 to 3 years, has given rise to a range of unintended consequences including:

- Increased complexity and lack of transparency

- Incentives for short-term behaviour

- Enormous target calibration challenges for Remuneration Committees

- Pay outcomes which are not clearly understood by stakeholders on many occasions

In summary, the ability for executives to earn sums in a few years that are life changing for them and their descendants, largely based on performance metrics that Remuneration Committees find very difficult to select or calibrate[18], has obvious weaknesses.

Note that these weaknesses have led some to suggest that incentives should be abandoned altogether. However, evidence also suggests that a high level of equity ownership does lead to improved company returns, innovation, and CSR over the long-term[19, 20]. Therefore incentives still have a place, but should be reformed.

A model based on long-term equity and debt

There should not be a one-size-fits-all model, but there should be a strong presumption in favour of a simpler model unless circumstances dictate to the contrary. Such a pay model would incentivise long-term behaviour, creating a "get rich slow" rather than "get rich quick" framework. Recent research has shown how increasing the long-term orientation of executive compensation increases long-term value and leads to improved long-run operating performance, innovation, and stakeholder relationships[19]. This emphasises the importance of long-term compensation in supporting pursuit of purpose.

The cumulative evidence suggests that the over-use of performance-based vesting (where bonus and share awards are triggered according to performance against pre-defined targets over 1 to 3 years) gives rise to many of the problems with the current pay model. At the heart of our proposal is to reduce the emphasis on this feature of incentives, with all the unintended consequences that arise. Instead packages should rebalance towards awards of long-term equity and debt[10, 20, 21, 24, 25], released over at least five years and in many cases longer periods, such as seven years. Awards should vest and be available for sale on a progressive basis to avoid major cliff-vesting events that could skew behaviour[8, 16, 25]. This will inevitably result in higher equity holdings persisting significantly beyond an executive’s tenure with the company.

The recommendation to de-emphasise performance conditions will be controversial, given the emphasis that this feature of pay design has had in shareholder guidelines and governance codes. We do accept that there are circumstances where performance conditions can work. Performance-based incentives that form a smaller portion of the package, may continue to offer a useful signalling and incentive purpose, and would place less strain on the target setting process that is a source of such difficulty for remuneration committees. Smaller incentives could be more truly variable, helping to build public confidence.

Moreover, particularly in distressed businesses, transformation or turnaround situations[19] or where there is a strong controlling owner or block-holder able to oversee target setting[26] then greater emphasis on performance-based vesting may be appropriate. In these situations there is clarity of objective, of measurement, and of oversight. However, in many circumstances the necessary conditions do not exist for large-scale performance-based vesting to operate effectively and without unintended consequences.

So we are not proposing a “one-size-fits-all” model, but rather a change in centre of gravity of market practice. While recognising the importance of pay structures and incentive plans that are tailored to a company’s strategy, market practice should shift *in general* towards less emphasis on performance-based vesting, and more emphasis on high levels of long-term shareholding to create the right incentives for long-term purposeful behaviour.

Equity released over 5 to 7 years

The timeframe of equity awards should be higher than currently. Research shows that the market may take five years fully to incorporate information about intangible investments into the stock price[22]. This suggests at least a comparable timeframe for the release profile of equity awards. Indeed a range of investor guidelines, financial services regulations, practitioner experience, and academic research[21, 24, 25, 27-33], suggests timeframes extending out to between 5 and 7 years for the vesting and holding of equity awards. Sale restrictions should lift on a phased basis rather than linked to any fixed date or event (such as retirement) to avoid perverse consequences, and also to mitigate against short-term behaviour that may arise, particularly towards the end of the executive's tenure[16, 28, 34]. The precise timeframe of release would depend on particular business circumstances[27] and we might expect to see sector differences between shorter and longer-term industries (for example recruitment consultants versus mining companies). However, the presumption is of longer timeframes than are prevalent today, with the current norm being 3 to 5 years. As under the current UK Corporate Governance Code, malus and clawback would apply as appropriate.

Proposals for long-term vesting of equity awards often come up against two arguments. The first argument is that the time period for the awards exceeds the average tenure of a CEO (for the world's largest 2,500 companies a recent study[35] found this to be 4.2 years or 5.6 years depending on whether they took office after a forced or planned succession). However, timeframes of tenure should not be confused with timeframes of accountability for actions taken while CEO. At the most senior levels, and certainly for CEOs, it is reasonable for vesting and holding periods to apply on a phased basis for a number of years after they leave the company. This creates appropriate incentives for CEOs to ensure that their actions are sustainable over the long term. An important aspect of sustainability is succession planning. Requiring CEOs to hold stock for a period after they leave the company should provide a powerful incentive to focus on a critical, but often underemphasised, component of their role.

The second argument is that executives will heavily discount awards that are deferred for a long period of time[9, 10, 25]. It is important to note that our main objective is to ensure greater long-term exposure to the share price. This can be achieved both through awards that are deferred, and so subject to malus and forfeiture on resignation, and through awards that must be held, and so are fully vested but subject to changes in the share price. Academic research and experience from the banking sector[9, 10, 25] suggest that the uncertainty created by forfeiture conditions is particularly corrosive to perceived value. Therefore, unlike practice in the banking sector where, for the most senior individuals in a UK bank, awards are deferred up to 7 years with malus applying, we would propose shorter *deferral* periods, of up to 3 years say, with the balance of exposure achieved through holding requirements for a further 2 to 4 years. Moreover, it would be reasonable to enable phased release of awards, for example over 3 to 7 years, rather than requiring all awards to be held for the full maximum duration.

But overall, in light of the behavioural risks associated with the potential for rapid build-up of wealth given current market levels of pay for CEOs, it is surely more important to get the structure of pay right to create the right incentives, even if that results in pay that is higher than it might otherwise have been. It has been noted that executives should accept a reduced level of award for replacing long-term incentive plans by restricted stock[9, 10, 24, 25, 29]. In some cases a discount of up to 50% has been argued for by investor groups[32, 36]. However, executives will legitimately discount awards where deferral periods are longer[25]. It would be better to accept lower discounts (say, of one quarter or one third) in order to achieve longer deferral periods, given that the increase in executive pay costs incurred will be dwarfed by the increased value arising from more purposeful behaviour[22, 23].

Increased stock ownership requirements

A rigorous study has down that firms with high CEO stock ownership outperform those with low stock ownership by a very significant margin of 4-10% a year[20]. This research shows that the relationship is very likely causal – that is, stock ownership drives the CEO to perform better, rather than CEOs knowing that their firm will perform better and therefore buying more stock. In principle excessive stock ownership may also lead to CEO entrenchment and risk-averse behaviour[37]. More research is needed to establish exactly where the trade-off resides. However, given that UK levels of CEO stock ownership are generally significantly less than the US levels, where research shows that the higher levels of shareholding are beneficial, it is reasonable to assume UK practice is not yet at counterproductive levels.

Amongst FTSE-100 CEOs the median level of after-tax equity exposure from all vested and unvested equity (including long-term incentive plans, discounted by 50% for the impact of performance conditions) is approximately £6.5m or 850% of salary[38]. Of this around £4.5m or 550% of salary is stock that is already vested, and beneficially owned by the executive. At the upper quartile, total equity exposure is around £20m or 2200% of salary. This suggests that current typical stock ownership guidelines for FTSE-100 CEOs of around 250% to 300% of salary are purely notional, and should be increased.

