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BIG INNOVATION CENTRE

The Purposeful Company

Executive Remuneration Report

Contents

The Purposeful Company

The Big Innovation Centre convened The Purposeful Company Task Force in 2015. The Task Force is a consortium of leading FTSE companies, investment houses, business schools and business consultancy firmsand policy makers. It has been examining how the governance and capital markets environment in the UK could be enhanced to support the development of value generating companies, acting with purpose to the long-term benefit of all stakeholders.

The Steering Group, co-chaired by Clare Chapman and Will Hutton, oversees the work of The Purposeful Company Task Force. The views expressed in this paper are those of the authors, having taken input from the Task Force members and Contributors. While all Task Force and Steering Group members subscribe to the Introduction and the Statement of Overarching Aims set out in Sections 1 and 2 of the Policy Report, membership of the Task Force cannot be taken to represent an endorsement of every specific policy recommendation. Authors are acting in their personal capacity and the views expressed here may not be taken to represent the views of their organisation.

A wide-ranging set of policy recommendations have been set out in The Purposeful Company Policy Report published on 27 February 2017, where more information on Task Force members may be found. This paper supplements the Executive Remuneration subsection in the Policy Report, and provides further discussion and data on the issues summarised there.

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Introduction

Executive pay has become a signature issue for the lack of trust in business in the UK. Critics of the status quo voice three primary concerns:

- That executive pay is not linked to performance and encourages short-term behaviour that is to the detriment of the long-term growth of the British economy;

- That executive pay has become disconnected from the pay of ordinary working people to an extent that is damaging social cohesion; and

- That shareholders do not have adequate control over executive pay practices, enabling companies to continue with practices against shareholder wishes.

Great companies need to attract great leaders, motivated to act with purpose. The commentary on executive pay is so relentlessly negative it is easy to forget this important fact. Good CEOs remain good value. Some of the commonly held views about executive pay are not borne out by the evidence. However, in this Policy Report we find that reform is required to ensure that incentives are aligned to long-term contribution, and that pay is better seen as deserved by all stakeholders.

First, pay structures need to be reformed to support purpose. CEOs should act purposefully because of and not in spite of their incentives. Executive pay needs to have less emphasis on performance-based incentive plans and more on high and long term shareholding. Bonus targets need to be focused on dimensions of purpose not short-term financial returns.

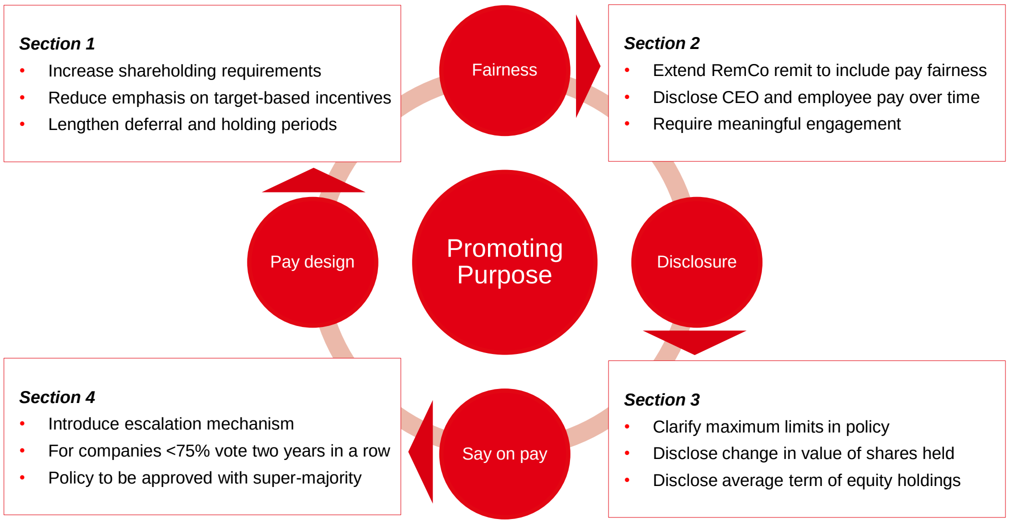
Second, companies need to take a much more active stance on pay fairness. The increase in pay ratios over the last thirty years is more capable of rational explanation than often assumed. However, public trust in pay fairness has been seriously eroded and must be rebuilt. Also, aspects of the CEO pay market and associated regulation make it inherently prone to inflation. There should be clear board accountability for ensuring pay fairness is considered and communicated, supported by appropriate transparency and employee engagement.

Third, despite significant advances over the last 15 years, executive pay disclosures still need improvement to ensure investors have the clear information they need to judge maximum pay opportunity and the link between pay and performance.

Fourth, the consequences may need to be strengthened for companies that lose remuneration votes or persistently achieve significant opposition. This will enable shareholders to take robust action against outliers, who can significantly influence the overall executive pay market.

This Executive Remuneration Policy Report sets out detailed evidence and policy recommendations in relation to each of these four areas.

Figure 1: Summary of Recommendations



Our approach is to base recommendations on the highest quality academic evidence and practitioner experience. The importance of evidential rigour in the executive pay area cannot be overstated. Executive pay is, unfortunately, complicated. The data is inherently volatile, and apparently clear relationships can, on closer scrutiny, simply be a result of underlying factors such as company size and sector as opposed to saying anything inherent about pay design or levels.

