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UK Corporate Governance Code and Guidance on Board Effectiveness Questions

Q1. Do you have any concerns in relation to the proposed Code application date?

No.

Q2. Do you have any comments on the revised Guidance?

The omission of any acknowledgement of the fact that the word 'shareholder' includes a powerful group who are in fact intermediaries is dereliction. The fact that the real investors who the intermediaries are supposed to represent are not even mentioned is unacceptable. In the long -term this wrong must be put right, but until that happens we strongly request that disenfranchised investors be explicitly recognised as an important component of the 'other stakeholder' group and that appropriate arrangements are made to consult with them.

The Revised Guidance on Board Effectiveness mentions remote workers, agency workers and contractors as people whose views should be heard. If it is possible for companies to arrange to get reliable and realistic representations of views from all these, surely means could be found to obtain views on behalf of individual investors (the beneficial shareholders).

It is not correct or appropriate to assume that the interests of fund managers are aligned with those of their clients. An individual investing in a pension or for any other purpose is likely to be investing with a time horizon of forty years or more. Most fund managers (the legal share owner or shareholder) are almost invariably driven by short term fund performance. The failure in the Corporate Governance Code, the Guidance and the Stewardship Code to recognise that the legal shareholders are nothing more than agents handling other peoples' money is a depressing sign that those drafting the Codes have not properly considered the governance issues that this raises.

Nor is this simply a 'stewardship' issue which can be addressed through the Stewardship Code. UKSA has been campaigning for many years on the disenfranchisement of private investors as a result of the way in which nominee accounts operate in the UK. It is very disappointing that both the Code and the Guidance implicitly reinforce this disenfranchisement by their failure to mention the private investor and the need for companies to engage with investors rather than just their agents.

Provision 5 states that "In addition to formal general meetings, the chair should seek regular engagement with major shareholders in order to understand their views on governance and performance against the strategy". We request that the words 'major shareholders' be changed to "major shareholders (which will include representation of individual shareholders)". Individual shareholders own 12% of the UK stock market (>30% if you include beneficial ownership via pension funds and other fund and investment products). They should therefore be included in the engagement process.

We have made further comments about shareholder engagement and shareholder committees which are contained in Appendix A.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

No. They are simply outline methods for allowing employees to have a voice in the board room. The key questions are:

- What are the outcomes that the voice of the employee is intended to achieve in each organisation?
- How will these outcomes be achieved and measured or monitored?
- How will the outcomes be reported to shareholders (and maybe other stakeholders)?

The proposed methods are a summary of a few options for implementing a nice-to-do initiative (employee engagement) which will provide government and politicians with a 'feel-good' factor. As set out they contain no substance and can easily be subverted to become a compliance requirement which adds no real benefit to the organisation or its employees. This would be a shame because there is scope for well structured and well managed employee engagement to achieve very significant benefits for the organisation and the employees.

The three options outlined also overlook the fact that there may be companies using other very effective and very successful methods of employee engagement. The 'explain' component of 'comply or explain' may partially address this issue. However, in practice there is huge pressure to comply, so whatever is written in the Code becomes best practice.

The real problem here is the drafting of the revised Code. The wording in Provision 3 which introduces the three options states: 'This would normally be a director appointed from the workforce…etc.' The wording should be changed to:

'Options might include, but are not limited to, a director appointed from the workforce…etc'.

Sir Brendan Barber, who commented on this issue at the last FRC Stakeholder Panel, has extensive experience and clear views on employee engagement matters. It would be worth discussing with him the drafting of Provision 3.

Individual shareholders should be given more importance in engagement. One way to do this is through the introduction of shareholder committees, such as we have proposed at RBS.

No company can be sustainable if it does not have good employees. However, Paragraph 3 and Paragraph 4 overstate the relative importance of employees and potentially undermine the primacy of shareholders which is clearly written into S172 and other parts of the Companies Act. Indeed, they may be in conflict with the Companies Act. We recommend the drafting explicitly acknowledges the primacy of shareholders.

Q4. Do you consider that we should include more specific reference to the UN SGDs or other NGO principles either in the Code or in the Guidance?

No

Q5. Do you agree that 20% is 'significant' and that an update should be published no later than six months after the vote?

