Response to FRC Directors Remuneration Consultation
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Local Authority Pension Fund Forum

Consultation Response

FRC Directors Remuneration – October 2013

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 58 local authority pension funds based in the UK with combined assets of approximately £115 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

1. Extended Clawback Provisions

Generally, LAPFF is supportive of clawback and malus provisions for directors pay. As outlined in our April 2013 document "Expectations for Executive Pay,"[1] LAPFF states that companies should 'clawback bonuses and variable pay in cases where ethical standards are breached, or where poor environmental or social performance causes demonstrable harm to company's reputation or social license to operate.' The remuneration committee should use its discretion in consultation with shareholders in determining whether and how to use clawbacks.

1.1. 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?

LAPFF supports reforms to the Corporate Governance Code (the Code) to adopt a comply or explain approach to clawbacks and malus. Companies are obliged by law to disclose whether there are any provisions for the recovery or withholding of any sum. However this obligation only applies to disclosure of future policy which need not be disclosed in a year when there is no vote. LAPFF supports annual disclosure of whether or not a company imposes a clawback policy and the reasons for adopting or not adopting that policy.

[1] http://www.lapfforum.org/TTx2/Publications/latest-research/files/2013MarchExpectationsonPayFINAL.pdf

1.2. Should the Code adopt the terminology used in the Regulations and refer to “recovery of sums paid” and “withholding of sums to be paid”?

Yes. The term ‘clawback’ does not appear in the Regulations. We view ’the recovery of sums paid’ (clawback) and ‘withholding of sums to be paid’ (malus) to be two distinct practices. The Code should require companies to specify whether they seek recovery of sums paid, or simply withholding of sums awarded but not yet paid.

The recovery of sums already paid or payable is a more transparent and preferable approach, The calculation of an amount which is subject to withholding involves assumptions about the relationship between restated financial figures and potential future proportionate value of the withheld amount in the context of the maximum amount that could vest. Although amounts withheld must now be separately disclosed the underlying assumptions need not be disclosed which may frustrate accountability and disguise the use of discretion by the remuneration committee.

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

The application of clawback or malus provisions should be the purview of the remuneration committee using its judgement to act in the best interest of shareholders.

The Code (or at least Schedule A to the Code) already identifies specific circumstances under which payments could be recovered and/or withheld.

> *“Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct.”*

The restriction of current guidance to “variable components” is not helpful. The Regulations refer to variable pay only in the context of recruitment remuneration and do not define the term. Reference to the categories of pay described by Schedule 8 Part 3 7 c) and d) would better define the kind of pay which the Code considers appropriate for clawback. Replacement of “exceptional” with “any circumstances including misstatement or misconduct” would provide remuneration committees with better flexibility. There may be more nuanced circumstances where executives’ decisions have resulted in demonstrable harm to the company, but not material misstatement. In these cases, the remuneration committee may want to exercise judgement to clawback awards. An example of this might be a breach of the ethical code of conduct, or actions that significantly harm the reputation of the company. LAPFF views it appropriate that remuneration committees have the ability to clawback payments in these more nuanced situations.

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

LAPFF is not aware of any listed company that has successfully recovered money to date for shareholders that had been previously paid to an executive. The legal obstacles to recovery are significant. The European Convention on Human Rights protects against legislation that applies retrospectively and also protects private property.

Recovery is probably unlawful without prior and explicit consent of the kind LAPFF is encouraging companies to seek in the process of developing and implementing clawback policies.

2. We would also welcome views on whether there is a need for any other changes to the remuneration sections of the Code

The main principle D1 asserts that the purpose of pay is to attract, retain and motivate. LAPPF considers that the inclusion of this assertion in the Code serves to perpetuate some common misunderstandings about how the market for executive talent operates in practice and in particular what motivates those working at the highest levels of listed companies.