We develop our approach to appropriate levels of shareholding based on two principles:

1. CEOs should rapidly (ideally within two years) build a shareholding so that the incentive provided by their shareholding dominates the incentive provided by a single year's opportunity under performance-based plans.

2. Over time, the shareholding should build so that lower quartile performance creates a penalty for the CEO through their shareholding equivalent to a year's compensation.

Coupled with lengthened release periods, these levels of exposure would create strong long-term alignment with sustainable performance.

The justification for the first principle is that an executive should be more concerned about whether the share price will be, say 25%, higher or lower in several years' time than by whether they hit short-term vesting triggers. Why 25%? Analysis across multiple sectors suggests that out-performance of 5% to 7% pa represents approximately one quartile of performance over 3 to 5 years. So for example the difference between median and upper quartile or between lower quartile and median within a sector over 3 to 5 years will typically be around 25% in share price terms. The aim is that this level of difference in medium term share price performance should offset an entire year's performance-based incentives.

Incentives are paid pre-tax and shareholding requirements are defined based on shares held after tax. This means that for a 25% share price movement to have more significant impact than a given incentive opportunity, the CEO would need to hold shares worth approximately 2x that incentive opportunity (a 25% change in share price would then change the value of shares held by 0.5x the incentive opportunity, which given that the shares are held after tax is approximately 1x the pre-tax opportunity, given UK total tax rate of close to 50%).

Therefore, meeting the first principle ensures that the difference of one quartile of performance over the medium term is equivalent to a year's incentives. Any executive who pursues short term actions to trigger a single year's incentive plan performance conditions at the expense of medium-term share price, will, over time, have the benefit of that year's incentives offset by the negative share price impact on their share portfolio. This creates a natural counterweight to the short-termism that performance-based incentives plans could create.

In a typical FTSE-100 company, a CEO might might have incentives of up to 500% of salary vesting in any given year based on performance targets. Therefore, the CEO's holding would need to be 10x salary in order for the shareholding to dominate the incentive opportunity on the basis defined. Note that there is no reason why this exposure should be restricted to fully vested equity – unvested equity should be included.

For a new joiner, a holding of 10x salary would take at least five years to establish. This is too long – it is important that the incentive effect of the high shareholding is achieved early in the CEO's tenure to ensure a long-term mind-set. To meet this goal within a rapid timeframe would therefore require some combination of:

- A rebalancing of packages away from performance-based incentives to stock awards;
- Payment of bonuses in shares;
- Initial stock awards or buy-in requirements for an executive on joining; or
- A phased approach so that performance-based incentives are increased in importance in the package over time as the shareholding builds up.

The goal of building to 2x total compensation over time ensures that a quartile's difference in performance creates an incentive impact equivalent to a year's total compensation. This ensures a strong focus on long-term share price. With median total compensation in the FTSE-100 being around £4m, a requirement of 2x total compensation would equate to a target total after tax equity exposure equivalent to around £8m or, again, around 10x salary. Although this sounds very high relative to current minimum guidelines, this level of holding is only around a quarter more than current median exposure in the FTSE-100[38] if unvested equity is included.

This level of exposure over the medium term therefore appears eminently achievable over a period of 5 years or so, if the package is appropriately structured..

Payment in debt

The case for payment in debt has been considered by a number of authors[39-43]. This is because of the significant evidence that the level of leverage in incentive packages does influence risk-taking behaviour[44]. Particularly in highly geared companies or volatile industries, equity can create an incentive for excessive risk. This is because the value of equity rises if a risk project pays off, but it is protected by limited liability if things go wrong – thus, equity gives them a one-way bet. Similarly if a firm is teetering towards liquidation, rather than optimally accepting a mild bankruptcy, the executive may 'gamble for resurrection'. In such cases use of long-dated unsecured debt can help create a counterbalance.

In the past, unfunded defined benefit pension plans were a form of debt compensation. Deferred compensation plans, of the type common in North America, can have similar impact. Research shows that executives with such plans led companies that were associated with lower bond yields and higher bond prices[40,41] suggesting that debtholders are indeed reassured by the CEO's lower incentives to pass risk onto them. Higher levels of debt-like compensation were also associated with lower bankruptcy risk, lower stock return volatility, lower financial leverage, and higher asset liquidity[42,43]. A return to the days of defined benefit pension plans for executives is unlikely to secure public or shareholder support. But there are other ways to pay executives in unsecured debt.

The simplest would be simply to convert the current practice of cash "pension contributions" into unfunded deferred compensation payments. These would accumulate in a fund and be payable, say, over the five years following retirement. The value of these on payment would only be reduced in case of default – either they would pay or, in case of default would reduce in line with other unsecured debtors.

Alternatively, Banks have used debt instruments and Contingent Convertibles ("CoCos") which align executives on a more continuously variable basis with the creditworthiness of the firm, via the change in market price of these instruments as creditworthiness varies. Indeed regulators have encouraged use of such instruments[33]. There are, however, formidable practical difficulties with using traded debt in compensation plans. Companies may not have sufficient tranches of traded unsecured debt to provide compensation vehicles of appropriate duration. Moreover, consumer-protection regulation often requires such bonds to be in high denominations only, so as to discourage retail investors – as such they may not be sufficiently fungible for compensation purposes.

Widespread adoption of debt-based compensation is therefore more likely to take the form of deferred compensation arrangements as described above or phantom arrangements based on credit default swaps – the value of a phantom award, initially 100, say, could move up or down in line with the movement in credit spreads.

Given the market trend towards less leveraged pay arrangements (shares rather than options) the focus for exploring debt-based compensation could initially be on those industries that are most volatile or leveraged, such as banking and commodity companies.

Smaller cash bonuses based on building intangibles

Given the evidence that the market can undervalue intangibles[22, 23], there is a case for retaining an element of shorter term incentive for executives to build intangibles, recognising that the benefits may not flow through into share price for some years. Although very long term equity could partly address this problem, there may be a motivational benefit of linking progress towards building intangibles to reward in the shorter term. This is not without problems given the difficulties of setting non-financial goals[18-45]. However, risks can be mitigated by ensuring that cash bonuses when used in this way are relatively small compared with long-term equity grants, and by ensuring that targets are structured with a high degree of "in the round" discretion for Boards, to avoid perverse consequences arising from mis-specified targets or metrics.

Evidence suggests that pay-outs from annual bonuses are both higher and less variable than from long-term incentives[38].This suggests that the calibration challenges faced by remuneration committees for bonuses are particularly acute. At the same time, bonuses are even more prone than long-term incentives to create unintended consequences of short-termism. We therefore suggest limiting any use of cash bonus to at most 25% of incentive pay including stock and debt awards given these calibration difficulties and in light of the evidence that long-term orientation of incentives is supportive of purposeful behaviour[19]. Bonuses based on financial metrics should be paid in shares subject to a deferral or holding period to ensure a counterbalance to any short-termism that could arise from pursuit of short-term financial metrics.

Use of discretion

Where performance-based incentives are used, it is essential that in-the-round discretion is available to remuneration committees to avoid the unintended consequences that may arise. Of course the smaller the role performance-based incentives play in the package, the less requirement there is likely to be for discretion, as the potential unintended consequences are of lower magnitude, and there will be greater acceptance from executives for "taking the rough with the smooth".

However, for discretion to have credibility with executives, there should be a clear understanding with shareholders that such discretion may act upwards as well as downwards. While the investor expectation for downwards discretion has become well-established, upwards discretion is less well accepted.

