TOWERS WATSON

External Memorandum

Date:	6 December 2013
To:	Catherine Woods, Financial Reporting Council
From:	Towers Watson
Subject:	**Response to the Financial Reporting Council "Directors' Remuneration – Consultation Document" of October 2013**

Dear Catherine,

We are writing to you in response to the Financial Reporting Council "Directors' Remuneration – Consultation Document" of October 2013 on three specific proposals relating to clawback arrangements, whether non-executive directors who are also executive directors in other companies should sit on the remuneration committee and actions companies might take if they fail to obtain substantial majority in support of a resolution on remuneration.

We have responded, on behalf of Towers Watson, to each of the specific questions in turn and would be happy to discuss further at any point.

Please contact Katharine Turner (katharine.turner@towerswatson.com) or Richard Latham (richard.latham@towerswatson.com).

Extended Clawback Provisions

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?
To confirm, we are aware that the current Code requirement (in Schedule A) states that *"Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct".* In light of perceived reward for failure in the current climate, we agree that the Code should include a "comply or explain" presumption that companies have provisions to recover and/or withhold variable pay.

We note, however, that the Code currently envisages "reclaiming", which we interpret to be genuine "clawing back" of remuneration after payment (as opposed to withholding before payment or vesting).

As further outlined further below, we consider that the adoption of genuine clawback is largely impractical and even unenforceable in some cases. That being said, the current Code requirement and increased overall focus on pay for performance/ appropriateness of recovery and withholding has already led to changing practice in this regard and our research shows that c.70% of FTSE100 companies have provisions in place to recover and/or withhold variable pay (with withholding provisions being the most prevalent as the most practical and enforceable).

Indeed, we expect that this practice will continue in light of the requirements contained in the new UK Regulations: (i) to disclose in the directors' remuneration policy "whether there are any provisions for the recovery of sums paid or the withholding of the payment of any sum"; and (ii) in the annual remuneration report, companies are required to disclose details of any sums recovered or withheld, and the reason why.

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We feel, therefore, that an amendment to the requirements of the Code (effectively adding withholding to reclaiming) would complement the requirements of the UK legislation and support changing practice, rather than necessarily prompt a change in practice.

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 terminology used in the Code does not explicitly distinguish between recovering and withholding of variable pay and we find that there is continued confusion regarding the operation of these concepts (and their relationship with the terms clawback and malus). The recent update to the ABI Principles of Remuneration has sought to clarify the distinction and helpfully defines each concept by reference to their more commonly referred to names of "clawback" and "malus". Our recommendation is that you adopt an approach consistent with the ABI.

Should the Code specify the circumstances under which payments could be recovered and/or withheld? If so, what should these be?
The Code already specifies examples of the circumstances under which payments could be recovered and/or withheld – i.e. *"in exceptional circumstances of misstatement or misconduct"*. Whilst they may not address the broader issue of poor management that leads to reduced shareholder value, we do not consider that the Code should set out a prescriptive set of circumstances. This should be left to each company to determine, having regard to its specific circumstances.

What is perhaps of greater importance, however, is whether Remuneration Committees have the discretion to operate the provisions to recover and/or withhold variable pay – or whether it should be more prescribed. Indeed, it is noted from the wording of this question that reference is made to *"…circumstances under which payments could be recovered…"*, rather than *"should"*.

Whilst it is of course important to encourage companies to put such provisions in place, we would not advocate a "should" obligation (but the right to operate such provisions if necessary) although feel that it will be important to monitor the extent to which companies do in fact operate such provisions (and the circumstances in which they do so). Such monitoring will, of course be possible under the new UK regulations (by reference to disclosure made in the annual remuneration report).

Are there practical and/or legal considerations that would restrict the ability of companies to apply clawback arrangements in some circumstances?
These are relatively well known (hence the prevalence of withholding/malus) and are somewhat factual rather than a matter of opinion. For example, reclaiming/clawback relies upon successfully accessing funds/assets already legally held by the director (perhaps now a past employee), there may be "wasted" tax liabilities for both the company and the director and, indeed, the authority to affect such clawback may not have been adequately documented so as to make such clawback provision legally enforceable.

Remuneration Committee Membership

Are changes to the Code required to deter the appointment of executive directors to the remuneration committees of other listed companies?
No.

We are of the opinion that the practice of serving executives sitting on the remuneration committees of other large companies leads to no significant measurable impact on the level of pay at those companies on whose remuneration committees they serve. This view holds both in terms of awarded pay and in terms of realised pay. Nor is there any discernible impact on the design of reward arrangements, as captured by the pay-performance sensitivity of executive pay at such companies.

Of greater importance, in our opinion, is ensuring that remuneration committee members are truly independent and have the time and expertise necessary to carry out their duties. We also believe that the pool and mix of non-executive directors should be increased rather than reduced (which could happen if this proposal were to be implemented).

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Votes Against the Remuneration Resolutions

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. The new UK Regulations require additional disclosure on this point and we do not feel that the Code needs to explicitly address this.

In any event, we feel that there is a practical problem with this proposal. For any notification to have value to the market, such a company would have to disclose the reasons why a substantial number of its investors did not support the resolution. Based on our experience, we find that many institutional investors and most private shareholders do not inform companies at all or on a timely basis of their reasons why support was withheld.

From a wider perspective, we are aware that the original proposal was for resolutions on remuneration under the new UK regime to be 75% (special) resolutions but, having debated and considered the point, it was decided that ordinary (50%) resolutions would be appropriate. Whilst accepting the requirements of the new UK regulations and the GC100 and Investor Group guidance (which suggests that votes against in excess of 20% may be considered significant), it should not be forgotten that the resolutions on remuneration are ordinary resolutions with require +50% in order to be passed.

Indeed, requiring particular (and prescribed) action to be taken in relation to a "significant" percentage of votes against resolutions on remuneration may raise the question: why shouldn't equivalent action be taken in respect of the other resolutions put forward at general meeting?

If yes, should the Code:

- **set criteria for determining what constitutes a "significant percentage";**
- **specify a time period within which companies should report on discussions with shareholders; and/or**
- **specify the means by which companies should report to the market and, if so, by what method?**

See overall response above

Are there any practical difficulties for companies in identifying and/or engaging with shareholders that voted against the remuneration resolution/s?
In terms of identifying shareholders that voted against the remuneration resolutions, we understand that this is relatively straightforward although sometimes the name of the shareholding entity is not particularly transparent (in terms of actual identity and geographical location). However, as explained above, ascertaining the reasons for their negative votes can be difficult and is likely to become more so. Factors include:

- Private shareholders are not required or expected to give their reasons;
- Reliance of many institutional investors, particularly those based outside the UK, to follow the voting guidance of proxy report agencies;
- Institutional investors not having the time and resource to commit to giving feedback on a timely basis. For example, this year there has been one high profile UK institutional investor that has taken 4 to 6 months to issue letters to FTSE 350 companies explaining why it could not support remuneration resolution; and

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- A perceived disconnect between the corporate governance officer at some shareholders and the fund managers, which can lead to conflicting messages being given to the CEO and the Chairman of the Remuneration Committee.

Finally, we encourage the FRC to bear in mind that that the views and positions of the myriad of investors in UK listed companies and voting guidance agencies vary widely and we consider that obtaining consensus on executive pay issues (including those focussed upon in this consultation) is unlikely.

Towers Watson
6 December 2013

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