As a result there are many studies on executive pay that can be highly misleading, based on insufficiently rigorous analysis of complex datasets. By contrast, academic studies that have been published in top quality journals have a number of safeguards. First, journals will demand that such studies use robust techniques of analysis and control that have been developed over decades. Second, papers will go through several rounds of stringent and challenging review and iteration before publication, a process that can take several years. Studies that have been through this process should therefore be accorded greater weight.

Practitioner insight can, of course, be extremely valuable in interpreting data. Rigorous analysis will always face limitations in the conclusions it can draw. But particular weight should be accorded to practitioner insight when it can also be shown to be consistent with robust academic analysis.

The best results arise when academic and practitioner insights are brought together in a complementary way. This is the approach that we have taken with The Purposeful Company Task Force, bringing together the best of theory and practice to develop policy recommendations that a strongly grounded in evidence, yet practical, implementable, and with the highest likelihood of bringing about desired change.

In the process we have developed what we believe to be the most comprehensive review yet of evidence as it relates to executive pay policy in the UK.

Executive Summary

Recommendation 1: Reform Pay Design

Shareholder guidelines and the UK Corporate Governance Code* should enable and encourage companies to adopt simpler pay structures for CEOs based on long-term equity and debt holdings to encourage long-term behaviour and to avoid the unintended consequences of excessive focus on performance-based incentives†.

- Packages should be structured so that exposure to the long-term value of the company out-weighs the potential gains from performance-based incentives vesting in any year. This means CEOs should rapidly (e.g. within two years of appointment) build up shareholdings of at least 2x the value of a year's performance-based incentives, with a target to increase this to 2x total compensation over time.
- This should be achieved through appropriate combination of: reducing performance-based incentive plans in favour of long-term awards of equity; paying bonuses in shares; and making joining awards of equity to CEOs, vesting over long periods.
- Pay should be long-term, with shares released on a phased basis over periods of up to at least 5 to 7 years depending on industry with at least half of the shareholding requirement applying for at least two, and preferably three, years after leaving the company. Release of equity for sale should be phased and block-release should not be triggered on any defined event (e.g. retirement).
- Performance-based incentives should balance unleveraged financial measures of growth and return and should include non-financial and strategic measures based on fulfilment of the company's purpose, to ensure that targets are aligned with how companies will deliver value over the long-term in line with that purpose.
- Bonuses based on financial targets should be paid in shares, with board discretion to vary the bonus up or down based on holistic judgement.
- Particularly in highly leveraged or volatile companies, boards should consider paying CEOs in unsecured debt (e.g. via deferred compensation plans) as well as equity.

* A suggested redraft of the UK Corporate Governance Code to reflect Recommendation 1 is provided in the Appendix.

† We use the term "performance-based incentive" to refer to a cash or equity award with performance targets attached (typically over short-term periods of one to three years). This contrasts with simple equity awards, which while they are linked to performance by virtue of the share price, do not have performance targets attached and are not, for our purposes, included in the use of the term 'performance-based incentive'.

Summary rationale for Recommendation 1

- Evidence shows that incentive plans based on performance targets over short periods of 1 to 3 years can cause short term behaviour to the detriment of purpose and long-term value.

- Evidence also shows that high levels of shareholding and greater long-term orientation of incentive pay have a positive impact on long term value, innovation, and long-term orientation of companies, consistent with greater purpose.

- Accordingly, packages should ensure that the primary incentive is to deliver long-term value through the share price, outweighing any incentives driven by target-based plans over the short to medium term.

- De-emphasising annual bonuses and target-based long-term incentives, making long-term stock awards, and requiring large shareholdings helps align executives with truly long-term decision making and purposeful behaviour.

- Simpler packages, with less reliance on performance conditions, would also avoid the extreme difficulties that Remuneration Committees face in setting robust targets. These changes would also help with stakeholder acceptance of pay-outs.

- Share awards increase transparency as they can be easily valued at the grant date, whereas incentives based on potentially multiple performance criteria cannot be. This makes it clear to stakeholders how much the CEO is being paid. In addition, it is clear under what conditions the CEO will be paid well – if the long-term stock price is high. This reduces the problem of a CEO being well-paid despite underperforming on performance measures given little weight in the bonus.

Recommendation 2: Strengthen board accountability for pay fairness

The UK Corporate Governance Code should be amended to broaden the role of the Remuneration Committee to oversee that business purpose is being translated into behaviour and decisions around reward, including in relation to pay fairness. The Remuneration Report should include a Fair Pay Report explaining the company's approach to pay fairness, and including specified metrics including relative movements in CEO and employee pay over time. The company should establish a meaningful process for engaging with employees on the Fair Pay Report.

The Fair Pay Report should replace existing remuneration report disclosures relating to the wider workforce and should cover, supported by data where appropriate:

- The company's philosophy and principles on pay fairness across the population (including how fairness is defined, see Figure 8 on page 38), the approach taken to internal and external comparisons, covering the structure and level of pay, and the approach taken to linking pay with performance, including the principal characteristics of incentive plans used.