No. Any vote against the Board recommendation on any resolution is potentially significant. It is up to the Board to consider all votes against and decide if any action is needed. Manifest, the proxy voting agency, in its voting guidance highlights to its customers any resolutions where more than 10% of shareholders vote against. You should not enshrine a culture than anything less than 20% is acceptable.

Yes, re update no later than 6 months if > 20% vote against.

The fact that 20% is considered significant is an indication of how reluctant major shareholders are to vote against the board. One of the weaknesses of the Corporate Governance Code is that it lacks meaningful and coherent links to the Stewardship Code. For retail investors (those investing in collective funds, pensions and via nominee accounts), the situation is worsened by the fact that the Stewardship Code places little obligation on fund managers and other institutional investors to vote in the interests of the beneficial asset owners. Most fund managers are driven by short-termism. Their own bonuses are determined by the quarterly, half-yearly or annual performance of their fund/s. They therefore apply pressure to company boards to deliver short term returns. The outrageous pay award to Persimmon Directors is a case in point. The LTIP award which has resulted in the CEO, Jeff Fairburn, being awarded over £100m in bonuses was designed to reward management for distributing existing shareholder value and not for creating additional value for shareholders. Of the five major shareholders who voted on the Persimmon LTIP in 2012 prior to its implementation only Axa voted against – and for the reason just stated. The other four, L&G, Blackrock, Aberdeen and Templeton all voted in favour.

One of the problems with the fund management industry is that it is fundamentally conflicted. Both the Corporate Governance Code and the Stewardship Code need to recognise and take account of this fact. We have commented further on this in our response to Question 17.

Q6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relation to the potential costs and other burdens involved.

Yes. There have been serious concerns recently about the approach to corporate governance in smaller companies – notably some AIM companies. Paragraphs 48 and 49 of the 'Proposed Revisions' document provide a sound justification for the removal of the exemption.

The critical thing is that the Chairman continuously ensures that the Board works effectively. Hopefully the Chair will seek and welcome feedback. If not, the SID must ensure that the assessment of the Chairman's performance and feedback is done.

However, we worry that it is not clear how the evaluation process should work. The Guidance implies that the SIDs would lead the evaluation. References to feedback and 'input from the workforce and other stakeholders' are vague and suggest that expensive (and often in our view unnecessary) consultancy input may be needed as well. If the whole process is done well, it will be beneficial, but it is easy to see how it could become an expensive compliance exercise which adds little value.

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

Yes, although it is not clear why the cut-off has been set at nine years. More than nine years does seem like 'too long' as a rule of thumb unless the company can explain and put forward a sound justification for the extension. The benefits of continuity and allowing appropriate time for NEDs to fully understand the company and thereby maximise their contribution to the business suggest that the nine-year period is about right.

We feel strongly that 'comply or explain' should apply in the context of independence. There are FTSE 350 companies in which none of the NEDs appear the have relevant industry experience. Inevitably, individuals with relevant industry experience (probably gained with a competitor) may be seen as being somewhat conflicted. An appropriate balance needs to be struck and it seems best to let boards make that decision and, if challenged, to explain it.

Q8. Do you agree that it is not necessary to provide for a maximum period of tenure?

Yes. The requirement for all directors to submit themselves for re-election annually deals with this issue.

Q9. Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

It is not clear how effective this will be or how well it will work in multi-national companies. The impact of the Code in this area is likely to be very limited. However, it helps to ensure that the Code is aligned with other initiatives aimed more directly at promoting diversity.

It is worth adding that we strongly support any measure which is effective in promoting gender diversity. ONS statistics for the period April to June 2013 (the latest for which information is available) show that women made up almost 47% of the UK workforce. Promotion within companies, along with external recruitment for senior management and board positions, should always be based on merit as defined by relevant experience and ability. If this principle is being applied in UK companies one would expect the proportion of women on boards to be typically in the range of 40 – 60%. A key requirement is that the internal executive pipeline should also reflect this balance. Occasionally, organisations may diverge from this over the short to medium term for good reasons. However, an imbalance over the longer term (over, say, three years) suggests that something is wrong in the selection and recruitment process and that selection is either not based on merit or that the candidate pool is artificially narrow. The result is that candidates selected are either not as good as they might be or that criteria other than merit are influencing the selection decision. Usually, it seems that it is a case of whether or not the individual's 'face fits'. This is corrosive and damaging for companies. It leads to boards that are prone to 'group think', that prefer the status quo, dislike being challenged and are at risk of a slide into complacency.