Attract

In normal circumstances candidates are attracted to a job once it is advertised, thus creating a market in potential candidacy. However it is a mistake to assume that the job (and therefore the pay) attracts the candidate in all instances of executive recruitment. Individuals are often approached by headhunters by word of mouth or other non-transparent methods. This process reflects many behavioural biases. In this model the headhunter is in fact attracted to the candidate rather than a wider pool of people attracted to the job The individual involved sets the terms required to attract them and the headhunter sets the rate of commission required to broker the deal. This model leads to overpayment.

Retain

Under normal market conditions, the level of pay would be determined with retention as an objective only in circumstances where there is a significant risk that retention is an issue. Automatically including retention as an objective makes two false assumptions. First that executives are always worth retaining;.there are numerous examples of high profile executives having received awards incorporating retentive elements only to be ousted by shareholders. Automatic retention pay levels can place remuneration policy in direct conflict with shareholders' wishes to either retain executives or pay them off. Second, that higher levels of pay due to retentive elements will not be bought out by alternative employers. The purchase of unvested outstanding incentives on recruitment of an executive is common practice and undermines any retentive effect which is claimed for pay policy. This is despite the almost universal use of 'attract, retain, motivate' as the objective of pay policy amongst listed companies.

Motivate

In LAPFFs experience motivation is only ever discussed in annual reporting in the context of pay policy. Current principle D1 challenges companies to explain how their pay policy serves the purpose of motivation and in doing so puts the cart before the horse. In setting motivation solely in the context of pay policy, the Code ignores the evidence from executives themselves about what really motivates them. LAPFF published its own study of employee motivation in 2012. The conclusions of "People & Investment Value[2]" are strikingly similar to the conclusions of work done in this area by

[2] http://www.lapfforum.org/TTx2/Publications/latest-research

PWC and the London School of Economics. Both rely on the views of executives themselves.

The FRC has an opportunity to encourage companies to recalibrate the offer made to employees, which LAPFF refers to as 'the employee value proposition' This could be in terms that are unique to each company and which reflect the observable evidence that there is more to motivation than pay levels.

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

No. In LAPPFs view such a change would not serve to address the fundamental problems that afflict the current model for setting executive pay levels. With regard to remuneration committee composition, the executive/non-executive status of committee members is less relevant to decision making than the quantum of pay they have experienced (directly or indirectly) during their own career. In this respect, attendance at remuneration committee meetings by employee representatives would provide a counter balance to such experience and would ensure companies meet the Code's expectations that they are sensitive to pay and employment conditions elsewhere in the group.

4. 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 Regulations, the guidance and the Code?

No. A comply or explain Code of Best Practice is not the appropriate device to ensure that quantitative disclosure of data already known to all companies is made to the market. The law (Schedule 8 Part 3 Para 23) requires disclosure of voting results for resolutions at the prior general meeting to approve remuneration policy and remuneration report. LAPFF does not consider that the disclosure required by the new regulations will comprehensively expose the general level of concern over remuneration. Many shareholders choose to reflect concerns over pay in their vote on remuneration committee members. Director elections are not covered by the law in this context. New share incentive schemes must be the subject of shareholder approval in accordance with the Listing Rules however new schemes are not covered.

LAPFF considers that the continuing obligations under the Listing Rules are a more appropriate device for ensuring market wide disclosure of proxy voting results.,

4.1. **Are there any practical difficulties for companies in identifying and/or engaging with shareholders that voted against the remuneration resolution/s?**

Yes the mechanism by which shares voted by pooled fund managers reflect the intentions of the underlying beneficiaries is not transparent. The FRC should act now to amend the Stewardship Code such that investment managers are required to disclose the method by which underlying beneficial owners views may be reflected in proportion to their economic interest in a pooled investment vehicle.

