

19 July 2007  
by email to [codereview@frc.org.uk](mailto:codereview@frc.org.uk)

Chris Hodge  
Corporate Governance Unit  
Financial Reporting Council  
Fifth Floor  
Aldwych House  
71-91 Aldwych  
London WC2B 4HN

Dear Chris,

In response to the FRC consultation on the Combined Code, I am writing to describe my suggested improvements and have included recommendations for improvements to the disclosure regime for directors' remuneration.

My qualifications for this are that I have been a remuneration consultant for over 20 years and am well known and respected in the industry. For example I write the remuneration chapters and am co-author with Professor Andrew Chambers of Tottels Guide to Corporate Governance, the 4<sup>th</sup> edition of which will be published in December. I have advised many FTSE 100, mid cap, small cap and AIM companies in my consulting life.

There is clear justification for changes to the Code:-

1. The SEC requirement to disclose the top 5 officers remuneration and the changes re total remuneration disclosure go further than current UK disclosure. The UK has, to now, led in this respect and should not fall behind.
2. The Directors' Remuneration Report Regulations have helped enormously in increasing the amount of disclosure. However some companies have used this as an opportunity to bury readers of annual report with large amounts of data which is very difficult to interpret.
3. The Preamble to the 2003 Code para 11 stated the requirement that the Remuneration Report is "clear, transparent and understandable to shareholders". This requirement was dropped from the 2006 Combined Code. Most Remuneration Reports would not pass this test, but it should be the aim of best practice. If this change is not made the FRC is open to criticism that is supporting obfuscation with regard to directors' remuneration.
4. How directors and senior managers are remunerated provides an important window on corporate governance more generally:-
  - a. If the process is well managed with a properly constituted Remuneration Committee which operates fully independently, appoints expert, professional, independent remuneration consultants to assist them, listens to both shareholders and management and evaluates their inputs, then this is a good sign that other corporate governance will be effective. If however the reverse is true, e.g. Remuneration Committee members seen to be too close to the Chief Executive, consultants appointed by and too close to management, shareholder concerns ignored and excessive remuneration awarded, then this is a sign that other corporate governance may be poor.
  - b. The choice of performance measures and their relative importance in the delivery of performance related pay is the second window on corporate governance, as they indicate what is felt to be important in the company. The exclusive use of profit in annual bonus plans

is a warning sign. The performance measures that determine the remuneration of the management of the company should include those that drive the future business success, e.g. customer satisfaction, customer retention, customer growth, average revenue per customers, employee satisfaction, staff turnover and average length of service, environmental and social responsibility measures, health and safety, effective relationships with regulators, etc. If these measures are not part of the incentive plans, then the company may be saying one thing to its shareholders but internally may be behaving quite differently. Hence, this is a crucial window on what is happening inside the company.

5. The way in which the Code is applied and interpreted could be improved especially in relation to “comply or explain”, which, I agree, goes to the core spirit of the Code. In my experience, the chairmen of my clients take the trouble personally to visit the institutions which invest in their companies to explain new proposals for directors’ pay and reward, some of which are innovative and do not readily conform to a standard model. Rarely do the chairmen meet the investment directors and often complain that the compliance representatives they do meet are knowledgeable neither about their companies nor about the proposals, their potential impact on the business or their effect on shareholders’ interests.
6. It is the essence of comply or explain that the explanation is unlikely to “tick the boxes”. A “red top” for non-compliance in relation to proposals which demonstrably represent a good deal between management and shareholders but which do not conform to a standard model devalues the core principle of comply or explain and removes a major plank of the Code.
7. A number of institutions (e.g. CIS and Morley) have adopted their own guidelines on directors’ pay and reward. As a result, when formulating new proposals companies may be faced with the prospect of complying with more than three sets of provisions (ABI, NAPF, Combined Code and guidelines adopted by individual institutions). A combined single set of clear guidelines would provide all companies with a standard measure against which their compliance can be measured and in relation to which the reasonableness of their explanations for non-compliance can be gauged.

There are 8 areas where the disclosure could be improved.