A practical proposal

The above prospectus sets out a radical agenda for change. However, the resulting remuneration packages are neither unrealistic nor unrecognisable, and can readily be achieved within the current compensation system. Noting that current median FTSE-100 CEO total compensation comprises roughly £1m of fixed pay (base plus pension) and £4m pa total compensation, the following package would deliver broadly a market competitive level of value, while meeting the principles set out above.

Table 2: Example package delivering competitive median FTSE-100 CEO total pay

Component	Design and level
Fixed Pay	£1m pa
Bonus	£0.75m pa, in cash, based on building intangibles, £1m max
Stock award	£2.25m pa, vesting 20% a year over 3 to 7 years
Total Pay	**£4m, in line with median FTSE-100 total pay**
Shareholding target	200% of fixed pay in vested stock
Depending on the risk and leverage of the company, the stock award could be partly delivered as long-dated debt. The stock awards (after tax) build to the target level of 2x the bonus opportunity within two years. Over time the stock awards would build up to a natural ongoing net of tax stock exposure of £6m through unvested stock. This is why a shareholding target on vested stock is added, to ensure that the total stock exposure is £8m, or 200% of total compensation.	

We would not encourage a one-size fits all model. Pay packages should be tailored to individual company circumstances and strategies. Indeed as previously discussed there may be circumstances where traditional performance-based incentives may continue to be appropriate. This may particularly the case in transformation or turnaround situations or distressed companies[19]. There are various different ways in which the goal may be achieved of focusing packages on higher and longer-term shareholding. However, in a number of situations a radically simpler approach may be preferable, based on long-dated stock awards in place of complex performance-based incentives.

The purpose of this example package is to show that a reformed model is perfectly achievable and not at all beyond the bounds of possibility. This approach also shows that purpose can be factored into pay plans without excessive complexity of non-financial measurement. As well as achieving better incentives for purposeful, long-term behaviour, the proposal also has the benefit of simplifying pay, and reducing headline maximum levels of total compensation, and avoiding the potential for outsized, and apparently random, rewards.

B. Fair Pay Charter

Table 3: Recommendation B

Recommendation	Description
Companies should be required to publish a Fair Pay Charter explaining policy and outcomes for wider employee pay and fairness and to engage with employees on its content including specified disclosures on pay comparisons	Boards should be required to produce a Fair Pay Charter covering their approach to wider employee pay and fairness. The Charter should be published on the Company's website at the same time as publication of the annual report, and an appropriate forum established for the Remuneration Committee Chair, together with appropriate members of management, to explain the report to, and obtain feedback from, at least UK-based employees. The Charter should cover, supported by data where appropriate: • The company's philosophy and principles on pay across the population fairness (including how fairness is defined) and the approach taken to internal and external comparisons, covering the structure and level of pay • Disclosure and explanation of the relative movement in pay over the last five years (building to ten over time) for the CEO and the average for the UK workforce and total workforce, and explanation in the context of the company's performance – shown for base pay and for maximum and actual total remuneration, indexed to 100 at start of the period • Explanation of how the policy on pay for the wider UK workforce differs from that for the CEO and other executives in terms of the elements of pay offered, the quantum of opportunity under those pay elements, and the target positioning of pay against the market together with justification for such differences • Explanation of the extent to which it is the company's policy and practice to pay living wages in the territories in which it operates, and how these are established, statutory disclosures on Gender Pay and philosophy and approach to equal pay issues • Explanation of the approach by which employees are consulted on the Fair Pay Charter and a summary of any themes emerging from the feedback on the prior-year's Charter

Fair Pay Charter

The rationale behind the Fair Pay Charter is to respond to the significant and legitimate public disquiet about inequality[46], and to encourage Boards to discuss the issue of fairness in relation to pay, which is relevant to creating an engaged workforce and purposeful company. The experience from the banking industry[47] has been that greater Board involvement in overseeing, monitoring, and reporting on company-wide pay outcomes has enhanced the level of rigour and scrutiny of pay decisions within the company. This would be reinforced by the requirement to engage with employees on the Charter.

Improving on pay ratios

The other argument in favour of the Fair Pay Charter is to act as a more holistic response than a policy that is being proposed in a number of quarters - namely pay ratios. Pay ratios are already being introduced in the US and have been suggested as a disclosure by the Investment Association[24] and Legal & General[36], as well as Chris Philp MP and the High Pay Centre[48, 49]. However, they have been removed from the draft EU Shareholder Rights Directive. It is too early to judge the impact of pay ratio disclosure in the US as the formal disclosure requirements do not start until fiscal years starting on or after 1 January 2017. Development of the regulations was mired for several years in detailed methodological debate.

Although well-intentioned, snap-shot pay ratios by themselves have the potential to create misleading comparisons and perverse incentives. For example, retailers will inevitably appear to do worse on the ratio than, for example, specialist financial services firms. Yet this does not suggest that retailers are less fair. A hotel company with a franchise model will inevitably have a lower ratio than one that owns and manages its own hotels. How to calculate the ratio for international companies is complex - should it be the UK workforce only, or the global workforce? Each has pros and cons and difficulties of comparison. Pay ratios can also penalise companies that offer higher non-monetary benefits, favour companies that outsource low paid work rather than keep it in-house, and act against troubled or start-up companies where the employee proposition may involve aspects other than pay. These issues show that the ratio could be reduced in ways that are quite counterproductive.

Furthermore, the public concern relates to inequality within society. This is a matter of public policy in relation to taxation, redistribution, regional development, education, and training. It is not clear that a focus on inequality within companies is the valid starting point for addressing inequality within society. Indeed it should also be noted that the evidence that inequality is bad for companies is at best mixed. A body of work relating to tournament theory emphasises the role that pay differentials have on performance incentives for those seeking promotion, and finds this impact is generally positive[50]. In related work, recent detailed analysis of inequality at the firm level suggests higher inequality within UK firms is associated with higher performance[51], presumably reflecting the fact that higher pay can attract more talented executives. Set against this, there is research that asserts that pay differentials can have a negative effect on employee motivation and engagement[52] and that in-firm inequality is negatively correlated to long-term performance[53]. This argues that it is in companies' self-interest to operate a more equal approach to pay.

Taken together, the research suggests that there is no single answer to this difficult question, and it is likely to be highly situational. The evidence would seem to suggest that great companies exist with wide pay differentials, and that these differentials can play an important role in attracting and motivating the best talent. At the same time, a pay system that is felt within the organisation to be unfair, and which provides rewards that are felt to be unwarranted, is likely to be corrosive to the social fabric of the organisation and may have adverse impact on performance. However, "more fair" may not mean "more equal", if pay differentials are seen to be proportionate to contribution.

A false premise

Behind many of the calls for pay ratios is a suggestion that CEO pay at listed companies is out of control due to governance and market failures, and that transparency on the comparison will bring about change. Even if it were true that CEO pay were too high, the idea that disclosure of ratios would shame companies into reducing CEO pay is not borne out by the evidence arising from past extensions of disclosure of CEO pay, which have simply led to a ratcheting effect. This is typical of the unintended consequences that have frequently arisen from pay regulations[54, 55].

The fact that pay ratios between the CEO and median worker have increased and are of the order of 100 to 150x in the largest UK companies is taken by some commentators to be manifestly absurd, with the scale of the disparity itself demonstrating that the system is broken. Indeed it is seems to fly in the face of principles of proportionality to argue that one individual is “worth” over one hundred times more than another. But a simple thought experiment shows that such wide differentials should not be surprising from an economic perspective.

