



Directors' Remuneration

A response to the FRC consultation on amendments to the UK Corporate Governance Code

Introduction

We're writing to comment on the above consultation document on behalf of the National Employment Savings Trust (NEST). We welcome the FRC's move to consult on potential developments to the UK Corporate Governance Code to address a number of issues relating to the new legislation on executive remuneration reporting.

We generally support seeing many of the important aspects of the revised regulations featured in the Code in the form of helpful guidance. We're less supportive of the inclusion of overly prescriptive stipulations that already feature in the regulations.

About us

Employers in the UK now have a statutory duty to enrol some or all of their workers into a pension scheme that meets or exceeds certain legal standards. They're also likely to make minimum contributions for these workers.

NEST is a defined contribution pension scheme that UK employers can use to meet their new legal duties. NEST is an easy-to-use, low-charge scheme that has a public service obligation to accept employers of any size or sector that want to use it.¹

NEST invests and owns stakes in thousands of companies globally and is likely to be among the very largest institutional asset owners in Europe. How these companies are governed and run is a concern of the members of NEST as it will be a determinant of the performance of NEST's funds and members' incomes in retirement.

Our response

Comply or explain

We have a profound interest in seeing the FRC continue to develop a robust Corporate Governance Code that's fit for purpose. It should build on the good work of earlier codes on corporate governance while retaining the flexibility of the 'comply or explain' approach. We believe that a good measure of success will be companies following the spirit of the Code and providing high-quality narratives and evidence, rather than tick box responses or policies.

It's also important that the Code continues to be used as a guide to good corporate governance practice and isn't overburdened by heavily prescriptive stipulations that deter company boards from thinking for themselves. We consider it the responsibility of companies to interpret the principles of the corporate governance code. They should apply them in a way that suits the nature of their business, as long as this continues to uphold the purpose of the Code and raises rather than lowers standards of corporate governance.

¹ More information about NEST available at: nestpensions.org.uk/schemeweb/NestWeb/includes/public/docs/key-facts-myths,PDF.pdf

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?

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

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

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

We support BIS's move to ask the FRC to revise the Code to require all large public companies to adopt clawback. Companies that don't comply should explain why they haven't done so and detail other mechanisms that they use to rebuke failure and errors.

With regard to whether the Code should adopt the terminology used in the regulations² this could be deemed too prescriptive for the remit of the Code. As disclosure on clawback provisions are already part of the new regulations there may not be a pressing need for the FRC to include this currently. A sensible approach could be for the FRC to keep company disclosures under review to gauge the appropriateness of further action.

The different nature of companies may present difficulties for the Code to set out specific circumstances under which payments could be recovered and withheld for all types of companies. Instead, the Code should ask companies to set out in the remuneration policy the circumstances under which payments will be recovered and/or withheld. Companies should be advised to disclose in the annual remuneration report instances when clawback has or hasn't been implemented and details of sums recovered and withheld. We believe remuneration committees should have the freedom and flexibility to implement and refrain from clawback and explain why the provisions haven't been met.

We're not aware of any practical and/or legal considerations that would restrict the ability of companies to apply clawback arrangements. If companies believe there are particular considerations in this area, the FRC should require them to disclose what these are in their remuneration policies.

Remuneration committee membership

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

We believe that independent non-executive directors (NEDs) have a key role to play in determining appropriate remuneration structures. If a non-executive is a serving director on another large company board, particularly from the same industry, then they could be perceived to have partial views about pay structures and levels. Curbing this practice may prompt industry to widen the pool in their search for NEDs, which we believe to be a positive move.

Consequently, companies are likely to be required to search and select from a wider pool, leading to a greater diversity of expertise, thinking and perspectives.

Companies may also have to put more effort into the recruitment of members to the committee because they need to look further afield, potentially to the unlisted and not-for-profit sectors. Such moves are likely to boost independence, reduce the risk of groupthink and broaden the diversity of backgrounds.

We therefore believe there is merit in the FRC encouraging a wider and exhaustive search for NEDs to the remuneration committee to further promote diversity.

² The regulations require quoted companies to disclose (i) provisions for the recovery of sums paid or the withholding of payment and (ii) the details of sums recovered/withheld and the reasons for doing so.

While we believe it would be helpful for the Code to provide this kind of guidance on remuneration committee membership, which would encourage independence and diversity, the FRC should also refresh thinking on how other board committees, such as audit and nominations could be more effectively constituted. The composition and conduct of all committees have a pronounced impact on the overall board's effectiveness in maintaining a broad mix of thought and flow of ideas that contribute to more effective decision making.

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?

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?*

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

We believe there is merit in the FRC encouraging effective reporting from companies to all shareholders soon after an AGM where a substantial vote majority hasn't been achieved. The FRC should also expect companies themselves to set out in their remuneration policy a time frame that's reasonable within which they'll report back to the market and by what means rather than setting a precedent for all companies in the FTSE 350. For example, smaller companies may be able to report back within a shorter time frame than larger companies.

While there may be merit in the FRC setting criteria for determining what constitutes a 'significant percentage', we're unclear whether a blanket criterion would suit the needs for all companies in the FTSE 350. We'd like to know what this criteria looks like prior to implementing it in the Code. That said, we're supportive of all companies considering a set of high-level criteria in helping them arrive at a figure for a 'significant percentage'.

While it's good practice for companies to routinely disclose in the annual remuneration report significant levels of dissent, we think there's merit in the FRC going further and asking companies to report this information through the Regulatory Information Service (RIS). A high level of voting dissent is a material concern to shareholders and reporting through RIS attaches importance to the issue and promotes wide and fair disclosure to all considered shareholders.

We believe that good practice for shareholders is to engage with companies either prior to or after voting against a resolution, whether this is on executive remuneration or another issue. The FRC should encourage companies to embark on or be receptive to open and effective dialogue with all shareholders both large and small and direct and indirect around AGMs, particularly where there are votes cast against. A practical challenge is that indirect shareholders invested via pooled funds don't appear on the share register. However companies should make every effort to engage with underlying asset owners to gain a more informed view. There may be times when asset owners, who may be restricted from voting themselves, may take a different view on remuneration to those of their fund managers.

Finally, a great help for large shareholders would be for companies to disclose in their policies how abstentions are treated in terms of how they're counted and interpreted.

Other possible changes

The remuneration section of the Code is heavily focussed on performance-related pay. We believe the FRC should include some wording that encourages companies to consider other aspects of pay and reward, for example, longer-term performance schemes that include non-financial benefits. We'd also ask the FRC to encourage companies to think about how their executive remuneration policies and structures impact both culture and behaviour across the organisation and their alignment with employee and customer interests.

Overall, we believe the Code would benefit from additional guidance for remuneration committees in considering the level of executive pay in the context of the individual, the company overall and in relation to all employees. Broader still, the remuneration committee should be informed of pay levels in equivalent sectors and industries and wider public concerns.