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relation to the potential costs and other burdens involved.

Yes, for the reason described above, namely that selection for and promotion to senior positions should always be based on objective criteria reflecting merit.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relation to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

We have no strong views on this. However, in most cases the annual report is already too long and full of information that is of limited interest to shareholders. We also suspect that some multi-national companies may face legal obstacles to collecting this data in some parts of the world.

Q12. Do you agree with retaining the requirements included in the current code even though there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or the Companies Act?

For the sake of coherence and completeness, yes.

Q13. Do you support the removal to the Guidance of the requirement currently retained in C 3.3 of the current Code? If not, please give reasons.

Yes, this seems sensible.

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

Yes, we agree with the proposed changes as stated in the revised Code although we suspect that they are likely to have limited impact in controlling executive pay.

We believe that, with regard to directors' pay, the remco should:

- set directors’ pay in the context of the pay schemes that operate for everyone else in the company.
- have regard to the principle of fairness.
- acknowledge that achieving the business's strategic objectives is not the sole preserve of the directors; it is a team effort that requires full commitment from all employees.

Investors should be able to hold the remco to account for decisions on directors' pay in the context of the above. In Appendix B we have summarised the areas of oversight which we would therefore expect the remco to have.

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

Greater engagement with private investors would be helpful. These are the people who are primarily interested in long term sustainable performance. Nominee managers, as far as we can tell, take no interest in stewardship issues. They see their role as being purely an administrative one in terms of providing a convenient investment platform for the private investors. The fact that the private investors have no shareholder rights seems to be of no interest to them. In the case of collective funds we believe that, despite protestations to the contrary, many fund managers are driven by short term performance because this is what they are measured against. They have little interest in long term sustainable performance. The recent situation at Persimmon in which four out of five of the largest shareholders voted through an egregious pay system which allowed directors to earn obscene bonuses illustrates the point. Only Axa voted against the pay scheme, stating that it was designed to reward managers for distributing existing shareholder value rather than creating any additional shareholder value.

It is not clear why well-paid directors of companies have to be given large bonuses to come to work and do the job they are already paid to do by way of their basic salary. It is good that they should be encouraged to hold shares in the company that employs them. However, they should do this by buying shares themselves in the market like any other investor.

We have made a number of additional suggestions which are contained in Appendix C.

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

This seems very unlikely. Sir Ronald Hampel speaking at the 25th Anniversary of the Corporate Governance Code 25th Anniversary Celebration at the FRC's offices on 11th January 2018 noted that executive pay was 'out of control'. Sir Win Bischoff described him as 'one of the founding fathers of the Code'. Sir Ronald's observation is a clear sign that it will take more than a few tweaks to the wording of the Remuneration section of the Corporate Governance Code to give meaningful impetus to boards in exercising discretion or restraint.

UK Stewardship Code Questions

Q17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of investment chain help drive best practice?

We believe that the Stewardship Code should more properly be renamed "The Investor Stewardship Code". Most of the stewardship of the company is done by Board of the company and its management. The current name sets the wrong expectation and one that is unachievable.

The code needs to be more explicit about the expectations of investors. The current code is superficial and quite vague. It encourages fund managers to vote the shares they hold but there is little guidance on how fund managers should vote to ensure the best interests of investors. This is particularly true on issues such as executive pay. The Code needs to recognise that the interests of asset managers and the investors (beneficiaries) are often divergent. Fund managers are often driven by short term measures of asset growth and total return. Investors, particularly in pension products, may have a horizon of 20 - 40 years or more.

Standard Life (now Aberdeen Standard Life) is a Tier 1 signatory to the Stewardship Code. However it was one of the largest investors in Carillion when it went into administration. Our understanding is that it had also loaned out a significant number of Carillion shares to short sellers.