A large UK retailer has a market capitalisation of £14bn and 7,000 stores. So on average each store is “worth” £2m to its shareholders. A store manager operates within a set of company frameworks and can have limited impact on the overall corporate brand. However, a really great store manager can promote improved local performance through motivating their staff and acting creatively within the span of control they are given. But it is clear that the impact a store manager can have is likely to be less than a multiple of the store’s current performance. So let’s assume, perhaps generously, that a store manager can add 50% to their store’s value – this equates to added value of £1m for shareholders. A worker in the store will have a smaller level of influence than the store manager – probably less than one-tenth of the influence, as they will largely operate within defined policies and procedures and have no control over pricing or promotions. This might equate to up to a £100,000 impact at the very most.

Now turn to the CEO, who is responsible for the entire £14bn enterprise. If the CEO can impact the performance of the company by just 1% (surely an underestimate), then this equates to £140m, being 140x the economic impact of a store manager, and 1,400x the impact of a store worker (the median paid worker will likely be from this population). So this simple thought experiment shows how it is quite logical, from a market perspective, for very wide pay differentials to arise. Equally, as company size and complexity increases, it is logical for the pay of the CEO to increase, whereas that of ordinary workers should not[51]. A CEO of a company with 1,000 stores has ten times the influence compared with a company of 100 stores. But the store manager has the same role in each case. Indeed a case could be made that even at current levels CEO pay does not fully represent the economic impact of the CEO on the value of the enterprise compared with an ordinary worker.

Since the FTSE-100 was launched in 1984, the market capitalisation of the median company has increased from £540m to over £8bn today, a 15x increase. By contrast pay in the UK’s largest companies has increased broadly 13x from around £300,000 pa (including the value of final salary pensions) to around £4m today. Median CEO pay is broadly the same percentage of market capitalisation today as three decades ago, as theory suggests[58].

Furthermore, the idea that CEO pay is out of control due to governance and market failure comes up against a significant body of contrary evidence. Pay at listed companies has increased no faster than pay across a number of high skill occupations (private companies, private equity, professional services, medicine, media, sports, and so on). Furthermore, there is evidence that increases in pay simply reflect the growing complexity of the world's largest companies, higher returns to scarce talent, and growing convergence in international executive pay markets[26, 56-59]. When hedge funds and private equity take control of companies they make many changes to the operation of the company, including potentially firing the CEO, but they do not tend to cut pay, and indeed frequently increase it[26, 56, 60]. If pay in listed companies were so out of line, we would expect to see changes when the listed company governance environment is replaced by close private supervision.

This all suggests that the disparity between CEO and worker pay is part of a broader economic phenomenon relating to returns to talent where there is scarcity, as opposed to a market failure. This makes the political problems created no less difficult – if anything more so. But it does suggest that an excessive focus on CEO pay levels at listed companies as opposed to broader drivers of inequality is misguided. Indeed there is evidence that public concerns about inequality relate as much to their own insecurity about future employment prospects as to the level of inequality in society of itself[46].

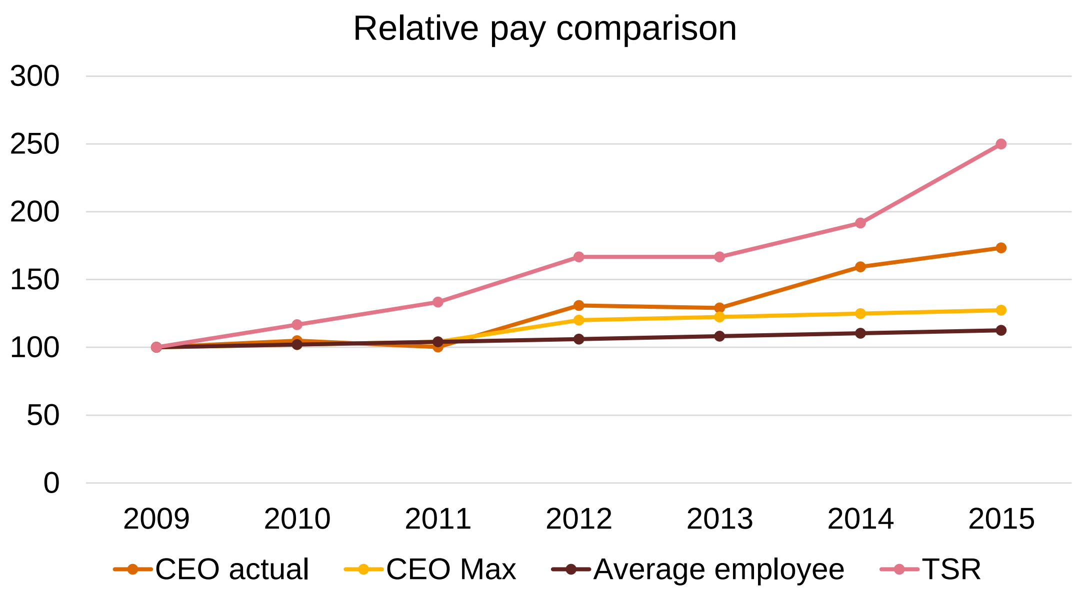
Policy recommendations relating to CEO pay quantum and inequality within firms should therefore be approached with some modesty, in terms of their likely efficacy in addressing the public's concerns about inequality. Furthermore, there is an argument that can be made that the relationship between CEO pay and worker pay is irrelevant given the completely different roles and markets for talent.

Pay comparisons over time, in the context of a holistic view of fairness

However, it cannot be denied that the differential between high pay and ordinary worker pay is a significant political issue. Pay ratios between CEOs and the average worker currently exceed what the public deem to be acceptable by a wide margin[46, 61] across the world.

Therefore we do believe that there is a compelling case for requiring companies to disclose information on their approach to pay fairness. Fairness can be defined in a number of ways and the onus should be on the board to articulate their position on the issue. Importantly "more fair" is not the same as "more equal". But comparison of pay trends between CEO and workers is part of the equation. However, for the reasons outlined above, we prefer comparisons between CEO pay and worker pay that focus on trends in actual and maximum pay over time, through disclosure of a relative pay index, rather than on the snapshot ratio at a given point in time. Hence our recommendation focusses on comparing indexed pay for CEO, and the average employee over 5 years or more, and rebased to 100 at the start of the period. This is preferable to creating a statistic that is prone to misleading comparisons between companies. We propose disclosing CEO pay both as maximum opportunity and actual paid. This enables assessment of whether CEO pay is rising structurally, relative to the wider population, or whether it is due to performance. For example as follows:

Figure 1: Example relative pay comparison



Given the political urgency of grappling with the issue of inequality in society, a purposeful company, powerfully rooted in the needs of its stakeholders, must have a robust view on its relationship to the inequality question. To retain the corporate social fabric, pay differentials within a purposeful company should be viewed by employees as justified and proportionate. This can be the case even if those differentials are very wide, but not if they are unjustified. We believe that a Fair Pay Charter would have the benefit of bringing these issues properly into the Board discussion in a holistic way, but also encourage companies better to explain why pay operates as it does, and if they cannot explain it, to change it. We believe this approach, with a requirement for specific quantitative and qualitative disclosures, coupled with the requirement to engage with employees, would create more meaningful change than simple publication of any single snapshot statistic.

