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Submission: Financial Reporting Council – Directors' Remuneration

Dear Catherine

This letter is EY's submission to the Financial Reporting Council (FRC) on the consultation document released in October 2013 'Directors' Remuneration' ("consultation document").

EY's key points of view regarding the questions posed by the FRC in the consultation document are as follows:

- **Extended clawback provisions:** We support the proposal to include, on a "comply or explain" basis, a presumption that companies have policies to recover and/or withhold variable pay in exceptional circumstances. However, we do not believe it is practical or appropriate for the Code to mandate the form of the clawback policy. We believe that the Code should limit itself to specifying that Boards adopt clawback policies to deal with the recovery and/or withholding of variable pay in exceptional circumstances.

- **Remuneration Committee Membership:** We do not believe that any changes to the Code are required. We believe that the provisions currently enshrined in the Code are effective to ensure shareholders question the composition of the remuneration committee so as it ensure its independence, transparency and the extent to which it facilitates diversity of thinking.

- **Votes against the Remuneration Resolution:** We believe that the existing requirements set out in the Regulations, the guidance and the Code are sufficient to deal with votes against a remuneration resolution. Imposing additional reporting requirements would not improve shareholder engagement and we believe allowing time for a company to provide a duly considered response, as required by the new Regulations, would far outweigh the merits of any immediate response.

We trust the information and views provided in our submission are useful and we would welcome the opportunity to discuss our views with you.

Yours sincerely

Mark Shelton
Partner – Human Capital

Enclosed – Attachment A: EY's responses to the questions in the consultation document

Attachment A: EY's responses to the questions in the consultation document

1. Extended clawback provisions

a. Is the current code requirement sufficient, or should the Code include a "comply or explain" presumption that companies have provisions to recover and/or withhold variable pay?

We support the proposal to include, on a "comply or explain" basis, a presumption that companies have policies to recover and/or withhold variable pay in exceptional circumstances such as financial misstatement or gross misconduct.

We believe the facility for Boards to clawback variable remuneration is a positive inclusion within companies' remuneration and governance framework. Including provisions in the Code requiring companies to have clawback policies in place provides the Board with additional control to allow greater alignments between executive reward and corporate performance and shareholder interests and in particular, control over factors that were not apparent at the time the relevant incentive was determined.

Whilst we support the Code's inclusion of a presumption that companies have clawback policies in place, we do not believe it is practical or appropriate for the Code to mandate the form of the clawback policy. This is discussed further below.

We note there is evidence that clawback polices are being adopted across public companies and based on our experience, a significant proportion of FTSE 350 companies, already have in place provisions to clawback incentives in the event of material misstatement of financial results and gross misconduct. Consistent with the Code's overall spirit to ensure it is adopted bearing in mind factors such as size, complexity, risk profile and appetite, we believe that the clawback provisions proposed should only apply to FTSE 350 companies.

b. Should the Code adopt the terminology used in the Regulations and refer to "recover of sums paid" and "withholding of sums to be paid"?

We agree that the terminology adopted in the Code should be consistent with the language in the Regulations regarding clawback.

c. Should the Code specify the circumstances under which payments could be recovered and/or withhold? If so, what should these be?

We believe that the Code should limit itself to specifying that Boards adopt clawback policies to deal with the recovery and/or withholding of variable pay in exceptional circumstances rather than specifying the circumstances under which clawback could be applied.

Whilst clawback policies typically focus on recovering or withholding variable pay in the event of material misstatement of companies' financial accounts, it is important to note that there are other broader events, which may not result in misstatement that could lead to Boards applying clawback (e.g., events that could impact a company's financial soundness and/or its reputation). Such events may be unique to the particular company.

Accordingly, we do not believe it is practical or appropriate for the Code to mandate the specific circumstances under which payments could be recovered and/or withheld. It is the Board's responsibility to adopt a clawback policy which is approppriatae to the company taking into account its incentive framework, financial and non-financial risks and stakeholder interests.

Further, we believe that specifying the circumstances under which clawback could be applied is at odds with the various practical and legal challenges that need to be taken into account (discussed further below).

d. Are there practical and/or legal considerations that would restrict the ability of companies to apply clawback arrangements in some circumstances?

There are several practical and legal considerations that would restrict the ability of companies to apply clawback arrangements. It is for this reason that we believe that it is not appropriate, nor practical, for the Code to specify the circumstances under which clawback could be applied.