Aberdeen Standard Life has been back in the news as recently as 22nd February. An article in the Financial Times on the £110million paid to Persimmon CEO Jeff Fairburn stated:

"Aberdeen Standard Investments, the Company's (Persimmon's) sixth-largest shareholder, criticised Jeff Fairburn's bonus as grossly excessive, adding that it remained a huge concern despite Mr Fairburn's decision to give some of the money to charity. Aberdeen standard Investments called on fellow shareholders to 'consider their voting positions on Persimmon's board members' which include Mr Fairburn, ahead of the company's annual general meeting in April".

This sounds like an excellent example of a major shareholder exercising the sort of stewardship that we expect from fund managers. Except that it is not. It is an example of utter bare-faced hypocrisy.

Aberdeen Asset Management was one of five major shareholders in Persimmon who in 2012 voted in favour of the Company's LTIP for directors. Subject to a dividend paying performance condition (the 'Capital Return Plan' - CRP), LTIP gave away 9% of the company (1 for 10, 30million shares) after 10 years – or earlier if dividends were paid earlier. UKSA easily identified the scheme as little more than a scam and tracked (and reported) its steady increase in value (from £300m - 2012 to £750m - now). At the time, we wrote to the six major shareholders in Persimmon (AXA was the only one that voted against the scheme) and asked them to clarify why they voted as they did. Aberdeen asset management wrote back with a number of dubious reasons for backing the scheme and adding:

'Part of our responsibility as long-term investors is to police the scheme and hold management to account, if it appears that not just the letter but also the spirit of the scheme is being breached then we will look to take appropriate action'.

Aberdeen, however, (and other major shareholders) sat back and watched as an already fundamentally flawed pay scheme was allowed to spiral out of control as the total payout to directors and senior mangers ballooned from £30m in 2012 to £750m 2017. Their current response of grandstanding and wringing their hands over the whole debacle while sniping at the Persimmon directors is a damning reflection on their integrity.

The fact is that the institutional investors have a corrupt process of cosy, secretive meetings with directors that suits them. Many who claim to be applying the letter and the spirit of the Stewardship Code are paying it little more than lip service. The hypocrisy of their self-righteous attack on the Persimmon directors does not sit well with their unacknowledged responsibility for what has happened. It is time for the FRC as the Regulator to step up to the plate and explain how, in the case of Persimmon, a transfer of value of this amount from shareholders to employees can go unacknowledged for six years. This whole scandal makes a complete mockery of the Stewardship Code.

On the question of having separate codes or enhanced separate guidance for different categories of investment chain, **i**t might be appropriate to have different guidance for say nominees and asset managers (for example).

Q18. Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

Yes, there is scope to apply comply or explain. However, there are also other fundamental issues to address. These include communication with investors on a more regular basis and demonstrating to investors that the asset manager is really acting in their best interests (e.g. not lending out shares to short sellers and certainly not without explaining the reasons for doing so to the investors).

Q19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

This needs further careful consideration. The tiering at present seems to be based largely on self-certification by asset managers / owners etc. Their web sites simply provide fine word and reassurances. The Standard Life website shows the number of company engagements during the quarter. This came to 209 in Q4 2016 – the latest data available in January 2018. It looks impressive but 'engagement' includes an email or a phone call. And why is no data available since December 2016? Company visits came to 26 in the quarter - approximately one per day across the whole investment team. There is a tick box list of issues discussed. I wonder if Carillion was visited in Q4 2017 and what was discussed? It all looks plausible but the information given is tick-box and process oriented. We need something more than this to demonstrate real stewardship. Asset managers should also be emailing their clients every quarter with a link to an updated stewardship report on their website. It shouldn't just be left to the clients to have to remember to go and look for this or access it via the FRC website.

Furthermore, most reporting is done in PDF format, which makes it very difficult to analyse and compare fund manager voting and engagement practices. The FRC should insist that fund managers reports include Excel easily analysable versions of the data.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

There needs to be much more reference in the CG Code and CG Guidance to investors. There is reference to large shareholders, shareholders and stakeholders but nothing about investors. This is a serious omission.

