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Company Secretary's Review

Executive Remuneration

Simon W. Holden considers the recommendations published by the High Pay Commission recently.

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Introduction

As the prospect of a double dip recession looms over the world economy it is clear that countries, including Britain, are heading into times of unparalleled austerity measures. It is against this backdrop that we have witnessed protests on a global scale. A constant theme to have stemmed from the protests is the anger felt at a tiny section of society – a tiny section that has been completely insulated from the belt-tightening impacting on the lives of the significant majority.

In the United States, the tiny minority is referred to as the "1 percent"; a reference to the growing wealth gap between America's wealthy elite and its overall citizenry, where the top 1% of Americans control a disproportionately large amount of the country's wealth (the figures suggest just over 40%). In Britain, the number is smaller yet at 0.1%. It is this top 0.1% of earners, with company directors in particular, who continue to enjoy a huge annual uplift in rewards.

The High Pay Commission's Report

On 22 November 2011, the High Pay Commission (the "HPC"), an independent inquiry set up by Compass and funded by the Joseph Rowntree Charitable Trust, published its final report on high pay and boardroom pay across the public and private sectors in the UK (the "Report"). The HPC has spent the past year exploring the growing division between those at the very top and everyone else. The research leading to the Report concluded that excessive top pay is deeply damaging to Britain as a whole, and action is urgently required to address it.

The Report's foreword highlights that the public is rapidly running out of patience with a system that allows those at the top to enrich themselves whilst everyone else struggles to make ends meet. The Report contains a startling comparison between those at the top and everyone else; since 1980, some top bosses have enjoyed an increase in pay awards of over 4000%, whilst by comparison the average wage for a middle-class career, such as a teacher or policeman, over the same period has increased from approximately £6,500 to £26,000 (300%).

The HPC has sought to understand the social trends giving rise to the disparity and explore why they matter. Based on three key principles of transparency, fairness and accountability, the Report makes recommendations to change the way companies behave and are regulated in respect of executive pay.

Lack of transparency

The Report found evidence that excessive high pay damages companies, is bad for the economy and has negative impacts on society as a whole. At its worst, as exemplified numerous times when it has made for the morning news, excessive high pay bears little relation to company success and can be seen to be rewarding failure.

The gross distortion that is now evident creates an impression that business leaders are in it for themselves, which the Report points out is damaging trust in British companies at a time when the majority of workers are seeing little or no increase in their pay.

The Report found that decisions leading to escalating high pay for senior executives are often concealed from shareholders and the public within complex remuneration arrangements, buried in the small print of companies' annual reports. This lack of transparency adds further to the impression that senior company executives are rigging the system for their own ends.

Previously unpublished figures show that pay at the top has spiralled to alarmingly stratospheric levels in some of Britain's biggest companies. In BP, in 2011 the lead executive earned 63 times more that the average employee. In 1979, the multiple was 16.5. In Barclays, top pay is now 75 times that of the average worker. In 1979, it was 14.5. Over this period, the lead executive's pay at Barclays has risen by approximately 4,900% to a staggering £4.4m.

The Report makes 12 recommendations to address what the HPC sees as a crisis at the top of British business, believing the time has come to act to build transparency, accountability and fairness into remuneration for senior executives in the UK.

The recommendations

◆ **Pay basic salaries to company executives** – Simplify executive pay by paying a basic salary, with remuneration committees awarding an additional performance related element only if "absolutely necessary" in the long-term interests of the company. Such performance element should be a simple award of shares at the discretion of the remuneration committee held for at least five years. Inevitably, there are likely to be different interpretations of what is "absolutely necessary" if this proposal is implemented as suggested.

◆ **Publish the top ten executive pay packages outside the boardroom** – Companies to publish the pay packages of the top ten employees outside the boardroom on an anonymous basis. A level of remuneration disclosure below board level now exists for financial services companies, but this would be a first extension to other sectors.

