BIS Enquiry into Corporate Governance

Written Submission from the United Kingdom Shareholders' Association (UKSA)

Our submission to the committee is set out below. It sets out:

- The main principles which UKSA's believes should underpin good corporate governance (UKSA Fundamentals).
- Our response to each of the specific terms of reference which the Committee is to consider.

UKSA exists primarily to campaign for the rights and interests of private shareholders in publicly quoted companies (see *3. About UKSA*).

1. UKSA fundamentals

Beneficial change will flow from recognition of four underlying truths:

1) That good governance requires that complex balances of special interests and socially desirable outcomes must be monitored by a representative balance of voices.
2) That individuals, investing their own money, must be one of those voices.
3) That transparency (or openness) is the most powerful (and cheapest) basis for public oversight.
4) That whatever changes are advanced there will always be an important role for shareholders and it is fundamental that intermediaries should not be shareholders. Only beneficial owners, or the appointed representatives of beneficial owners, should be shareholders and have shareholder rights.

2. Response to the terms of reference of the Committee

2.1 Directors Duties

2.1.1 Is company law sufficiently clear on the roles of directors and non-executive directors, and are those duties the right ones? If not, how should it be amended?

No comment.

2.1.2 Is the duty to promote the long-term success of the company clear and enforceable?

No comment.

2.1.3 How are the interests of shareholders, current and former employees best balanced?

Through submitting to representative scrutiny. UKSA favours committees with no statutory power of action but with statutory power of communication. An example of such a structure (for private shareholders only) was developed by UKSA for The Protection of Shareholders Bill 2009.

2.1.4 How best should the decisions of Boards be scrutinised and open to challenge?

See 2.1.3 above.

Efficient scrutiny requires good communication. In that context we mention that the structure of statutory communication with shareholders (Annual Report and AGM) was designed for another age and has become unfit for purpose, partly because of lack of input from real investors to the many changes made over the years.

2.1.5 Should there be greater alignment between the rules governing public and private companies? What would be the consequences of this?

Not necessary. There is room for more than one type of business entity. However business names should clearly designate the type of legal entity represented.

2.1.6 Should additional duties be placed on companies to promote greater transparency, e.g. around the roles of advisors. If so, what should be published and why? What would the impact of this be on business behaviour and costs to business?

Well, yes, but it's asking the wrong question. The right one is 'to whom should advisors report, and what other interest groups should have access their advice':

- Auditors, are elected by shareholders and should report to them
- Remuneration consultants aren't elected by shareholders but they should be, and should report to them.

2.1.7 How effectively have the provisions of the 1992 Cadbury report been embedded? How best can shareholders have confidence that Executives are subject to independent challenge?

No further comment

2.1.8 Should Government regulate or rely on guidance and professional bodies to ensure that Directors fulfil their duties effectively?

Neither (exclusively), see UKSA fundamentals. However, whatever process is in place it should be clear who is responsible for sanctioning what. At the moment it appears that companies can ignore provisions of the Companies Acts when it suits them provided it does not upset the major institutional shareholders.

2.2 Executive Pay

2.2.1 What factors have influenced the steep rise in executive pay over the last 30 years relative to salaries of more junior employees.

a. Key Factors: Background and context

The Cadbury Report (1992) recommended that executive pay could be controlled most effectively through good corporate governance while the Greenbury Report (1995) strongly supported the view that pay should be linked to performance. The recommendations of both were well intentioned. The response to Greenbury, however, provided the impetus for the introduction of highly geared and

more complex pay schemes. These schemes have provided the basis for excessive pay awards for the reasons summarised below.

b. Key factors: Sound principles with unintended consequences

Important factors influencing sharp increases in and loss of control over executive pay include:

- Complexity of many pay schemes – particularly with regard to long-term incentives (LTIPs) which often make up a significant proportion of the pay award.
- Lack of clarity surrounding the ultimate payout - particularly with regard to the long term element of the incentive, much of which relies on directors being rewarded with a specific number of shares. Complexity and lack of clarity make it very difficult for most shareholders to understand and challenge the schemes.
- Performance targets which are not sufficiently demanding; median bonus payouts for directors last year were 72% of the maximum possible payout[1]. Shareholders have little or no say in the setting of performance targets and are rarely in a position to know what is appropriate. Some companies do not publish details of the performance targets until several years after the year to which they relate claiming that they are commercially sensitive.
- Following every financial setback (e.g. the financial crash of 2008) performance targets are frequently reset to a new low starting point. As the economy recovers this creates a ratchet effect on executive pay.
- There is a binding vote on pay policy at the company's AGM but policies tend to be expressed in very broad-brush terms. It is the detailed application of the policy that determines the outcome of the pay award. The vote on the pay award itself is advisory only and is retrospective, by which time the pay award has already been made. There is no current basis on which shareholders can effectively block an excessive pay award.

One other factor, not related to the design of executive pay schemes themselves, is important. Statistics from the Office for National Statistics (ONS) show that in 2014 some 59% of shares in UK companies were held in multiple-ownership pooled accounts (nominees). The beneficial owners do not, therefore, appear on the company register, do not receive notifications from the company about the publication of the annual report or details of the AGM and have no voting rights. This means that the majority of the investors in UK companies (the beneficial owners) are disenfranchised. Consequently, most companies can do anything they want on pay without fear of challenge from the majority of their investors.

2.2.2 How should executive pay take account of companies' long-term performance?

Many fund managers are judged on performance in league tables over relatively short periods. Consequently, they apply pressure to companies and their directors to deliver short-term results – even though focussing primarily on the short-term makes little commercial sense for most businesses.

The current system for redressing this using incentive based pay awards for achievement of long term outcomes is inherently unsatisfactory because:

- the long term is by nature uncertain;

[1] Directors' remuneration in FTSE 250 companies. The Deloitte Academy. December 2016

- outcomes can easily be significantly influenced by factors outside executives' control;
- the longer a reward is deferred, the less motivational impact it has.

Directors of FTSE 350 companies are in almost all cases paid very good basic salaries. It should not be necessary to pay additional rewards which often amount to two, three or four times their basic salary to get them to work to an appropriate mix of long and short term objectives. The logic used to justify the payment of large performance rewards is simply spurious.

The basic approach to directors pay should be that:

- Directors should be paid a good salary to deliver performance outcomes which meet the short, medium and long term needs of the business.
- There should be regular feedback on performance against key goals and targets (long and short-term) which have been approved by the shareholders (including the beneficial ones).
- Directors who fail to perform should be dismissed without large compensation payments for loss of office.
- If there is to be a performance-related element to a directors' pay the maximum payout for spectacular performance should be not be more than, say, 50% of salary other than in the most exceptional circumstances.
- Directors should be strongly encouraged to buy and hold shares in the business. These dealings should be reported in the annual report and at the AGM.

2.2.3 Should executive pay reflect the value added by executives to companies relative to more junior employees.

The fact that directors have a greater impact on the performance of a company is already reflected in their basic salary which is significantly higher than that of more junior staff. If directors are to be paid a bonus it should be, in percentage terms, the same as or very similar to the bonus that anyone else in the business can earn. By definition, the financial payout from any bonus will be greater than the payout that others receive. There seems no justification for directors receiving a bonus which in percentage terms is dramatically larger than the bonus paid to more junior members in the business.

2.2.4 What evidence is there that executive pay is too high? How, if at all should government seeks to control or influence executive pay?

Evidence that executive pay is too high

There is no absolute measure of what is 'too high' or 'too much'. However, the following points should be considered:

- The gap between executive pay and that of other employees has widened inexorably over the last thirty years. Between 1980 and 1990 total median earnings for chief executives of the largest organisations (those with over 20,000 employees) increased by 309%. The median weekly earnings for all full-time male employees went up by just 128%[2].

[2] Executive Remuneration in the FTSE 350 – a focus on performance related pay. A report for the High Pay Centre from Incomes Data Services - October 2014.

Despite a few 'setbacks', when directors' average total pay actually declined year on year (primarily during the bursting of the dot.com bubble and the 2007/8 financial crisis), the trajectory of chief executives' pay has been ever-upwards. Between 2000 and 2013 the median earnings for FTSE 100 chief executives increased by 240% compared with 43% for all full time employees. The median pay of FTSE 250 chief executives increased by 208% over the same period[3].