Q21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

Fund managers should organise at least one and ideally two events each year to which all their investors are invited. The managers should give an account of how they have exercised their stewardship of other people's money. See also suggestions under Q19 for better engagement with investors. It would do no harm for asset managers to organise visits for their investors (similar to those run by UKSA and ShareSoc for their members) to some of the larger companies in which they are invested.

Q22. Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code refer more explicitly to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas that should be addressed?

Probably not; it should be sufficient for them to be covered in the CG Code if asset managers think these things are not being properly addressed by companies in which they are invested they can raise them as a GC issue with the company concerned.

Q23. How should the Stewardship Code encourage reporting in the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside the Stewardship Code?

It is important that this happens. The GC Code and the Guidance document provide a common benchmark for investors as to what 'good' looks like in relation to GC. The same should be true for the Stewardship Code. As indicated in Qs 17 and 19 above there is currently plenty of scope for asset managers to score well and be rated in Tier 1 on Stewardship despite the fact that when you look closely at what they are actually doing it doesn't amount to very much.

Q24. How could the Stewardship Code take account of some investors' wider view of responsible investment?

We cannot answer this open ended question, without examples of what these 'wider views' might be.

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

Yes, certainly in the context of issues like the use of child labour at very low rates of pay in some parts of the world. There are also issue with people not being paid the minimum wage (particularly women) in places like India because, although the country has a minimum wage, the government does not enforce it. Even if a company is purely UK-based, if it sources product from overseas (and particularly from third world countries) the Stewardship Code should take into account its supply chain.

Q26. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

We need more information on what is being suggested. If managers are reporting meaningfully (i.e. providing useful information to investors, then third-party monitoring and assurance shouldn't be necessary. As indicated above, the current code is too superficial and to vague to allow investors to hold managers to account on stewardship issues. In this situation independent assurance would be helpful – but it could be expensive and is sure to be a cost which will be passed on to investors.

Q27. Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

Yes.

Q28. Should board and executive pipeline diversity be included as a specific expectation of investor engagement?

This is covered in the CG Code. Asset managers should push companies to address this as part of their commitment to the CG Code.

Q29. Should the Stewardship Code explicitly request that investors give consideration to company performance reporting on adapting to climate change?

Only where it matters and in a form that is relevant. Clearly, for large energy users (glass, steel, bricks etc.) then reporting on CO2 emissions is important. For companies like supermarkets the situation is more complex. They are not ultimately big emitters of CO2 gases. However, they are major contributors to food waste in Britain. UK households throw away some 7 million tons of food each year – partly because they are encouraged to over-buy by food retailers. Supermarkets also generate waste with absurd aesthetic requirements for fruit and vegetables. Much is discarded because it doesn't conform to standards of appearance. They also encourage growers to over-plant so that minimum order quantities can be fulfilled even if there is a poor crop. Up to 30% of salad and root crops is regularly ploughed back into the ground without ever being harvested. Failure to address the problem of absurd 'best before' and 'use by' dates is another problem. The result of this is that more and more land is being brought into productive use so that we can all throw away enormous amounts of food. In Brazil the rain forest is being steadily depleted (contributing to climate change) to bring land into production to produce soya to feed to animals in rich countries so that more meat can be produced. Yet much of that meat is being thrown away. These are the complex environmental issues that need to be addressed with the food retailers. The UK government's big contribution to all this is to make everyone pay 5p for a plastic carrier bag. At the same time it seems keen to stoke up demand for air travel despite the damage that this is known to cause to the environment. So, yes, companies should be required to state what they are doing to reduce their own impact on climate change. But is must focus on those activities which really are damaging. Platitudes and obfuscation about how Sainsbury's uses rainwater harvesting off its shop roofs to reduce water usage in its stores in west Wales is an irrelevance in the context climate change.

Q30. Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

Yes, this would be a good idea. It would help to ensure that they do not just treat it as another compliance issue. Some guidance on this would be helpful for investors as well – i.e. What might investors expect to see from signatories in this context? What would 'good' look like?

Q31. Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

This would be very appropriate. We have no particular views at present on how it should be achieved.