The requirement to engage

We do not believe that employees should have a formal say on pay packages. The purpose of engagement is to build trust and create accountability in the board for the overall pay approach. The remuneration committee is responsible for only a subset of pay decisions and so any employee engagement would be undertaken with appropriate management representatives also present, as the remuneration committee should not supplant executive accountability. We would envisage companies being given flexibility in the engagement mechanism, so they could create an engagement process that suited their circumstances and existing processes, and which aligned with any broader requirements for employee voice.

C. Reform of Directors' Remuneration Reporting regulations

Table 4: Recommendation C

Recommendation	Description
The Directors' Remuneration Reporting regulations should be updated to enable greater stakeholder understanding of a company's maximum pay and relationship between pay and performance	The Directors' Remuneration Report should include: • Disclosure over each of the last five years of the (£ Sterling) change in "total company wealth" of the CEO, comprising remuneration for the year plus or minus changes to the value of unvested and vested share and debt based remuneration, compared with the (£ Sterling) change in market capitalisation of the business over those years, together with a justification for the relationship • Within the remuneration policy a clear monetary maximum should be stated and justified for each element of remuneration other than those linked to the value of shares, in which case the limit should be based on the initial value of shares awarded • The single figure table should show how much of the single figure of remuneration arises from the impact of growth in share price on share incentives between the date of grant and measurement of performance and should show a separate total single figure excluding this amount

The relevance of Recommendation C (and later Recommendation D) to purpose, is that trust in business must be rebuilt if companies are to be given the freedom and licence to act in a purposeful manner. More purposeful companies should lead to a virtuous circle of greater trust in business, but in the current environment it is necessary to make changes actively to rebuild trust in the business ecosystem – nowhere more so than in executive pay. This justifies our interest in both executive pay disclosure and shareholder voting regimes. Nonetheless, any intervention should be based on robust evidence.

Improving pay versus performance disclosures

The current UK disclosure regulations[62] attempted to improve the disclosure of pay versus performance through two disclosures:

- Definition of a "single figure" of pay showing the total amount crystallising for an executive by virtue of satisfaction of performance conditions in the year, including the impact of any share price growth since the grant of share awards.

- A requirement to disclose over up to ten years this single figure of pay, the rate of vesting of short and long-term incentives as a percentage of maximum, and the TSR of the company.

However, this way of disclosing pay and performance has three serious flaws:

- The single figure is not as a result of a single year's performance but rather a blend of one year, three year, and possibly other performance periods, and as a result is inevitably mismatched against the performance comparison.

- TSR is presented as an indexed or percentage amount, which does not differentiate by size, although a TSR of 10% adds ten times the value in a £100bn company that it does in a £10bn company.

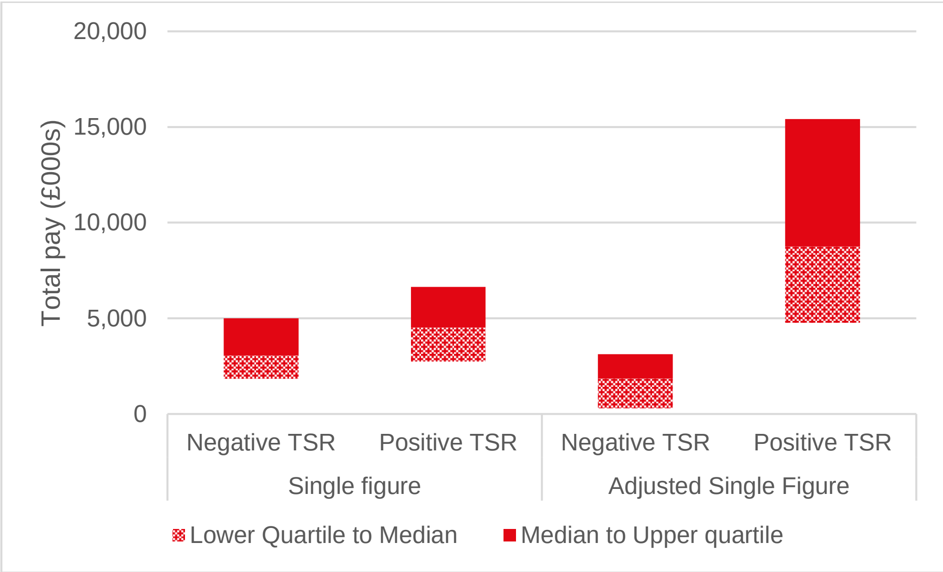
- Looking at a single year's crystallising pay is a very poor measure of the rewards to the CEO or indeed of their incentives, as it ignores the changes in value of outstanding deferred awards and fully vested shareholdings – such an approach would not be accepted by any top quality academic journal.

Indeed use of this kind of comparison has led to flawed conclusions about the link between CEO pay and performance, which have nonetheless become influential[3, 48].

Particularly given the levels of shareholding by CEOs present in large UK companies, any meaningful pay-for-performance comparison should include the change in value of stock-holdings over the period. The average FTSE-100 CEO has an after-tax equity exposure of £6.5m[38]. If the share price of their company falls by 20% over a year, this costs them £1.3m after tax, equivalent to a salary cut of £2.3m pre-tax. Even if they are "paid" £2.3m in salary and bonus for the year, their net return from being CEO of the company in that year would be zero. In effect they would not have been paid.

The chart below compares the single figure of pay for CEOs in the FTSE-100 for their most recent reporting year[38]. The companies are split between those that delivered a positive Total Shareholder Return (TSR) over the year (just under 2/3rds of companies) and those where TSR was negative (just over 1/3rd of companies). The left-hand bars show the reported single figure. The right-hand bars show an adjusted single figure, being the reported single figure plus or minus the pre-tax change in value of previously granted equity (vested shares still held by the executive and unvested deferred awards).

Figure 2: FTSE-100 CEO pay for positive and negative TSR companies, before and after adjustment for previously granted equity



Companies delivering positive TSR over the year had a slightly higher median single figure of pay - £4.5m as opposed to just over £3m for those companies that delivered negative TSR. This is a 50% difference at the median, however, there is significant overlap between the quartiles of pay for the positive and negative TSR companies, showing that some poorly performing companies were paid more, on a single figure basis, than companies that performed more strongly. This is not an analysis that has been subject to detailed controls, but note that the median market capitalisation for both the negative and positive TSR groups was almost identical, so there is no obvious size affect distorting the results.

The right-hand set of bars adds the change in value of previously granted equity. The impact of declining share price on the negative TSR companies reduced the pay of the CEOs of these companies by over one-third at the median, or about £1.3m. Indeed for more than one in five of the negative TSR companies, the fall in value of shares more than offset the single figure of pay for the year, meaning that those CEOs in effect received negative pay.

Using the adjusted figures the difference between the pay of the negative and positive TSR companies increases to nearly a factor of three and there is no overlap in the quartiles. This analysis demonstrates the importance of ensuring CEOs are significant shareholders in their business, but also shows the importance of developing a pay disclosure that includes changes in the value of previously granted equity.

We therefore believe it is important to have an additional disclosure to show the net (£ sterling) change in company wealth of the CEO over the year comprising both remuneration crystallising and the change in value of outstanding equity. This should then be compared to the (£ sterling) change in value of the company over the same period. Companies would be permitted to show other measures of value in addition.

Although there will be some complexity in valuing in-flight long-term incentives awards that are still subject to performance conditions, this should be resolvable to a satisfactory degree, to make this a meaningful disclosure.

