rlam®
royal london asset management

55 Gracechurch Street, London EC3V 0UF   t: 020 7506 6500   f: 020 7507 6500   www.rlam.co.uk

Catherine Woods
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN
Submitted by email: remcon@frc.org.uk

4 December 2013

Dear Ms Woods,

Consultation Response: Directors' Remuneration

I am pleased to submit Royal London Asset Management's (RLAM) response to the FRC consultation on Directors' Remuneration (October 2013).

RLAM is one of the UK's leading investment companies, managing assets on behalf of institutional and wholesale clients, as well as its parent company, Royal London Group, the UK's largest mutual insurer. RLAM recently acquired The Co-operative Asset Management, including its responsible investment and corporate governance functions. RLAM has approximately £72 billion in assets under management.

If you have further questions regarding our views on this matter or on corporate governance and remuneration in general, please don't hesitate to contact me.

Regards,

Ms Ashley Hamilton
Corporate Governance Manager
Royal London Asset Management (CIS) Limited
ashley.hamilton@royallondonmanchester.co.uk
t: +44 161 903 6813 m: +44 7725 352 186

Response to the consultation questions

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?

We do not believe the current code requirement is sufficient. We recommend that the FRC update the Code to include a specific comply or explain requirement for companies to describe whether they have a policy to recover and/or withhold variable pay.

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, we believe the FRC needs to provide a clear distinction between "recovery of sums paid" (clawback) and "withholding of sums to be paid" (malus). Clawback is materially different from malus, as it requires the repayment of cash already awarded and paid to the directors. We believe clawback is the preferable requirement, as it is likely to serve as a greater deterrent. However, we recognise that in practice, clawback may be difficult to implement and may become embroiled in legal proceedings.

Malus requires the withholding of sums awarded but not yet paid. We do not view this to be as effective a deterrent as true clawback mechanisms. Evidence from a recent PwC study indicates that executive directors discount the value of long-term incentives by up to 50%.[1] If directors psychologically discount the value of shares awarded to them but not yet paid, malus may provide less of a deterrent.

Recognising the challenges that companies may face in applying a true clawback, the application of malus or a combination of the two may be acceptable. However, we strongly urge the FRC to require companies to clearly disclose whether they have a policy to recover sums paid or withhold sums to be paid (or both). Companies should also disclose under what circumstances they will apply each type of recovery mechanism.

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

We believe misstatement and/or misconduct should be the bare minimum requirement advocated by the FRC. However, we believe there may be circumstances where there has not been a misstatement or misconduct in the narrow sense, but where the actions of the director

[1] http://www.pwc.com/en_GX/gx/hr-management-services/publications/assets/making-executive-pay-work.pdf

may have a direct impact on the reputation of the company and/or its ability to operate within a given market or community.

For example, we would argue that recent trading scandals and price-fixing at several international banks may constitute grounds for applying clawback or malus if the board determined that the actions and decisions of the directors promoted behaviour that had a material negative impact on the firm and its shareholders. Increasingly, companies are including environmental and social metrics within their remuneration plans whereby executive directors are rewarded or penalised based on their performance in this area. We are supportive of this trend and see clawback mechanisms as an extension of this practice, recognising that the financial, reputational and operational impacts of director behaviour may take several years to materialise.

Ultimately, we believe the decision rests with the board on whether and under what conditions clawback or malus will be applied. However, we urge the FRC to issue guidance stating that companies *may* apply these mechanisms in circumstances *other* than misstatement or misconduct, should they see fit. Such a statement would provide shareholders with the ability to hold boards accountable for how they apply clawback or malus, and for how their decisions to apply it may affect the long-term value and sustainability of the company.

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

Yes, we expect there will be several practical and legal constraints. We believe it may be more difficult for companies to implement true clawback than to implement malus. We expect our colleagues in the legal profession will provide a substantive response to this question.

We would like to emphasise however that companies will need to establish clear terms and conditions within executive contracts that explain what types of events may trigger clawback arrangements, whom has authority to determine if clawbacks are appropriate, and in what timeframe they can be applied. We urge the FRC to provide guidance to companies on writing clear employment contracts for executives, noting that companies need to clearly communicate the terms of the clawback arrangements to their shareholders.

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

We are not aware of any evidence that demonstrates that CEOs serving on remuneration committees results in materially higher pay or more poorly designed pay packages. For this reason, we are not in a position to form an opinion on this issue.

However, we believe that there are several factors the FRC should consider when coming to its conclusion. We are aware of some serving CEOs that are excellent remuneration committee members. The fact that they themselves must grapple with questions of motivation and reward for their own workforce on a daily basis may give them unique insight into how other companies may also achieve an appropriate balance.