- Explanation of how the policy on pay for the wider UK workforce differs from that for the CEO and other executives in terms of the elements of pay offered, the quantum of opportunity under those pay elements, and the target positioning of pay against the market together with justification for such differences.

- Explanation of the extent to which it is the company's policy and practice to pay living wages in the territories in which it operates and how these are established, statutory disclosures on gender pay, and broader approach to equal pay issues.

- Explanation of the approach by which the company engages with employees on the Fair Pay Report and a summary of any themes emerging from the feedback on the prior-year's report.

- Tabular disclosure over the last five years (building to ten over time) of the maximum annual pay opportunity for the CEO; the actual amount paid (on a statutory single figure basis) and average pay for all other employees, or an appropriate subset representative of at least the general UK workforce.

- Graphical representation of the above tabular disclosures formed by rebasing each pay element to 100 at the start of the period, and a narrative explanation of the comparative trend over time (see Figure 9 on page 39).

Summary rationale for Recommendation 2

- The evidence suggests that levels of executive pay and the growth in pay differentials across large companies are more rationally explicable than commonly thought, although the executive pay market has features that make it prone to inflation.

- Nonetheless, there is significant public disquiet about inequality and listed company CEO pay is a visible symbol of that inequality in the minds of many. There is an urgent need to rebuild trust in the rigour of the process by which pay is set.

- A purposeful company should have a strong understanding of how its stance on pay relates to the broader societal debate about fairness, as this will build trust and also employee engagement, and is consistent with operating with purpose.

- A mandated disclosure and employee engagement requirement will elevate the priority of this discussion within boards, “nudging” behaviour towards greater restraint and fairness.

- The disclosure should meet public demands for transparency, and explanation, of the disparity between CEO pay and worker pay, but this should focus on relative trends in actual pay and pay opportunity over time rather than on a snapshot ratio.

- Pay ratios do not lend themselves to valid comparisons between companies, even within the same industry, and would likely add to misunderstanding over executive pay as well as potentially creating perverse incentives.

- The evidence that lower ratios are always better is not borne out by the evidence which in fact tends to show a positive relationship between pay differentials and performance in the UK and US.

- Any statistic about pay relativity must be set in the broader context of a company’s approach to fairness, which may be defined by external as well as internal relativities, as well as by contribution, and so the Fair Pay Report should be broader than statistics.

Recommendation 3: Enhance executive pay disclosure

The Directors' Remuneration Reporting regulations should be updated to enable greater stakeholder understanding of a company's maximum pay and relationship between pay and performance.

- The single figure table should disclose how much of the single figure arises from growth in share price on share incentives between the date of grant and measurement of performance and should show a separate total single figure excluding this amount.

- The single figure table should include the wealth impact on CEOs of the pre-tax change in value over the year of previously granted equity over the year. This item should also be shown in the ten year history together with the absolute total shareholder return achieved by the company over each year.

- Disclosure of share interests should include weighted mean period to release for each of shares beneficially held, subject to service, and subject to performance.

- Within the remuneration policy a clear monetary maximum should be stated and justified for each element of remuneration other than those linked to the value of shares, in which case the limit should be based on the initial value of shares awarded.

Summary rationale for Recommendation 3

- Current disclosures comparing pay and performance are extremely misleading and lead to widespread misunderstanding of whether executive pay is actually linked to performance, as they focus only on a single year's pay-outs and not the incentive effect of holdings of previously granted equity.

- Changes in value of equity holdings are a major contributor to executive incentives and should be shown, compared against the aggregate value created over the period, to enable a much better and more complete analysis of executive pay.

- Potential upside due to increase in share price flowing through into share awards should not be capped – however, this should be separately disclosed to enable stakeholders to assess where the single figure pay outcomes sits against the maximum disclosed in the policy, and to see the contribution to the single figure from share price growth.

- Boards should have to explain why they have chosen the level of maximum pay for the CEO, and that maximum should be clearly defined – in particular the practice of allowing certain elements, such as final salary pensions, to be in effect uncapped should end, with a clear monetary limit on these.

- Disclosure of term of share awards reflects importance of lengthening holding periods.

Recommendation 4: Toughen shareholder voting powers

A binding vote regime should be triggered when companies lose, or repeatedly fail to achieve a threshold level of support on, the advisory remuneration vote.

This could be implemented through legislation or through changes to the UK Corporate Governance Code. If a company loses the advisory remuneration vote in any year or receives 25% or more vote against the advisory vote two years in a row then:

- The company should bring forward their remuneration policy for approval at the next AGM of the company as a Special Resolution requiring a 75% majority to pass.

- If implementation is via regulation rather than the Code, then at the same AGM a motion would be brought forward enabling shareholders to dis-apply, by simple majority, the requirement to pass the remuneration policy by a super-majority.

Where issuing recommendations based on benchmark policies, proxy voting agencies should:

- Give clear guidance during engagement with companies if proposals are likely to attract a negative voting recommendation and take into account the views, if made public, of major shareholders in a company when making voting recommendations on proposals where strategic fit is a strong element of the rationale.