1. The remuneration report should be clear, transparent and understandable to shareholders. This objective should be stated in the Combined Code.
2. Total remuneration needs to be shown. At present its constituents are spread over several pages and not added up. Total emoluments only account for one third of the total remuneration. Companies should have to disclose the net present value of total remuneration awarded and the value of total remuneration received (i.e. including options exercised and LTIPs that vest in the year).
3. Disclosure should be for the top 5 highest paid executives (as in the US) as well as all directors.
4. For the CEO the total remuneration - awarded and received - for the past 5 years should be shown in a table or graph alongside the TSR graph. (Companies could then explain and demonstrate the linkage of pay to performance and the level of pay awarded and received versus the stated policy - this supports your goal of accountability.)
5. The maximum and expected compensation upon termination should be stated for each executive director.
6. The fees paid to consultants for advice to the Remuneration Committee and the fees for other services to the Company should be stated for each consultant. This could help to demonstrate the extent to which multi-disciplinary consultancies are providing services which might conflict with remuneration advice. Companies have been required to disclose audit fees for some time and the reasons for this are generally accepted. This principle should be extended to remuneration consultancy where there is also a potential conflict.
7. Disclosure of any agreements by directors to sell shares at a future date at an agreed price.
8. Disclosure of loans to directors that are made on preferential terms and/or at below market rates.

Arguably, both 7. and 8. should be disclosed under the current Listing Rules and all that is required is guidance from the FRC on their interpretation of what they view as appropriate.

### **Options for Non-Executive Directors**

I would also propose one change to the Code in respect of the grant of options to non-executive directors to remove the word “exceptionally” in the third sentence of Para B.1.3. It is common practice for non-executive directors to be awarded share options:-

- i. in US companies quoted on NY Stock Exchange and NASDAC
- ii. in Private Equity backed companies,
- iii. in private companies,
- iv. in pre IPO companies.

This practice is particularly common in start up companies who want to utilise the experience of non-executives, but wish to keep their costs under control. The use of options is one mechanism companies can use to keep their costs down and attract talented NEDs. The current wording of the Combined Code is at odds with what is common practice. The safety net would still be there as shareholder approval would still be needed.

If you would like to meet to discuss the rationale for these recommendations, I would be happy to do so.

Yours sincerely,

Cliff Weight  
Director

## BACKGROUND, SUPPORTING ARGUMENTS AND FURTHER DETAIL

### **1. THE REMUNERATION REPORT SHOULD BE CLEAR, TRANSPARENT AND UNDERSTANDABLE TO SHAREHOLDERS**

The Preamble to the 2003 Code said in para 11.:-

11. The revised Code does not include material in the previous Code on the disclosure of directors' remuneration. This is because "The Directors' Remuneration Report Regulations 2002" are now in force and supersede the earlier Code provisions. These require the directors of a company to prepare a remuneration report. It is important that this report is clear, transparent and understandable to shareholders.

The statement that "It is important that this report is clear, transparent and understandable to shareholders." does not appear in the 2006 Combined Code. We think this objective is important and should be re-instated in the next version of the Combined Code.

### **2. TOTAL REMUNERATION NEEDS TO BE SHOWN**

#### **The problems**

1. The Directors Remuneration Report Regulations have produced very long and confusing reports, e.g. the 16 pages of GlaxoSmithKline. However it is not clear how much the CEO or other executive directors actually received or were awarded. There is lots of explanation, but this seems to only obscure the truth.

Total emoluments make up only one third of total remuneration (see our survey of CEOs of ten largest UK plcs). Pensions, share plans and options make up the other two thirds.

2. The press coverage of "fat cat" pay is ugly, unfriendly, uncompromising, unhelpful and totally negative. There is no competitive advantage in providing more and/or better information to shareholders as this only provides more ammunition to the press which they will use to criticise the company.

Therefore the Government/FRC has a legitimate role to intervene and help the market work more effectively.

3. The 2003 Code (in the preamble) states that Remuneration Reports should be clear, transparent and readily understandable by shareholders. In the current environment companies have been unwilling to do this. Therefore the FRC should force companies to do so.

The actual remuneration received/awarded in the year has to be reported in 4 separate tables (Directors Remuneration Regulations Schedule 7A Part 3 paras 6, 7-9, 10-11 and 12.) Nowhere is there a requirement for these separate elements of remuneration to be totalled. In our view there should be. The FT leader column on 15<sup>th</sup> April 2003 also recommended this and continue to do so from time to time.

## Recommended Total Remuneration disclosure

This would be best done by the disclosure of both the total remuneration awarded in the year and the total actually received in the year.

### Suggested Definitions

Total remuneration **awarded** is the sum of salary, bonus, benefits, the increase in the transfer value of accrued pension and the expected value of share plans and share options and any other long term incentive arrangement.

The Expected Value could follow the SEC definition. There are strong technical arguments for using the Fair Value at the date of award and this would be discounted to reflect the percentage of awards that lapse due to the non or partial achievement of non-market related performance conditions, but not for the probability of leaving and would not be spread over the vesting period. However the benefit of using the same rule in the main global markets is such that it may be better to use the SEC definition.