Explaining the maximum pay level in the policy

The current UK reporting regulations[62] for directors' remuneration require the maximum for each element of remuneration to be defined in the directors' remuneration policy, and the regulations then require a shareholder vote to pay above that maximum. The maximum potential payable under the policy must be illustrated in a scenario chart at the time the policy is approved.

There is currently no requirement to explain why the remuneration committee chose this maximum amount as appropriate. It would create good discipline on remuneration committee thinking for them to have to justify this decision, including any market reference points used. This would also help stakeholders understand why the maximum pay is reasonable.

Beyond rebuilding trust in the policy regime, there is a further reason why clarity on the maximum pay level is justified. There is some evidence that very high CEO pay relative to norms or relative to other executives within the company can be correlated with lower firm value[63, 64]. These findings may be reflective of situations of entrenched CEOs or hubris, which create knock-on problems. This evidence suggests that it is reasonable for shareholders to receive a full explanation of why the maximum within the policy is deemed appropriate by the remuneration committee.

Clarifying the maximum pay level in the policy

The regulations allow the maximum to be expressed "in monetary terms or otherwise". In practice this has led to the maximum being defined in different ways for different components. For example salary has frequently not had a formal maximum; final salary pensions have been defined in terms of the benefit rather than the maximum value; for long-term incentives the maximum is typically defined in terms of the initial face value of the shares awarded rather than the value of shares when they pay out.

Although there is a good rationale behind these variations, in aggregate they have resulted in shareholders not actually voting on a clear pay maximum within the policy, and have arguably led to loss of public faith in the effectiveness of policy to restrain payments and has been cited as an example of the policy regime being ineffective or cicumvented[48].

In practice there are “good” and “bad” reasons why the maximum may have been exceeded:

- The typical “good” reason is that the maximum in the scenario chart normally excludes share price growth. Given that long-term incentive awards are denominated in shares, a strongly increasing share price combined with good levels of achievement against performance conditions can result in pay-outs ahead of the initial maximum face value of awards. Shareholders are generally supportive of pay-outs in such cases as they reflect performance – unless the grant was made at a temporarily suppressed price.

- “Bad” reasons may include a significant contribution to the single figure from a final salary pension when an executive receives an unusual pensionable salary increase, or a large salary increase that is beyond what was envisaged in the modelled policy. In some cases this has led to disclosed pension values in many millions of pounds when the scenario chart in the policy suggested a value of hundreds of thousands. In some cases this can lead to the stated maximum being exceeded in a way that would not realistically have been foreseen by shareholders.

To address this we propose two developments. First of all, for any remuneration element where the value in the single figure does not depend on share price growth, there should be a clear monetary maximum under the policy. This should also be true, for example, for defined benefit pension plans. Where the value of a benefit is unpredictable (as with a final salary plan) the company will be forced to make a realistic assessment of the maximum amount, and would then be required to obtain shareholder approval for any excess payment over that amount.

It would be counterproductive to impose a limit on value that arises purely from share price growth, as this is directly aligned with shareholder returns. Therefore, the maximum value of share awards would, as now, be defined by reference to their face value at date of grant.

However, we believe that it would be helpful for shareholders and other observers to understand the component of the single figure of pay that arose from share price growth as opposed to fixed pay or achievement against performance conditions. Therefore we suggest the addition of two columns to the single-figure table to show:

i. The single figure with share awards valued based on the share price at date of grant of those awards

ii. The additional amount within the actual single figure disclosure that arises because of share price growth

The amounts under (i) and (ii) above would by definition add up to the total single figure. This would help readers of the report to understand any cases where the single figure has exceeded the maximum in the scenario chart at the time the policy was approved. This disclosure is already included on a voluntary basis by some companies, and can help reduce misunderstandings about the drivers of pay and how it compares with the policy limits.

D. Reform of the shareholder vote on pay

Table 5: Recommendation D

Recommendation	Description
A binding vote regime should be triggered when companies lose, or repeatedly fail to achieve a threshold level of support on, the advisory remuneration vote	If a company loses the advisory remuneration vote in any year or receives 25% or more vote against the advisory vote two years in a row then: • The company should be required to bring forward their remuneration policy for approval at the next AGM of the company as a Special Resolution requiring a 75% majority to pass; and • At the same AGM a motion would be brought forward enabling shareholders to dis-apply, by simple majority, the requirement to pass the remuneration policy by a super-majority Proxy voting agencies should: • Give clear guidance during consultation with companies if proposals are likely to attract a negative voting recommendation; and • Take into account the views of major shareholders in a company when making voting recommendations.

Evidence on say on pay

There is substantial evidence that "say on pay" regimes have been effective in improving alignment between executive pay and shareholder interests. In the UK, introduction of say on pay in 2003 has been followed by a range of features sought by shareholders including: reduction in notice periods; removal of retesting of performance conditions; generally tougher performance conditions; less generous leaver and change of control treatment on LTIPs. This anecdotal experience has been backed up by comprehensive analysis of say on pay regimes globally[64]. This analysis shows that say on pay regimes have been associated with reduced rate of increase in CEO pay, and improvement in the sensitivity of CEO pay to performance, and introduction of shareholder-friendly pay features, with the changes particularly concentrated on those firms with the weakest governance and most problematic pay policies.

As noted by a number of authors, the market for executive pay is not perfect. Non-executive directors face asymmetric incentives in relation to CEO pay packages: CEO packages are trivial relative to the finances of the company in most cases, and the desire to avoid creating disgruntlement amongst management teams is clear. Say on pay has undoubtedly created a potential for reputational risk that has added steel to remuneration committee decision making, and created a counterweight to the fear of executive dissatisfaction that can affect remuneration committee behaviour.

It is too early fully to analyse the overall impact of introducing a binding vote in the UK as most companies have only had one policy approval so far. However, even the initial round of binding votes brought about clear limits on recruitment remuneration that had not previously existed and which would appear to have had a dampening impact on joining packages for CEOs compared with some of the more extreme practices of the past. Moreover, anecdotally it seems clear that the binding nature of the policy has brought with it a harder constraint on what can be offered to executives when they leave in certain circumstances. The international evidence[64] suggests that, if anything, non-binding regimes have been more successful than binding regimes in influencing pay outcomes. However, the researchers caveat this conclusion by noting the wide degree of variety between different regimes (for example binding votes on policy, as in the UK, versus binding votes on quantum of payments, as in Switzerland[65]).

Associated with the binding policy vote there has been more active use of the advisory vote by shareholders over the last few years which has brought about a number of further advantageous changes including: widespread disclosure of annual bonus targets (now adopted by two-thirds of the FTSE-100); introduction of malus and clawback; and introduction of post-vesting holding periods (by over half of the FTSE-100) to increase total LTIP terms to 5 years[17, 38].

It should be noted that some of these changes have arisen from changes to the UK Corporate Governance Code, whereas others have arisen from shareholders using their voting powers under the advisory regime as they have been able to do since 2003. Therefore, while particular market developments cannot always be directly associated with a single regulatory development, overall the current system appears to produce a well calibrated set of powers for shareholders that create a feedback loop. This in turn leads to evolution in practices in the market over successive AGM seasons. There was strong support for the new system in a qualitative research exercise carried out in 2014 following the first round of reporting and AGMs under the new system[66].

Binding votes

The evidence suggests that the existing voting regime has been broadly successful. However, there have been concerns in some quarters that while the vote on policy is binding, the vote on how that policy is implemented is non-binding. This means that there is felt by some to be no direct consequence of losing the advisory vote, and in particular losing the vote does not stop the contentious payments being made to executives.