Summary rationale for Recommendation 4:

- Evidence shows that the current UK voting regime, combining triennial binding policy vote and annual advisory vote on implementation of policy, is effective overall, but a small proportion of companies (c. 2%-3%) either lose the advisory vote or repeatedly secure only lower than normal levels of majority support on the advisory vote.

- There is a case for allowing practice to develop, given recently announced intentions from investors to vote against the Chair of Remuneration Committee in the case of persistently low levels of shareholder support. However, we do accept the imperative to give the public confidence that shareholders have all necessary powers.

- Introducing a binding vote for all companies every year is a disproportionate response to the problem, and would likely have many unintended consequences.

- Therefore, it would be better to design an escalation approach such that only those companies showing an inability to sustain high levels of shareholder support would trigger a binding regime. This would enable shareholders to have impact on outliers, who can have a disproportionate impact on market pay levels.

- The requirement to bring back the policy to a vote with a super-majority imposes a higher bar for approval for companies that have not maintained high shareholder support in the past. This provides a disincentive against companies either having their report voted down or consistently getting opposition above 25%, and a sanction if they do.

- Having the vote on policy rather than outcome enables shareholders to bring pressure to bear in relation to any problematic area of policy.

- The parallel motion enabling disapplication of the super-majority ensures that, in the rare cases where a disruptive minority group of shareholders exists, they cannot hold a company to ransom on a binding basis against the wishes of the majority. This is only necessary if the policy is implemented via regulation rather than via the Code.

- The existence of a 25% threshold condition will give greater influence to proxy voting agencies. It is therefore important that they engage fully with companies, provide clear guidance, and take into account the views of the company's major shareholders, to avoid unintended consequences of the escalation mechanism.

1. Reform Pay Design

The Case for Change

Our analysis and recommendations in this Report primarily focus on CEO and Executive Director pay. The CEO holds a distinctive position as the most senior executive. This gives them a particular accountability for balancing the performance and long-term health of the business. CEOs also do not suffer from the information asymmetry faced by boards, and so may be in a better position to govern performance-based incentives for their executive teams. While companies may well wish to have a degree of alignment in pay design across those executive teams, the recommendations here particularly have the CEO in mind.

The main accusation made against CEO pay is that it is not linked to performance and is therefore unjustified. This apparently simple claim can in fact take three different forms, which are frequently confused or conflated, but which it is important to assess separately.

- The first is that growth in executive pay levels over the last couple of decades is not justified given that the performance of companies *in general* has not improved over that period, whether measured by market capitalisation or returns[1]. The Government's Green Paper on Corporate Governance Reform presents this argument with reference to a chart showing a quadrupling of CEO pay since 1998 plotted against a broadly flat FTSE-100 Index.

- The second is that pay is not linked to performance in that bonuses can still pay out even if performance is poor, and there is no obvious correlation between the highest pay figures and the best performing companies[2]. This is apparently supported by the fact that bonuses consistently pay-out at 75% of the maximum on average.

- The third is that pay is linked to the wrong sort of performance – i.e. to short term performance measures that encourage executives to act in a short term manner, thereby harming the long-term performance of companies and the UK economy[3].

In many ways the third of these accusations is the most serious. If true, it implies that executive pay practices may be harming economic growth and could be contributing to the current plateau in productivity growth. Therefore, this is where we start in this Section. We return in Section 2 to the question of the growth in CEO pay levels in recent decades, and in Section 3 to the link between pay outcomes and company performance.

In summary, we find strong evidence that pay structures can encourage short-term behaviour. This is a serious issue that demands reform of executive pay.

Problems with current CEO incentives

Current incentive plan designs, in particular performance-based vesting over relatively short timeframes of 1 to 3 years, act to undermine long-term and purposeful leadership of companies. There are several strands of evidence for this, a number of which were discussed in detail in The Purposeful Company Interim Report[4]. In summary:

- Executive behaviour (for example in relation to cutting R&D expenditure, cutting capital expenditure, managing positive news releases, and other short-term controllable executive action) can be distorted by upcoming incentive vesting events and by equity vesting patterns, with the effect being most extreme when performance conditions are close to being triggered[5-9]. This suggests that so-called "long term" incentives with performance-based vesting actually encourage short-term behaviour as vesting dates and triggers approach.

- Executives discount complex performance-based long-term incentive plans to an excessive degree, thereby reducing their effectiveness[10,11].

- Short-term or poorly designed financial incentives can crowd out creativity and intrinsic motivation and thereby act to inhibit purposeful behaviour, can be ineffective in incentivising performance in relation to complex multidimensional jobs, and can lead to excessive risk-taking and even unethical behaviour[12-17].

- Research and experience shows that CEOs can have significant influence over target setting and partly as a result of information asymmetry, Remuneration Committees struggle to set consistently challenging targets as shown by the fact that incentive pay-outs are consistently biased towards "above-target" levels[18,19].