Total remuneration **received** is the same as that awarded except for all long term incentives and share options, the amount of money made, or lost, in the latest year is included, i.e. the amount in £s of LTIP that vests in the year and for options amount of any gain on options exercised in the year.

### Example:

The figure for gains would be added to the other remuneration received to get the total remuneration received:

	Total Awarded £000	Total Received £000
salary	1,100	1,100
benefits	81	81
Pension: Transfer Value of increase	990	990
<u>sub total fixed</u>	<u>2,171</u>	<u>2,171</u>
bonus	516	516
bonus matching award Expected Value	223	
Options awarded Expected Value	7,800	
LTIPs awarded Expected Value	880	
Gain/(loss) on bonus match shares that vested		100
Gain/(loss) on shares vested		500
Gain on options exercised		5,000
<u>Sub total variable</u>	<u>9,419</u>	<u>6,116</u>
<b>Total Remuneration</b>	<b>11,590</b>	<b>8,287</b>

The simplest way to do this would be to change the total emoluments disclosure so that it also had to show the pension TV and the long term incentives awarded and received and the total remuneration awarded and received, i.e.

Current	Proposed Minimum Requirement
Salary	Salary
Benefits	Benefits
Bonus	Bonus
Total this year	Pension (Transfer Value of increase plus DC contributions)
Total previous year	Long term incentives awarded
	Total Remuneration awarded this year
	Total Remuneration awarded last year
	Long term incentives received
	Total Remuneration received this year
	Total Remuneration received last year

#### 4. DISCLOSURE SHOULD BE FOR THE 5 HIGHEST PAID EXECUTIVES

There are now fewer executive directors. This is partly a by product of Higgs, who wanted reasonably sized Boards and a majority of independent non-executives. However, the Directors Remuneration Report Regulations may have influenced some companies to keep some high paid executives off the main Board.

In the US the 5 highest paid executives have to be disclosed. We recommend the UK adopts this approach.

As Europe is about to enact the current UK approach, the UK Government should legislate to require the disclosure of the 5 highest paid executives and all directors.

#### 5. CEO 5 YEAR DISCLOSURE

The 5 year TSR graph has been a great step forward. But companies seem to have missed the point that it is meant to demonstrate the linkage of pay to performance. Therefore we recommend the following disclosure for the CEO.

	2003	2005	2006	2007	2008
TSR	100	80	70	75	85
TSR of relevant index	100	75	67	75	85
<i>Total Remuneration Awarded £ million</i>	<i>2.5</i>	<i>1.0</i>	<i>5.4</i>	<i>3.2</i>	<i>3.0</i>
“ indexed to 100 in 2003	100	40	216	128	120
<i>Total Remuneration Received £ million</i>	<i>2.1</i>	<i>5.5</i>	<i>10.8</i>	<i>4.6</i>	<i>4.2</i>
“ indexed to 100 in 2003	100	262	514	219	200

Companies could be given the option to put this information in a graph, with the total remuneration £s amounts underneath the graph or as data labels.

Best practice will soon emerge to show the total remuneration awarded and received, for at least the CEO, for the past 5 years, **together with** an explanation of changes in total remuneration and the linkage to performance in terms of TSR and possibly other performance measures.

It is unnecessary to require the disclosure of others than the CEO (and/or the highest paid director) as this will add volume without clarity. If the pay of the CEO is OK, then the pay of the other directors is usually OK too. If there is a problem then the other disclosures will give the necessary information to identify this.

## 5. CONTRACTUAL TERMINATION PAYMENT DISCLOSURE

The case of Michael Green at Carlton is another example of why we feel there is a need for further legislation. It is not at all “clear” or “readily understandable by shareholders” (these are the new Combined Code words - preamble para 11) from reading the 2002 Carlton annual report that such large amounts on termination would be due. It is “transparent” to an expert, but to do so one has to read the 2002 report together with the shareholders circular of 2001.

Shareholders need to know the total remuneration of each director, in order to evaluate if termination arrangements are appropriate.

*We recommend that companies should have to state in the Remuneration Committee Report the potential termination payment payable to each executive director if he were to leave. The amount should be in £.* This data should be in addition to the current explanation required regarding contracts, which should explain the way the termination payment would be calculated. Where payments are contingent or mitigation, then a “target” level should be used. Where payments are linked to share prices the payment should be estimated based on the year end share price.