Peter Parry – Policy Director, UK Shareholders' Association

Cliff Weight – Policy Director, UK Individual Shareholders' Society

APPENDIX A

Shareholder Engagement (Q.2)

The informal nature of current shareholder engagement (cosy chats with selected shareholders behind closed doors) does not work well for the broad shareholder base. It is not clear whether investors are each being told the same story, how information is being spun, or whether complete or only partial information is being given out. Investors will ask different questions during engagement meetings and so may develop different interpretations of what the company is trying to achieve.

Ad hoc engagements tend to only occur when a problem arises.

Currently, when a large number of investors are “consulted”, it is difficult to have the same conversation with each investor and the proposal often changes over the process of engagement. Currently, the different views of different investors create a very “messy” backcloth in which to engage.

For example, in relation to remuneration proposals, there is often no clear trail from the initial proposal though to the final version voted on by shareholders.

Voting happens too late in the process. Discussion and voting at the AGM is ineffective, as institutions do not like to vote against the directors’ recommendations. A more professional and systematic process is required.

This impasse can be broken through the introduction of Shareholder Committee.

The Benefits of establishing a Shareholder Committee are:

1. Systematic briefings between the company and knowledgeable Shareholder Committee Members.
2. Shareholder Committee Members will develop good background knowledge, relationships and trust with the company over time.
3. Shareholder Committee Members will be presented with consistent information and explanations, and members will have a forum for the exchange of questions and views.
4. Increased transparency.
5. A Shareholder Committee will report to all shareholders via the annual report, AGM or other route as appropriate.
6. A Shareholder Committee will focus on governance and strategy issues, and will not interfere with the day-to-day management of the company.
7. A Shareholder Committee can be established on a purely advisory basis and does not require any specific powers.
8. A Shareholder Committee might also include workers, customer representatives and other key stakeholders if desired. There is considerable flexibility on how it might operate in practice.
9. It is unlikely that the cases of Persimmon, Carillion, BP, BHS and Sports Direct would have occurred if such a committee had existed at those companies. And the problems would surely have been resolved quicker if each had had a Shareholder Committee.

APPENDIX B

Suggested areas of oversight on pay for the Remuneration committee (Q.14)

Investors should be able to hold the remco to account for decisions on directors' pay in the context of the above. We have summarised below a number of areas of oversight which we would therefore expect the remco to have:

- Oversight of the company's policies on pay for directors and all other employees. We say '*policies'* because we would only expect there to be one policy or at most two (one for hourly-paid employees and the other for salaried staff) in most companies. It is the role of HR to devise the detail but it is important that the remco has proper oversight.
- Oversight of cost-of-living increases for all salaried staff who are not unionised.
- Oversight of the total amount of money allocated to staff for performance related bonuses and the percentage that this represents of payroll costs for the staff participating in the bonus scheme. It is up to HR to work up the proposal and provide any justifications necessary.
- Oversight of the amount of money allocated for company-wide performance payments to staff and the percentage of basic payroll costs that this represents for all staff involved in the scheme.

This information should be reported in the AR. This will allow shareholders to question the board and the remco on any anomalies including, for example,

- why directors (or any single director) is getting an increase in basic pay of, say 5%+ when everyone else is getting less than 2%
- if the pot for personal performance among staff is 15% of relevant payroll costs (maximum 30% for any individual showing outstanding performance), why is that directors are receiving personal performance bonuses of over 100% of basic pay?
- if the pot for company related bonus payments is, say, 10% of relevant payroll costs, why is that directors are enjoying bonus payments of 50% or more of their basic salary?

This should not burden the members of the remco with a lot of additional work. It should provide a better way of holding the remco to account in a situation in which directors' pay seems to have parted company with everyone else's.

APPENDIX C

Further ways in which the Code could support executive remuneration that drives long-term sustainable performance? (Q.15)

The following comments are supplementary to our answer to Question 15.