This evidence suggests that some elements of the "performance pay model" promoted over the last 20 years by investor and governance guidelines are faulty. This model, which is based on bonuses and "long-term" incentive plans with performance targets over relatively short periods of 1 to 3 years, gives rise to a range of unintended consequences including:

- Increased complexity and lack of transparency

- Incentives for short-term behaviour

- Enormous target calibration challenges for Remuneration Committees

- Pay outcomes which are not clearly understood by stakeholders on many occasions

In summary, the ability for executives to earn sums in a few years that are life changing for them and their descendants, largely based on performance metrics that Remuneration Committees find very difficult to select or calibrate[19], has obvious weaknesses.

However, evidence also suggests that a high level of equity ownership, and longer term pay orientation, do lead to improved company returns, innovation, and CSR over the long-term[20,21]. At the same time higher levels of debt-like pay (deferred compensation and unfunded pension plans for example) are associated with lower corporate bond yields, lower bankruptcy risk, lower stock return volatility, lower financial leverage, and higher asset liquidity[22-26].

So the idea that incentives do not influence CEO behaviour is not borne out by the evidence. They do, just not always in the manner intended. Indeed, with CEOs now subject to such high powered incentives, it is particularly important to ensure that packages are structured to support purposeful, long-term behaviour. It is precisely because incentives do work that they should be reformed. This is the focus of Recommendation 1.

Policy Recommendation

A model based on long-term equity and debt

The cumulative evidence suggests that the over-use of performance-based vesting (where bonus and share awards are triggered according to performance against pre-defined targets over 1 to 3 years) gives rise to many of the problems with the current pay model. At the heart of our proposal is to reduce the emphasis on this feature of incentives, with all the unintended consequences that arise. Instead packages should rebalance towards awards of long-term equity and debt[11, 21, 27-29], released over at least five years and in many cases longer periods, such as seven years. Awards should vest and be available for sale on a progressive basis to avoid major cliff-vesting events that could skew behaviour[9, 17, 29, 30]. This will result in higher equity holdings persisting significantly beyond an executive's tenure.

The recommendation to de-emphasise performance conditions will be controversial, given the emphasis that this feature of pay design has had in shareholder guidelines and governance codes. We do accept that there are circumstances where performance conditions can work. Performance-based incentives that form a smaller portion of the package, may continue to offer a useful signalling and incentive purpose, and would place less strain on the target setting process that is a source of such difficulty for Remuneration Committees. Smaller incentives could be more truly variable, so restoring public confidence.

Moreover, particularly in distressed businesses, transformation or turnaround situations[20] or where there is a strong controlling owner or blockholder able to oversee target setting[31] then greater emphasis on performance-based vesting may be appropriate. In these situations there is clarity of objective, of measurement, and of oversight. However, in many circumstances the necessary conditions do not exist for large-scale performance-based vesting to operate effectively and without unintended consequences.

So we are not proposing a "one-size-fits-all" model, but rather a change in centre of gravity of market practice. While recognising the importance of pay structures and incentive plans that are tailored to a company's strategy, market practice should shift *in general* towards less emphasis on performance-based vesting, and more emphasis on high levels of long-term shareholding to create the right incentives for long-term purposeful behaviour.

Recommendation 1

Shareholder guidelines and the UK Corporate Governance Code should enable and encourage companies to adopt simpler pay structures for CEOs based on long-term equity and debt holdings to encourage long-term behaviour and to avoid the unintended consequences of excessive focus on performance-based incentives[‡].

- Packages should be structured so that exposure to the long-term value of the company out-weighs the potential gains from performance-based incentives vesting in any year. This means CEOs should rapidly (e.g. within two years of appointment) build up shareholdings of at least 2x the value of a year's performance-based incentives, with a target to increase this to 2x total compensation over time.

- This should be achieved through appropriate combination of: reducing performance-based incentive plans in favour of long-term awards of equity; paying bonuses in shares; and making joining awards of equity to CEOs, vesting over long periods.

- Pay should be long-term, with shares released on a phased basis over periods of up to at least 5 to 7 years depending on industry with at least half of the shareholding requirement applying for at least two, and preferably three, years after leaving the company. Release of equity for sale should be phased and block-release should not be triggered on any defined event (e.g. retirement).

- Performance-based incentives should balance unleveraged financial measures of growth and return and should include non-financial and strategic measures based on fulfilment of the company's purpose, to ensure that targets are aligned with how companies will deliver value over the long-term in line with that purpose.

- Bonuses based on financial targets should be paid in shares, with board discretion to vary the bonus up or down based on holistic judgement.

- Particularly in highly leveraged or volatile companies, boards should consider paying CEOs in unsecured debt (e.g. via deferred compensation plans) as well as equity.

[‡] We use the term "performance-based incentive" to refer to a cash or equity award with performance targets attached (typically over short-term periods of one to three years). This contrasts with simple equity awards, which while they are linked to performance by virtue of the share price, do not have performance targets attached and are not, for our purposes, included in the use of the term "performance-based incentive".