Such practical and legal considerations include:

- Application of clawback – setting guidelines around the application of clawback would not be appropriate because:

  i. Determining which group of employees to whom the clawback policies could apply may differ by company and may need to be tailored for each application (e.g., the application of the policy to executive directors only could exclude other individuals whose incentives were based on misstatement);

  ii. Process for determining which individual's incentive was impacted by misstatement (and how) can be complicated and require judgement and discretion; and

  iii. Recovering incentives from employees, including past employees whose incentive was based on the misstated figure would be costly and time consuming and would need to be considered taking into account wider context (e.g., recovering small amounts of incentives may incur a greater cost to the company than the recovered amount itself).

- Determining the event that triggers clawback – as we have noted above, whilst clawback policies typically focus on recovering or withholding variable pay in the event of material misstatement of companies' financial accounts, it is important to note that there are other broader events, which may not result in misstatement that could lead to Boards applying clawback (e.g., events that could impact a company's financial soundness and/or its reputation). While consistency within an organisation on applicability is important, it is less important for consistency across organisations as risk factors will vary dramatically by sector based on business and industry issues.

- Determining the clawback amount – determining the precise amount to be clawed back can be complex and a Board would typically need to use its discretion and judgement to consider a variety of factors such as whether there was any incremental remuneration gain from the clawback event as well as the individual's influence over the clawback event.

- Facilitating repayment of the clawback amount – facilitating the actual repayment of the clawback amount can be complex. The simplest mechanism to reduce the amount of unvested awards (i.e., deferred bonuses or long-term incentives). Clawbacks on delivered pay however are much more complex and may not always be practical, particularly in the case of past employees. Furthermore, there are various tax and legal consequences that need to be considered on a case-by-case basis.

- Time constraints – it is important to note that employees would expect some certainty regarding the time limit regarding the company's clawback policy. However, again this would be unique to a company's circumstances.

- Exceptions to clawback – it is important to recognise that there may be exceptions to clawback, for example, where the misstatement does not relate to performance measures used to determine the incentive. In such cases, it may be necessary for the Board to deal with the event through other measures (e.g., performance management). Finally, it is important that clawbacks not be triggered in the event of a good decision that was properly made that resulted in poor performance.

2. Remuneration committee membership

a. Are changes to the Code required to deter the appointment of executive directors to the remuneration committees of other listed companies?

We do not believe that any changes to the Code are required. We believe that the provisions currently enshrined in the Code are effective to ensure shareholders question the composition of the remuneration committee so as it ensure its independence, transparency and the extent to which it facilitates diversity of thinking.

We acknowledge public debate regarding membership of executive directors on remuneration committees of other listed companies. However, we believe that the argument that this situation exacerbates the 'ratchet effect' in executive pay is exaggerated and this is supported by data published by Manifest which shows no relationship between shareholder dissent and companies whose remuneration committees include a FTSE 350 executive director and shareholder dissent.

Further, we believe there are genuine commercial reasons for executive directors to be appointed to remuneration committees of other FTSE companies. For example, companies may wish to benefit from the experiences of a particular executive director who may have a deep understanding of issues facing the company.

3. Votes against the Remuneration Resolution

a. Is an explicit requirement in the Code to report to the market in circumstances where a company fails to obtain at least a substantial majority in support of a resolution on remuneration needed in addition to what is already set out in the Regulation, the guidance and the Code?

We believe that existing requirements set out in the Regulation, the guidance and the Code are sufficient to deal with votes against a remuneration resolution and effectively promote shareholder engagement:

- The Regulations require companies to disclose details of votes on the previous year's resolution(s) and where there was a "significant" vote against, the company needs to summarise any known reasons and the actions it has taken to respond. The guidance suggests that votes against a resolution greater than 20% could be considered "significant".

- The Code itself also includes provisions regarding communication with shareholders and the need for Boards to disclose what steps they have taken to engage and understand the views of shareholders.

It is not clear how additional and somewhat duplicate requirements, even on a "comply or explain" basis, would benefit shareholder engagement. We believe that imposing additional requirements could, in practice, detract companies from effectively addressing shareholder concerns as there is a risk that companies will need to focus more time on complying with the mandatory process.

Moreover it is impossible to predict how quickly companies can respond to shareholder dissent as this would vary depending on the company's particular circumstances (e.g., shareholding structure, shareholder concerns and remuneration framework). We believe that allowing time for each company to generate a duly considered response is more appropriate and ultimately more useful to shareholders than defining a manner and timeframe in which they must respond.