In response, Theresa May, in a speech prior to becoming Prime Minister, indicated that there should be binding votes on executive pay. This has been interpreted by some as annual binding votes on pay outcomes, and policy proposals have been prepared by at least one Member of Parliament on this basis[48].

Discussion with shareholders in the UK reveals split views on binding votes[24]. Some shareholders favour binding votes on outcomes, reflecting the frustration they feel that advisory votes against do not change the decisions made by the company that caused the negative vote. However, many shareholders are concerned about the unintended consequences of a binding vote on outcomes, a number of which were responsible for both Australia and the UK rejecting binding votes on pay outcomes in reviews of say on pay legislation since 2011[65]:

- Exactly on what is the binding vote to be held? The whole report or elements thereof? In practice the binding vote would need to be held on specific pay outcomes (for example annual bonus). However, shareholder dissent with remuneration committee decisions has often been in different areas, such as treatment of leavers for example.

- A binding vote results in a level of direct intervention by shareholders on a specific company decision that absolves directors of their responsibility to shareholders, and undermines their role.

- A binding vote undermines the reliability of contract between the company and executives, which could significantly affect the ability to of UK listed companies to attract and retain talent compared with overseas or private companies.

- Precisely what are the consequences and remediation required on losing a binding vote?

- There is a risk that shareholders will be less willing to cast a negative binding as opposed to advisory vote (e.g. would the BP report have been voted down if it was binding?) because of the potential destabilising consequences for CEO motivation and retention – this would weaken the feedback loop provided by the current non-binding regime.

- There is a concern about excessive consultation by companies seeking to ensure that they would not lose a binding vote.

- There could be issues with binding votes and contract law coming into conflict.

- A binding vote on executive pay arguably elevates pay to an unjustified level compared with other critical aspects of corporate action, and creates a level of forensic intervention by investors that is misaligned with their input in more important areas such as major investments, acquisitions, strategy and so on.

Taking all of the above into account, and given that the detailed international evidence does not suggest binding votes are more effective, we do not see a clear case for universal annual binding votes on pay outcomes at this time. However, as referenced above, a voting system that keeps the pressure on Remuneration Committees to act in shareholders' interests and to take tough decisions can have benefits in ensuring appropriate restraint is exercised.

Significant opposition short of losing the vote

There has been some shareholder frustration that a small number of companies appear to have largely ignored substantial non-binding votes against remuneration. Experience suggests that companies that actually lose a remuneration vote generally respond to shareholder concerns in the following year. However, some shareholders are concerned about the implications of companies that consistently tolerate higher levels of opposition, short of losing the vote. The fact that substantial minority shareholder opposition should lead to some Board accountability led to the following provision in the remuneration reporting regulations[62]:

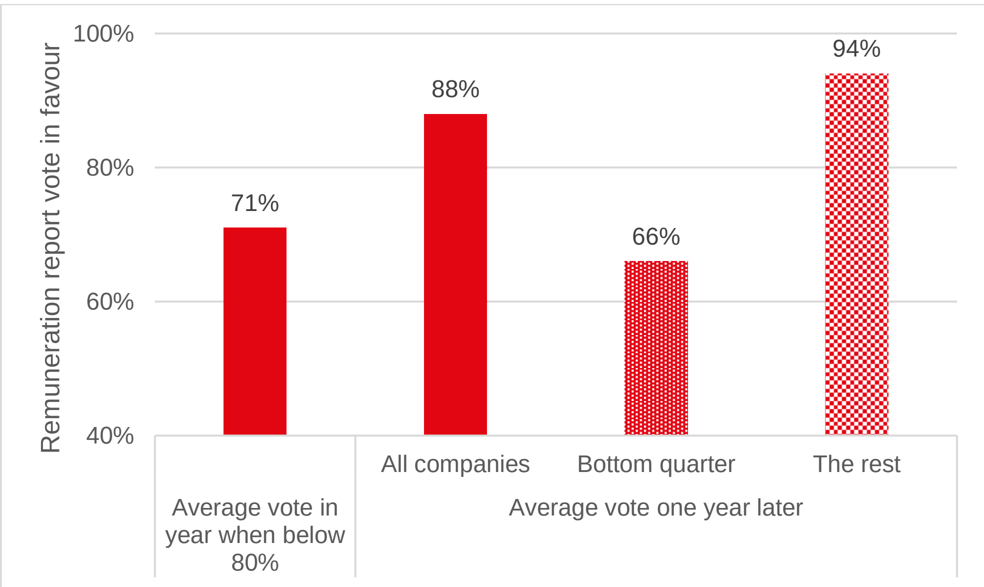
> *Where there was a significant percentage of votes against either resolution, where known to the directors, the reasons for those votes and any actions taken by the directors in response to investors' concerns [should be disclosed].*

This is also reflected in the broader guidance in the UK Corporate Governance Code that when, in the opinion of the board, a significant proportion of votes have been cast against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.

The GC100 group has indicated[67] that 20% vote against should be deemed "significant" in the context of the regulations. Legal & General have also defined 20% as representing "large voting opposition", requiring the board to state what it is doing to address concerns[36].

Approximately one in ten FTSE-350 companies have received votes in favour of 80% or fewer (abstentions excluded) over the last three years[68], suggesting that 20% opposition represents broadly a lower decile level of support. These companies received an average vote in favour of 71%. The average vote for the remuneration reports for the same companies one year later was 88%, suggesting that they had achieved significant improvement and that they had responded to shareholder concerns (see Figure 3).

Figure 3: Shareholder votes for companies receiving "low" levels of support



However, this aggregate data conceals a split population. Between a fifth and one-quarter of the companies receiving a vote in favour below 80% also received less than 80% in the following year, with their average vote even falling slightly from 69% to 66%. The remaining three quarters or so of companies improved their vote from an average of 71% to 94%, well into the levels suggesting substantially full support.

While this does not suggest an endemic problem of lack of responsiveness to shareholder votes, it does suggest that around 2% of companies are prone to persistently low levels of support, in addition to the 1% of companies or fewer who actually have their remuneration reports voted down.

The scale of this problem does not appear to us to warrant a wholesale change in the voting regime applying to all companies. Given the lack of evidence in favour of binding vote regimes, and the problems with a binding vote on pay outcomes outlined above, we do not support introduction of an annual binding vote on pay outcomes for all companies at this time. It appears to us to be a disproportionate response to the problem at hand, and in any case there is no evidence that it would have the desired impact. However, some development of the existing regime, with impact focussed on this small number of companies, may be appropriate.

A proportionate response based on an escalation mechanism

Public trust in business is at a low point and perception of executive pay practices is a significant contributor to that. Polling evidence suggests that the public is supportive of greater shareholder powers to address the issue[46, 48]. Given that distrust on pay is creating a damaging negative externality across business as a whole, there is a case for taking active steps to demonstrate to the public that the issue is being taken seriously, while strongly encouraging business and shareholders to drive reform. However, any further regulation should be sensitive to the charge of potential unintended consequences.

We accept that further voting powers for shareholders are politically necessary and that this is likely to include binding votes. Our policy recommendation, however, is to create an escalation mechanism that focusses binding votes on those cases that warrant greater attention.