Detailed Policy Discussion and Rationale

Equity released over 5 to 7 years

The timeframe of equity awards should be higher than currently. Research shows that the market may take five years fully to incorporate information about intangible investments into the stock price[32, 33]. This suggests at least a comparable timeframe for the release profile of equity awards. Indeed a range of investor guidelines, financial services regulations, practitioner experience, and academic research[27-29,34-39], suggests timeframes extending out to between 5 and 7 years for the vesting and holding of equity awards. Sale restrictions should lift on a phased basis rather than linked to any fixed date or event (such as retirement) to avoid perverse consequences, and also to mitigate against short-term behaviour that may arise, particularly towards the end of the executive's tenure[17, 30, 40]. The precise timeframe of release would depend on particular business circumstances[34] and we might expect to see sector differences between shorter and longer-term industries (for example recruitment consultants versus mining companies). However, the presumption is of longer timeframes than the current norm of 3 to 5 years. As required by the current UK Corporate Governance Code, malus and clawback would apply as appropriate.

Proposals for long-term vesting of equity awards often come up against two arguments. The first argument is that the time period for the awards exceeds the average tenure of a CEO (for the world's largest 2,500 companies a recent study[41] found this to be 4.2 years or 5.6 years depending on whether they took office after a forced or planned succession). However, timeframes of tenure should not be confused with timeframes of accountability for actions taken while CEO. At the most senior levels, and certainly for CEOs, it is reasonable for vesting and holding periods to apply on a phased basis for a number of years after they leave the company. This creates appropriate incentives for CEOs to ensure that their actions are sustainable over the long term. An important aspect of sustainability is succession planning. Requiring CEOs to hold stock for a period after they leave the company should provide a powerful incentive to focus on a critical, but often underemphasised, component of their role.

The second argument is that executives will heavily discount awards that are deferred for a long period of time[10, 11, 29]. It is important to note that our main objective is to ensure greater long-term exposure to the share price. This can be achieved both through awards that are deferred, and so subject to malus and forfeiture on resignation, and through awards that must be held, and so are fully vested but subject to changes in the share price. Experience suggests that once awards cease to be forfeitable, the level of discount applied by executives reduces substantially

Overall, in light of the behavioural risks associated with the potential for rapid build-up of wealth given current market levels of pay for CEOs, it is surely more important to get the structure of pay right to create the right incentives, even if that results in pay that is higher than it might otherwise have been. It has been noted that executives should accept a reduced level of award for replacing long-term incentive plans by restricted stock[10, 11, 28, 29, 35]. In some cases a discount of up to 50% has been argued for by investor groups[35, 38, 42]. However, executives will legitimately discount awards where deferral periods are longer[29]. It would be better to accept lower discounts (say, of one quarter or one third) in order to achieve longer deferral or holding periods, given the reduced saving in executive pay is dwarfed by the increased value arising from more purposeful behaviour, which can add 2%-3% a year to shareholder returns[32, 33].

Increased stock ownership requirements

A rigorous study has down that firms with high CEO stock ownership outperform those with low stock ownership by a very significant margin of 4-10% a year[21]. This research shows that the relationship is very likely causal – that is, stock ownership drives the CEO to perform better, rather than CEOs knowing that their firm will perform better and therefore buying more stock. In principle excessive stock ownership may also lead to CEO entrenchment and risk-averse behaviour[43]. More research is needed to establish exactly where the trade-off resides. However, given that UK levels of CEO stock ownership are generally significantly less than the US levels, where research shows that the higher levels of shareholding are beneficial, it is reasonable to assume UK practice is not yet at counterproductive levels.

Amongst FTSE-100 CEOs the median level of after-tax equity exposure from all vested and unvested equity (including long-term incentive plans, discounted by 50% for the impact of performance conditions) is approximately £6.5m or 850% of salary[44]. Of this around £4.5m or 550% of salary is stock that is already vested, and beneficially owned by the executive. At the upper quartile, total equity exposure is around £20m or 2200% of salary. This suggests that current typical stock ownership guidelines for FTSE-100 CEOs of around 250% to 300% of salary are purely notional, and should be increased.

We develop our approach to appropriate levels of shareholding based on two principles:

1. CEOs should rapidly (ideally within two years) build a shareholding so that the incentive provided by their shareholding dominates the incentive provided by a single year’s opportunity under performance-based plans.

2. Over time, the shareholding should build so that lower quartile performance creates a penalty for the CEO through their shareholding equivalent to a year’s compensation.

Coupled with lengthened release periods, these levels of exposure would create strong long-term alignment with sustainable performance.

The justification for the first principle is that an executive should be more concerned about whether the share price will be, say 25%, higher or lower in several years’ time than by whether they hit short-term vesting triggers. Why 25%? Analysis across multiple sectors suggests that out-performance of 5% to 7% pa represents approximately one quartile of performance over 3 to 5 years. So for example the difference between median and upper quartile or between lower quartile and median within a sector over 3 to 5 years will typically be around 25% in share price terms. The aim is that this level of difference in medium term share price performance should offset an entire year's performance-based incentives.

Incentives are paid pre-tax and shareholding requirements are defined based on shares held after tax. This means that for a 25% share price movement to have more significant impact than a given incentive opportunity, the CEO would need to hold shares worth approximately 2x that incentive opportunity (a 25% change in share price would then change the value of shares held by 0.5x the incentive opportunity, which given that the shares are held after tax is approximately 1x the pre-tax opportunity, given UK total tax rate of close to 50%).