◆ **Standardise remuneration reports** – Standardise remuneration reports in a format to be designed by the Financial Reporting Council, to include a figure for the total remuneration received by each executive and a methodology for how it has been calculated. This is to counter the increasing complexity of reports, leading to unclear disclosure and lack of understanding of details of remuneration packages.

◆ **Require fund managers and investors to disclose how they vote on remuneration** – All fund managers and investors to fully disclose how they vote on all issues of corporate governance, including executive remuneration. While this is not strictly to do with high pay as such, the HPC's intention is to reinforce transparency in the oversight of the executive by shareholders through voting. It is likely that it is aimed at making fund managers more accountable to their stakeholders.

◆ **Include employee representation on remuneration committees** – Employees to be represented on remuneration committees. The HPC proposes this should be voluntary, with the threat of legislation or fines if not implemented within a three-year period. The HPC believes that greater engagement with employees may help restrain executive pay and mitigate negative impacts on morale as well as encourage a greater engagement with the workforce.

◆ **All publicly listed companies should publish a distribution statement** – Due to the HPC's finding that many shareholders have a low level of engagement on issues of executive pay, it recommends that all publicly listed companies publish an annual statement of the distribution of income over a period of three years, showing percentage changes in total staff costs, company reinvestment, shareholder dividends, executive team total package and tax paid.

◆ **Shareholders should cast forward-looking advisory notes on remuneration reports** – Shareholders to vote on the remuneration arrangements for three years following the date of the vote; i.e. on the total potential remuneration and the potential pay outs of a performance element, if one is included, based on a range of outcomes. This would include future salary increases, bonuses and all benefits, including pensions. The HPC recommends that the vote should remain non-binding for the time being. Any such requirement would need to allow sufficient flexibility for any change in circumstances which may require changes in remuneration policy and packages.

◆ **Improve investment in the talent pipeline** – Companies to implement a defined and structured talent pipeline to ensure suitable and qualified successors are promoted from within the company where possible.

◆ **Advertise non-executive positions publicly** – The recruitment of non-executives to be openly advertised, making remuneration committees open to a wider group and thereby encouraging diversity and ending the closed shop culture of appointments.

◆ **Reduce conflicts of interest of remuneration consultants** – Companies to publish the extent and nature of all services provided by remuneration consultants, acknowledging this is only the first step if cross-selling is seen to continue.

◆ **All publicly listed companies should produce fair pay reports** – All publicly listed companies to produce a fair pay report as part of their remuneration report, which would build trust in pay policies.

◆ **Establish a permanent body to monitor high pay** – A permanent body be established on a social partnership basis, much like the Low Pay Commission, to monitor pay trends, police pay codes in UK companies and report annually to the Government and the public on high pay. The HPC also hopes that establishing such a body would ensure company legislation is effective in ensuring transparency, accountability and fairness in pay at the top of British companies.

What next?

The HPC has no formal governmental status and the report carries no official weight. Nevertheless, in the current climate, its recommendations have received considerable media attention. A number of these recommendations are similar to proposals included in the consultations on executive remuneration undertaken by the Department for Business Innovation & Skills ("BIS"), which closed on 25 November 2011. No doubt BIS will consider the Report in conjunction with the responses received to its consultations.

It seems likely that there will be some regulatory changes resulting from the BIS consultation; possibly more disclosure, employee representation on boards, etc. Therefore, most companies will need to consider any such changes by reference to their 2013 reporting period.

Conclusion

Pay does indeed matter. The Report concludes by confirming that who gets what and how they are paid affects how people behave. In a business, it affects motivation and engagement. In the economy, it affects social mobility, entrepreneurialism and potentially impacts on growth. The status quo is no longer acceptable or sustainable; action is required.

Given the starting comparisons, figures and background research, it is easy to agree with the Reports' findings; the issue goes deeper than high pay. The debate is not just about who gets what, but how businesses should behave and what our economy should look like. A business model where profits accrue in the hands of the few is deeply flawed and unsustainable, says the Report – investors wouldn't invest in early stage forms of such a business model, and therefore should not condone long-standing forms of such business models. Sometimes, change is indeed good.

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