Our proposal is that a binding vote regime should only be triggered for a company if they lost an advisory remuneration vote or if they faced a vote against by shareholders above 25% two years in a row. We have chosen a threshold different from the 20% identified by GC-100 and Legal & General. We cannot see a case for any mandatory action on remuneration being triggered by a level of opposition that would be insufficient to defeat a Special Resolution. Note that the difference in impact between 20% and 25% as a threshold is not great, with 20% capturing around 1 company in 10 in a given year, and 25% capturing 1 in 12[68]. This appears to us to be an appropriate proportion of companies to capture – representing approximately lower decile support levels. A threshold of 25% of the register could also be considered (representing around a 33% vote against given typical rates of participation in AGM votes). However, in our view this is too lenient a threshold especially for a “two strikes” approach.

Given that only around 3% of companies achieve this level of opposition two years in a row or lose their remuneration report advisory vote, this escalation mechanism would focus additional attention on a proportionate number of companies, where the pay policies are viewed as most problematic by shareholders. Note that this approach is similar to the Australian "two strikes" approach[65].

Note that any approach that involves "special measures" being triggered by a 25% threshold could be argued to give undue influence to proxy voting agencies: for example a vote against recommendation from ISS is typically associated with a vote against of 30% or more in the UK[38]. On occasion this can be because of the proxy voting agency's influence on the tail of a company's share register, where investors do not invest in their own research.

However, given that our approach is a "two strikes" approach, based on more than 25% vote against two years in a row, we do not consider this problem to be too great. Moreover, proxy voting agency recommendations typically reflect concerns of major shareholders, with whom they regularly consult on their voting guidelines.

However, we do think that there is a case for reviewing the approach of proxy agencies to engagement. In particular, we believe it would be good practice for proxy agencies to:

- Be open to consultation with companies and to provide clear guidance when proposals are likely to attract a negative recommendation;

- Take into account the views of a company's major shareholders when making voting recommendations, particularly, for example, when those shareholders are supportive of an unconventional approach taken by the company.

Equally, shareholders themselves should review whether they are taking their stewardship responsibilities sufficiently seriously. We will provide a separate analysis of the role of investor stewardship in a separate policy paper. Fuller analysis of the role of proxy agencies is beyond the scope of this policy paper.

We considered three possible remedies for companies triggering the binding vote regime.

Option (D) (i) – binding vote on incentive payments

A company triggering the binding regime could be required to bring forward their bonus and LTIP payments for binding shareholder approval for, say, each of the next three years.

The logic is that a company that had shown it was unable to operate its approved policy in manner securing the highest levels of shareholder support, would need to get binding shareholder approval for the key decisions made within that policy.

The proposal to require a binding vote on pay outcomes suffers from all of the disadvantages of binding votes outlined above. However, it would have the advantage that the costs of a binding vote would only apply to a small number of companies that had not been able to sustain high levels of shareholder support for how they implemented their remuneration policies. It would therefore be a more proportionate approach than applying binding votes to all.

A further unsatisfactory feature of this approach is that the reasons for the shareholder opposition to the remuneration report may be quite different from the items subject to subsequent binding vote. For example, if a company has had its remuneration report voted down for over generous treatment of a departing executive (quite a common cause) it seems bizarre for the remedy to relate to bonus payments for the continuing CEO.

Option (D) (ii) – requirement to reapprove policy with a super-majority

A company triggering the binding regime could be required to bring their policy back for approval, at the next AGM requiring a super-majority of 75% to have it approved.

The logic here is that binding approval of a policy gives a company a licence to operate within that policy. A company that has shown an inability to maintain high levels of shareholder support for how they are operating the policy is required to come back to have that licence renewed.

The logic behind requiring a 75% majority on the policy vote when triggered in these circumstances is to create a clear deterrent for companies and remuneration committees. If the policy vote requires 75% vote to pass, this is likely to lead to a policy that is less flexible and written less in favour of executives. Therefore, when deciding whether to risk losing an advisory vote, or risk repeat opposition above the trigger level, remuneration committees would be clear that the downside would not just be the reputational consequences of the advisory vote itself, but potential practical reduction in future flexibility in the policy.

The main disadvantage of this approach is that it may be considered disproportionate ever to require a supermajority on a binding remuneration matter, given that much larger decisions relating to corporate activity, for example, can be taken on a simple majority. There is also a risk of giving undue influence to activist investors or proxy voting agencies.

To guard against this, at the same AGM at which the policy is brought for reapproval, a parallel resolution could be tabled authorising the requirement of a super-majority. If this resolution were defeated, then a simple majority would apply to the policy vote. Therefore, if there were reason to believe that the vote could be subject to unintended consequences due to, for example, a large activist shareholder, it would be possible for a majority of shareholders to avoid being “held to ransom” by a minority investor.

Option (D) (iii) – require a company to bring a binding vote of confidence in the work of the Remuneration Committee

A company that receives a vote in against of 25% or more on the advisory remuneration resolution is at risk of triggering our proposed binding regime at their next AGM. At that subsequent AGM a motion of confidence in the work of the remuneration committee would be tabled. If, at that subsequent AGM, the vote against the advisory resolution is again more than 25%, then the result of the vote of confidence becomes active and must be made public. If the vote of confidence is lost, then the Board must, within three months of the AGM make a statement as to the action they are going to take to rebuild confidence in the Remuneration Committee's work, which must, at least, include replacement of the Chair of the Remuneration Committee (although that does not imply the individual's removal as a Director).

Note that this approach bears some comparison to the Australian "two strikes" rule. Under that rule, following one vote of 25% against, the next AGM has a "spill resolution" such that if the remuneration report again receives votes of 25% or more against, shareholders can require an AGM at which the directors stand for re-election[65].

We are not recommending the Australian approach here for two reasons. First, the UK (unlike Australia) has annual re-election of directors in any case. Therefore shareholders can hold directors accountable if they wish at the next AGM (and indeed some shareholders have a policy of escalating to vote against the chair of the remuneration committee if they have to vote twice against the remuneration report). Second, the low incidence of votes against Directors (and the tiny number of cases there have been in Australia of the spill meeting being triggered) suggests that shareholders do not see this as a proportionate response to a remuneration matter.

The purpose of the trigger mechanism is to provide a deterrent against a remuneration committee tolerating repeated high levels of shareholder opposition. But the remedy should not be so great as to destabilise the company. This is why the approach suggested within this option in effect allows shareholders to bring about a change in the remuneration committee chair if the binding regime is triggered, without having to vote a director off the board. It could be argued that the reputational incentive to avoid this possibility will be sufficient to make companies more reluctant to drop below the 25% threshold, and thus to avoid being "repeat offenders".

Summary

The complexity of the approaches outlined above, and the potential unintended consequences show that it is not easy to improve on the UK's current regime. Indeed a case could be made that any further regulatory intervention in this area is unwarranted, given that shareholders already have escalation mechanisms available to them. However, the political context is such that a workable proposal for further binding votes is required, and on balance our preference is option D (ii), requiring companies subject to the escalation mechanism to bring their policy back for approval with a super-majority.

Although the current voting system works well, we believe that, at the cost of some complexity, our proposed policy could helpfully increase the impact of the existing non-binding vote, while focussing on the 3% or so of companies with the most problematic pay practices. The approach would not create additional cost or disruption for the c. 97% of companies who neither lose their advisory votes nor receive 25% or more vote two years in a row. Given the requirement to build public confidence in the shareholder voting system, we believe an escalation option is worthy of further consideration. The proposed approach works with the grain of, and strengthens, the current system.

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