Therefore, a shareholding of 2x the incentive opportunity that can vest in any given year ensures that the difference of one quartile of performance over the medium term is equivalent to a year's incentives. Any executive who pursues short term actions to trigger a single year's incentive plan performance conditions at the expense of medium-term share price, will, over time, have the benefit of that year's incentives offset by the negative share price impact on their share portfolio. This creates a natural counterweight to the short-termism that performance-based incentives plans can create.

In a typical FTSE-100 company, a CEO might might have incentives of up to 500% of salary vesting in any given year based on performance targets. Therefore, the CEO's holding would need to be 10x salary in order for the shareholding to dominate the incentive opportunity on the basis defined. Note that there is no reason why this exposure should be restricted to fully vested equity – unvested equity should be included.

For a new joiner, a holding of 10x salary would take at least five years to establish. This is too long – it is important that the incentive effect of the high shareholding is achieved early in the CEO's tenure to ensure a long-term mind-set. To meet this goal within a rapid timeframe would therefore require some combination of:

- Rebalancing packages away from performance-based incentives to stock awards;
- Payment of bonuses in shares;
- Initial stock awards or buy-in requirements for an executive on joining; and / or
- A phased approach so that performance-based incentives are increased in importance in the package over time as the shareholding builds up.

The goal of building to 2x total compensation over time ensures that a quartile's difference in performance creates an incentive impact equivalent to a year's total compensation. This ensures a strong focus on long-term share price. With median total compensation in the

FTSE-100 being around £4m, a requirement of 2x total compensation would equate to a target total after tax equity exposure equivalent to around £8m or, again, around 10x salary. Although this sounds very high relative to current minimum guidelines, this level of holding is only around a quarter more than current median exposure in the FTSE-100[44] if unvested equity is included. This level of exposure over the medium term therefore appears eminently achievable over a period of 5 years or so, if the package is appropriately structured.

Payment in debt

The case for payment in debt has been considered by a number of authors[22-26]. This is because of the significant evidence that the level of leverage in incentive packages does influence risk-taking behaviour[45]. Particularly in highly geared companies or volatile industries, equity can create an incentive for excessive risk. This is because the value of equity rises if a risky project pays off, but it is protected by limited liability if things go wrong – thus, equity gives them a one-way bet. Similarly if a firm is teetering towards liquidation, rather than optimally accepting a mild bankruptcy, the executive may ‘gamble for resurrection’. In such cases, use of long-dated unsecured debt can help create a counterbalance.

In the past, unfunded defined benefit pension plans were a form of debt compensation. Deferred compensation plans, of the type common in North America, can have similar impact. Research shows that executives with such plans led companies that were associated with lower bond yields and higher bond prices[23,24] suggesting that debtholders are indeed reassured by the CEO’s lower incentives to pass risk onto them. Higher levels of debt-like compensation were also associated with lower bankruptcy risk, lower stock return volatility, lower financial leverage, and higher asset liquidity[25,26]. A return to the days of defined benefit pension plans for executives is unlikely to secure public or shareholder support. But there are other ways to pay executives in unsecured debt.

The simplest would be simply to convert the current practice of cash “pension contributions” into unfunded deferred compensation payments. These would accumulate in a fund and be payable, say, over the five years following retirement. The value of these on payment would only be reduced in case of default – either they would pay or, in case of default would reduce in line with other unsecured debtors.

Alternatively, banks have used debt instruments and Contingent Convertibles (“CoCos”) which align executives on a more continuously variable basis with the creditworthiness of the firm, via the change in market price of these instruments as creditworthiness varies. Indeed regulators have encouraged use of such instruments[39]. There are, however, formidable practical difficulties with using traded debt in compensation plans. Companies may not have sufficient tranches of traded unsecured debt to provide compensation vehicles of appropriate duration. Moreover, consumer-protection regulation often requires such bonds to be in high denominations only, so as to discourage retail investors – as such they may not be sufficiently fungible for compensation purposes.

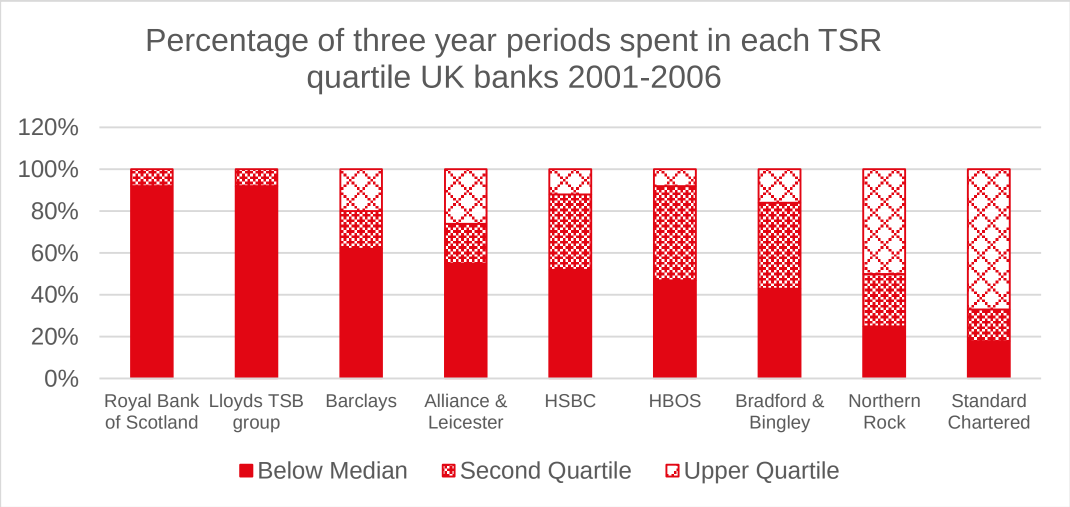
Widespread adoption of debt-based compensation is therefore more likely to take the form of deferred compensation arrangements as described above or phantom arrangements based on credit default swaps – the value of a phantom award, initially 100, say, could move up or down in line with the movement in credit spreads.