While we acknowledge that there may be an inherent conflict of interest and tendency for serving CEOs to preserve the status quo, this conflict may not be limited to those individuals as a group. We believe the concern regarding group-think and the status quo within remuneration committees stems from the larger problem of a lack of diversity on UK corporate boards. Remuneration committees comprised of directors from diverse backgrounds and professional experiences are more likely to challenge the status quo. We applaud the efforts of UK companies to improve diversity by appointing more women to their boards. We regularly discuss this issue privately with companies we invest in and encourage them to implement appropriate succession planning and to promote diversity. However, we think companies would also be well-served by seeking directors from different cultural backgrounds and industry experience to serve on their remuneration committees. We therefore take the view that restricting serving CEOs from participating in remuneration committees may not directly address the problem of group think. It may in fact limit the pool of qualified candidates to serve on remuneration committees.

Finally, the factor that we find most compelling with regard to restricting CEOs from serving on remuneration committees is the argument that a full-time executive simply does not (or should not) have the time outside of their executive responsibilities to be an active and effective member of a remuneration committee. However, if we were to take this argument to its logical conclusion, we may also argue that serving CEOs may not have sufficient time to devote to audit committees or nomination committees, particularly during times of financial crisis or director search processes.

Based on these observations, we urge the FRC to reconsider this issue in light of the broader concerns regarding board structure and diversity, as well as the time commitments of serving CEOs more generally.

6. **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?**

Yes, the Code should be amended to stipulate that companies should report to the market when it fails to secure a substantial majority support for *either* the binding vote on remuneration policy and/or the non-binding vote on remuneration implementation.

7. If yes, should the Code:

a) set criteria for determining what constitutes a 'significant percentage';

We concur with the views of the GC 100 that a "significant percentage" likely constitutes 20%. We also agree that the board should disclose in the annual report what it considers to be a significant percentage if this differs from 20%. For companies with a major shareholder or where company insiders own a significant proportion of the outstanding shares, the 20% threshold may not be sufficient. In these circumstances, we would consider dissent by 20% of the *independent* shareholders to constitute a "significant percentage."

b) specify a time period within which companies should report on discussions with shareholders; and/or

In order to facilitate meaningful and full participation by shareholders in discussions with the remuneration committee, we recommend the following procedures.

Within 30 days of failing to obtain a significant percentage support for one or both of the remuneration votes, the board should report to the market by way of an RNS announcement. The announcement should contain:

- The process by which the board expects to review remuneration in consultation with the shareholders;
- The timeline for the consultation process; and
- Information on how shareholders can contact the remuneration committee to provide their views.

c) specify the means by which companies should report to the market and, if so, by what method?

Companies should report to the market by way of a RNS announcement within 30 days of the vote, as outlined above.

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

Often companies will consult only with their top ten shareholders. While in some cases this is practical and reasonable, it may not always be sufficient. The FRC should encourage companies to reach out to shareholders outside the top-ten list. In particular, companies should seek the views of their critics, and of shareholders that demonstrate their commitment to long-term stewardship through engagement and consistent application of their voting policies.

The FRC should also urge companies to consult with the underlying asset owners. This may be a challenge because asset owners are not always listed on the share register, as the assets are often held by an intermediary. While asset owners often delegate the responsibility for voting and engagement to their investment managers, some asset owners will retain the right to vote and engage with companies in their portfolios. In some cases, asset owners may hold views that differ from their investment managers on issues of corporate governance and remuneration. Companies will therefore be rewarded if they proactively seek the views of the underlying asset owner, as well as from the investment management industry.

Finally, we note that proxy voting agencies are also key stakeholders, as their analysis feeds into how shareholders will ultimately vote. Any misunderstanding on the part of the proxy voting agencies may affect the vote outcome.

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

We do not believe it is necessary to remove any items from the Code at present.

10. 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?

We agree that the Code should continue to address the three broad areas concerning remuneration. We expect some revisions to the Code may be needed in the future, but we would caution against making changes immediately. We would prefer to observe and understand the outcomes of the new binding vote on pay before recommending further changes to the Code.

rlam is a marketing brand including the following companies:
Royal London Asset Management Limited registered in England & Wales number 2244297; Financial Services Authority (FSA) register number 141665.
Royal London Pooled Pensions Company Limited registered in Scotland number SC048729; FSA register number 110456.
Royal London Unit Trust Managers Limited registered in England & Wales number 2372439; FSA register number 144037.
Royal London Cash Management Limited registered in England & Wales number 19632; FSA register number 121844.
All of the above are authorised and regulated by the Financial Services Authority.
It also includes Royal London Asset Management Bond Funds Plc registered in Ireland number 364259 and regulated by the Central Bank of Ireland.
All these companies are subsidiaries of The Royal London Mutual Insurance Society Limited registered in England and Wales number 0099064 (FSA registration number 117672).
Head office: 55 Gracechurch Street, London EC3V 0RL. Our ref: 2012-LH1