- Principle P is an aspiration based on fine words. One of the biggest problems with directors' pay schemes is that they are often complex and opaque to the point at which it is sometime unclear whether the directors themselves understand how they work. If the link between a given level of performance and a given reward is not clear, then the motivational impact of the scheme has to be questioned. As described below, the performance-related elements often do not appear particularly stretching and the link between pay and the successful delivery of strategy is often tenuous at best and completely unfathomable at worst. Often outcomes are dependent on factors beyond the control of the director/s or on factors (such as EPS) which can be manipulated.
- It is all very well for the code (Principle Q) to state that no director should be involved in deciding his or her remuneration outcome. However, as with so many issues surrounding executive pay, it is not clear what this really means in practice. Much of the pay that directors earn today is made up of bonuses. These bonuses are based on the achievement of performance targets. It is hard to believe that directors have no input to both defining the metrics for their performance targets and in influencing the targets that are set for them. One of the most damaging aspects of the current system of large performance-based pay awards is that even the most stretching targets are regularly achieved. This suggests that the targets themselves are often not very stretching, which in turn suggests that that not only are directors being paid handsomely for mediocre performance but also that the company is not performing as well as it could.
- The performance targets set for directors often depend for their achievement on the performance of employees at all levels in the organisation. It is certainly up to the CEO and the board to ensure that those at lower levels are properly directed and managed so as to maximise the performance of the company. However the enormous disparity between what Directors can earn by way of bonus (not just the quantum but also the percentage as a proportion of basic salary) looks entirely unjustified. In this respect it is very appropriate that the remuneration committee should have oversight (but not decide) of the pay policies for all employees as set out in Provision 33.
- Provision 37 states that remuneration schemes and policies should provide boards with the discretion to override formulaic outcomes. This is certainly true: they absolutely should. However, the Code (and certainly the Guidance) could go further. For example, the Guidance should suggest that:

  - the pay policy could include a cap on directors' pay; this 'maximum' could be defined as a cash amount (i.e. not a number of shares or options), or a % of the market capitalisation or the increase in market capitalisation.
  - Bonuses should always be defined in cash terms using the average share price over, say, the last twelve months; this would help to avoid downward manipulation of the share at a particular point in time when part of the bonus is awarded in shares. (Note: retrospectively changing the averaging period to boost remuneration would not be allowed, for obvious reasons.)

- There should also be a requirement for an agreed proportion of the bonus to be paid as shares.
- Shares paid out as bonus should have to be held for a minimum period. The suggestion in the Code of a holding period of at least five years and possibly longer, to include post-employment periods (2 years for CEOs), is very welcome. Their value at the end of the holding period should be used to calculate an adjusted Single Total Figure of Remuneration in that year (i.e. the change from the date of vesting to the end of the holding period) that would have to be disclosed.
- Performance targets for directors' bonuses should be disclosed to shareholders and voted on at the start of each year. We understand that there will be howls of protest that this falls foul of stock exchange rules on what a company can and can't say about trading prospects. Announcing openly and transparently how much money the CEO will be paid for specific levels of EPS, Cash flow or whatever, merely puts all shareholders on a level playing field. However, a system which pays out large performance related bonuses and which these are kept secret from shareholders until after the pay award has been made and the money paid over to the recipient is clearly absurd. Directors would treat the notion that other employees in the business should be able to keep their performance targets secret between them and their manager until after they have been paid their bonus as laughable. The argument that it is inappropriate for directors to reveal their performance targets merely demonstrated just how fundamentally flawed the whole system is.

Overall, the Code and the supporting Guidance are much too gentle and deferential on remuneration. They should be tougher, more radical and more specific.

There also needs to be much more thought given to the link between the Corporate Governance Code and the Stewardship Code. The FRC has done much to hold fund managers to account in terms of actually voting the shares that they own on behalf of the beneficial owners. However, there is still far too much room for the 'agents' to use their voting rights in a way that suits them and their own best interests rather than the interests of the investors who have put their own money at stake.

We believe that the FRC should consider working with its own stakeholders to produce radical detailed guidance on executive remuneration. From a pure reporting point of view much reporting on directors' pay leaves a lot to be desired. For example the reporting on pay scenarios for the coming year is often highly misleading for investors. Similarly, the single figure for pay excludes LTIP awards until they vest with the result that large economic gains to directors remain hidden. Research by UKSA into the situation at Persimmon shows starkly the lack of fitness for purpose in current pay reporting.

The conclusion has to be that pay reporting is simply not fit for purpose. This is a subject that the FRC ought to revisit. As mentioned, most pay reporting falls well short of the requirements contained in Principle P of the Code.