A number of LAPPF members have funds invested in third party pooled vehicles and internally managed funds. The results of voting audits conducted by our members illustrate the problem. In a number of cases, votes were cast both ‘For’ and ‘Against’ the same proposal at the same meeting due to the inability of the external manager to facilitate split voting of the position held by the pooled fund. In this context, a company deciding to engage with investors based on the proportion of shares voted against a remuneration resolution would be basing their decision on an underestimate of the level of concern amongst investors.

5. Is the Code compatible with the Regulations? Are there any overlapping provisions in the Code that are now redundant and could be removed?

D1 states that

“A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.”

Although compatible with UK law (the regulations) there is potential for conflict with over-arching European law. For many of the companies to which the Code applies the latest Capital Requirements Directive (CRD IV article 94(1)(g)(i)) sets a ceiling on the proportion of total pay which may be represented by variable pay without further explicit shareholder approval. The Financial Conduct Authority has already announced its intention to transpose article 94 in full into its Remuneration Code in the UK regardless of the outcome of the legal challenge which the UK government has lodged with the Court of Justice of the European Union (ECJ).

LAPPF believes the Code should frame its advocacy of variable pay in the context of a new legally recognised principle that variable pay should not generally form more than 50% of total pay.

D.1.3 requires companies to seek shareholder approval for grant of options to non-executive directors. Under the regulations such grants will in future not be possible unless approved future policy tolerates this practice. As such this provision appears to be redundant.

D.2.1 requires a statement about the relationship of remuneration consultants to the company. This is now redundant. The law as set out under Para 22 b-c of the regulations is much more stringent.

D.2.3 allows for the power to determine non-executive pay to be delegated to a board committee subject to an adjustment to articles which give shareholders this power. The disclosure provisions relating to non-executive fees in Para 25 and 28 of the new regulations are consistent with the idea that shareholders need full disclosure of non-executive pay to exercise their powers under the Articles. The suggestion in the Code that a board committee is able to determine fees risks divorcing disclosure from the power to act on information that is disclosed. This provision should be removed.

D.2.4 encourages companies to provide a vote on new long term incentive schemes insofar as required by the Listing Rules. The Listing Rules exempt schemes for individual directors from shareholder approval. The regulations prohibit payments under any scheme that does not form part of approved remuneration policy and are therefore stricter than the Listing rules in this respect. The provision should either be dropped or amended to reference the new legal imperative.

Schedule A states that upper limits should be set for annual bonuses. Such limits are now required by the regulations and this guidance is now redundant.

Schedule A states that where appropriate, performance metrics for incentive schemes should include non-financial criteria. This contrasts with Article 94 of CRD IV which distinguishes between performance metrics that measure business unit or overall corporate performance and performance measures that measure individual performance. It is clear that metrics which show corporate performance should be financial and that non-financial metrics should only be used when considering individual performance. This provision should be re-worded to ensure consistency with the directive.

6. Should the Code continue to address these three broad areas? If so, do any of them need to be revised in the light of developments in market practice?

a) some aspects of the design of performance-related remuneration

As stated above, LAPFF expects companies to take advantage of aspects of their offer to employees other than pay when seeking to retain and reward them. LAPFF has set out its expectations for changes in market practice with regard to remuneration in its 'Expectations on Executive Pay' document which was sent to FTSE 350 companies in April 2013.

b) the process by which remuneration should be set

Remuneration consultants are widely used by companies in their process to determine remuneration. LAPFF advocates a simpler model of pay based on long term profits which would not need interpretation via specialist consultants. Reframing the Code to highlight the advantages of simpler pay structures (including the avoidance of reliance on external consultants) would bring the Code into line with LAPFFs expectations of future practice.

The Code (D2.2) observes that the Remuneration committee is the body responsible for setting executive pay. Such committees have failed to produce pay arrangements that are acceptable to the public and public anger over excessive pay has produced legislation which makes shareholders views sovereign with regard to pay arrangements (via the binding vote). This is a significant change in market practice and needs to be reflected in changes to the Code.

c) some disclosure requirements

Potential conflicts with disclosure requirements in the regulations are stated above.