### *Example disclosure*

Name	salary	contract notice length	maximum termination payment	“target” termination payment
Smith	£500,000	12 months	£1,250,000	£750,000
Jones etc				

For the avoidance of doubt, any payments from long term incentive and bonus plans that are accelerated, or where performance conditions are waived, would be included in the potential termination payment. This approach would ensure there were no surprises - as was the case with Carlton and others.

**6. THE FEES PAID TO CONSULTANTS FOR ADVICE TO THE REMUNERATION COMMITTEE, AND THEIR FEES FOR OTHER SERVICES TO THE COMPANY SHOULD BE STATED FOR EACH CONSULTANT.**

Remuneration Consultants have a potential conflict of interest, particularly if they are:-

- Auditors, such as E&Y, PWC, KPMG or Deloitte & Touche.
- Actuaries such as Mercer, Towers, Watson, Wyatt or Hewitt
- Part of a larger group selling advisory services, e.g. Mercer which is part of Marsh, Aon Consulting which is part of Aon.

Such organisations predicate their business strategy on cross selling other services. Such behaviour is culturally imbedded. Progress up the career ladder requires consultants to act in the best interest of the group by introducing their colleagues, by cross selling other services and by not doing anything that might threaten existing relationships. Even if they have externally announced changes, it will take years to change an imbedded culture - even assuming they really want to change!

The Conference Board in the US in their report on Public Trust concluded that management had got too close to their remuneration consultants. This is also true in the UK. It is a big problem. Companies and directors are still in denial mode. The problem needs some light shedding on it. The FRC can help as described below. This will give investors and the press the necessary information to force directors to recognise the problem exists and must be managed better.

The current disclosure requires a description of other services provided by the consultants who advise the Remuneration Committee. The information that companies provide is of little use, but takes up quite a bit of space.

*We recommend* that companies have to disclose the fees for advice on Remuneration Committee issues and for other services and whether the Remuneration Committee appointed the consultants. The requirement to describe other services can be dropped.

Example disclosure to meet this new requirement would be:

**Fees for advice on executive remuneration**

Consultant	Fees for advice on Remuneration Committee issues	Fees for other services to the Company and Company Pension Funds	Appointed by Remuneration Committee?
Independent Remuneration Solutions	£15,000	Nil	Yes
KPMG	£100,000	£2,500,000	Yes
Towers	£150,000	£1,250,000	Yes
Linklaters	£20,000	£5,000,000	No
Hay	£2,000	£150,000	No

## 7. DISCLOSURE OF ANY AGREEMENTS BY DIRECTORS TO SELL SHARES AT A FUTURE DATE AT AN AGREED PRICE.

Such arrangements are structured to guarantee to lock in a gain from shares, LTIPs or share options if the share price falls below a specific level in the future. This is contrary to the spirit and intention of investors and shareholders who are not currently being informed of such arrangements. Examples of such arrangements are put options, derivatives and structured products sold by investment banks.

A number of companies permit executives to sell their shares back to the company or to exchange them for other shares. If such sales are to be transacted at the mid market price, rather than the bid price then this agreement should be disclosable as directors are receiving a benefit which is not available to all shareholders of that class of share.

## 8. LOANS TO DIRECTORS THAT ARE MADE ON PREFERENTIAL TERMS AND/OR AT BELOW MARKET RATES

For example a bank lent the newly appointed CEO of a FTSE company a £2million of non-recourse loan at LIBOR, for him to buy shares in his new company, with the shares as the only security. The only economic justification for the bank was that they expected future business from the CEO/company. The economic result was that the CEO was able to buy £2 million of shares and the company announced his commitment to the company and “alignment with shareholders”. However the truth was that if the share price went down, he could not lose as he would settle the debt with the shares and the bank would take the loss.

We recommend that such loans be disclosed.

## 9. AWARDS OF OPTIONS TO NON-EXECUTIVE DIRECTORS

It is common practice for non-executive directors to be awarded share options:-

- i. in US companies quoted on NY Stock Exchange and NASDAC
- ii. in Private Equity backed companies,
- iii. in private companies,
- iv. in pre IPO companies.

This practice is particularly common in start up companies who want to utilise the experience of non-executives, but wish to keep their costs under control. The use of options is one mechanism they can use to keep their costs down and attract talented NEDs.

The Combined Code para B.1.3 has particularly strong wording in regard to the award of options to Non-Executive Directors. We think it should be amended to omit the word **exceptionally** in the third sentence, i.e.

B.1.3 Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non executive directors should not include share options. If, **[delete exceptionally]**, options are granted, shareholder approval should be sought in advance and

any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision A.3.1).