- Research suggests there is no obvious link between high levels of executive pay and outstanding company performance. The IDS report commissioned by the High Pay Centre[4] provides a statistical analysis of the correlation between pay and performance. It concludes that:
    - 99% of the change in annual bonuses could not be explained by changes in pre-tax profit;
    - 99% of the change in annual bonuses could not be explained by changes in EPS.

  The same picture emerges where total shareholder returns are measured against other FTSE companies or a peer group of companies. There was no noticeable correlation between the relative ranking of long-term incentive plan (LTIP) share awards and the relative ranking of changes in Total Shareholder Return over three years. Even in cases where company performance has been good or very good in absolute terms (WPP, Berkley Group, Taylor Wimpey, Persimmon etc.) it is hard to see how the company's performance justifies the very generous pay awards made to directors.
- Able and competent people who will make good chief executives are not that rare. It is claimed that able, high–performing directors have to be drawn from a small pool of talent. Very high salaries, therefore, have to be paid to attract them. However, as Andrew Hill writing in the Financial Times has noted, chief executives are not like oil paintings:

  'Good ones may be rare but they are not as scarce or as valuable as they think. Similarly, the people who search for them are not quite as useful or expert as they pretend'[5]

These factors suggest that executive pay is too high and that shareholders are paying more than is necessary to get and retain them.

Government influence

Government attempts to influence pay through incomes policies and pay restraint have not been satisfactory in the past. Direct government intervention is, therefore, probably not desirable. However, government should be involved with shareholders in monitoring executive pay and helping to devise means of controlling it before it becomes excessive. The government and the wider public sector are big employers. Very high levels of pay for senior executives in the private sector inevitably result in pressure for increased pay awards for senior people in the public sector. Government intervention should be collaborative, forward looking and on-going. Intermittent, retrospective and reactive action which aims to close the stable door after the horse has bolted is not helpful.

[3] Ibid

[4] Ibid

[5] Headhunters and CEOs are less valuable than they think; Andrew Hill, FT 16.11.2015.

2.2.5 Do recent high profile shareholder actions demonstrate that the current framework for controlling executive pay is bedding in effectively? Should shareholders have greater role?

No. High levels of executive pay have been a contentious issue since at least 1995. Since then executive pay has continued to increase with excessive pay awards for a few chief executives setting a new benchmark for the rest. Despite occasional rebellions by shareholders, most pay awards are still waived through with a significant majority voting in favour.
The current system can't work effectively while:

- All but the very largest shareholders are unable to make any meaningful input into the setting of targets which trigger performance-related pay awards. In almost all cases shareholders are not told what the targets are for the coming year;
- Shareholders have no binding vote over the actual pay award and have no means of blocking or controlling it;
- Shareholders (and even, occasionally, those receiving the awards) are unable to understand the basis of calculation of the pay award due to its sheer complexity;
- As mentioned in the last paragraph of the response to Q1, a system is allowed to continue in which 59% of investors are not shareholders; their name does not appear on the shareholder register, they have no right to attend the AGM and they have no voting rights.

2.3 Composition of Boards

2.3.1 What evidence is there that more diverse company boards perform better?

No comment

2.3.2 How should greater diversity of board membership be achieved? What should diversity include, e.g. gender, ethnicity, age, sexuality, disability, experience, socio-economic background?

No comment

2.3.3 Should there be worker representation on boards and/or remuneration committees? If so, what form should this take?

No comment

2.3.4 What more should be done to increase the number of women in Executive positions on boards?

No comment

3. About UKSA

The United Kingdom Shareholders' Association (UKSA) was founded in 1992. UKSA's fundamental purpose, as set out in its Memorandum of Association, is to promote the

interests of individual shareholders and investors within the United Kingdom by all possible means. It is a not-for-profit body which relies on membership subscriptions for finance and on the voluntary efforts of its members, including board members, for the bulk of its activities.

UKSA's key aims are to:
- Campaign for the rights of private shareholders
- Give its members direct access to company directors
- Help members make better investments
- Support its community of members

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