Given the market trend towards less leveraged pay arrangements (shares rather than options) the focus for exploring debt-based compensation could initially be on those industries that are most volatile or leveraged, such as banking and commodity companies.

Incentives measures linked to long-term value and the company's purpose

Incentive plan measures in UK companies are dominated by measures such as Profit Before Tax, Earnings per Share, Relative TSR. These measures have a common feature in that they are enhanced by leverage. Although Relative TSR should take into account risk and return, in practice experience suggests that in a market upswing the measure creates an incentive to adopt leverage at least as great as other companies in the peer group. This was most evident in the run-up to the banking crisis (see Figure 2). Over the period 2001 to 2006 three of the highest four performers on a rolling basis on relative TSR within the UK banking were HBOS, Bradford & Bingley, and Northern Rock, all of whom were either bailed out by the Government or subject to distressed takeovers.

Figure 2: Percentage of three year periods spent in each TSR quartile 2001-2006



Source: Datastream, PwC analysis

The underperformers on a relative TSR basis were firms like Barclays, HSBC, and Lloyds, which, at least up to the point at which Lloyds acquired HBOS, had been managed on a sounder basis through the crisis.

Financial regulators[37] have argued that measures such as Relative TSR, Return on Equity, and Earnings per Share can encourage excessive risk and they cannot now be used in the banking sector other than as part of a balanced scorecard including non-financial and risk-adjusted measures. Cedar Rock, a long-term value investor, has similar concerns about leveraged measures[46] arguing that they provide an incentive for excessive leverage, underinvestment in value enhancing revenue expenditure items (such as marketing and brand, training and development) and preference for share buybacks over dividends. They argue that performance should be based on unleveraged measures of growth and return, with a particular focus on unleveraged return on capital. We would support the view that returns-based measures have been underemphasised in UK companies, despite the Investment Association Guidelines for some time stating that measures should balance growth, returns, and risk[38]. We support the view that where financial measures are used for target-based incentives, measures of growth and return should be balanced within financial measures, and should be based on unleveraged definitions.

Given the evidence that the market can undervalue intangibles[32, 33], there is a case for retaining an element of shorter term incentive for executives to build intangibles, recognising that the benefits may not flow through into share price for some years. As we recommend in The Purposeful Company Policy Report, it is vital for companies to express their purpose in terms of tangible financial, non-financial, and strategic goals. The measures used will depend upon the company's purpose but could include, for example: strategic goals, customer satisfaction; employee engagement, diversity, and social mobility; health & safety; or progress towards sustainable business goals (as in, for example, the Unilever Sustainable Living Plan). Well-defined, such metrics are not "soft" metrics, but rather a clear and quantifiable articulation of the company's purpose and route to long-term value creation. These could be linked to incentives.

Although over the very long term equity should reflect intangibles and purpose, there is a motivational benefit of linking progress towards achieving the company's purpose to reward in the shorter term. This is not without problems given the difficulties of setting non-financial goals[19, 47]. However, risks can be mitigated by ensuring that cash bonuses when used in this way are relatively small compared with long-term equity grants, and by ensuring that targets are structured with a high degree of "in the round" discretion for Boards, to avoid perverse consequences arising from mis-specified targets or metrics.

Evidence suggests that pay-outs from annual bonuses are both higher and less variable than from long-term incentives[44]. This suggests that the calibration challenges faced by Remuneration Committees for bonuses are particularly acute. At the same time, bonuses are even more prone than long-term incentives to create unintended consequences of short-termism. We therefore suggest that bonuses based on financial metrics should be paid in shares subject to a deferral or holding period to ensure a counterbalance to any short-termism that could arise from pursuit of short-term financial metrics.

Use of discretion

Where performance-based incentives are used, it is essential that in-the-round discretion is available to Remuneration Committees to avoid the unintended consequences that may arise. Of course the smaller the role performance-based incentives play in the package, the less requirement there is likely to be for discretion, as the potential unintended consequences are of lower magnitude, and there will be greater acceptance from executives for “taking the rough with the smooth”.

However, for discretion to have credibility with executives, there should be a clear understanding with shareholders that such discretion may act upwards as well as downwards. While the investor expectation for downwards discretion has become well-established, upwards discretion is less well accepted.

A practical proposal

The above prospectus sets out a radical agenda for change. However, the resulting remuneration packages are neither unrealistic nor unrecognisable.

We would not encourage a one-size fits all model. Pay packages should be tailored to individual company circumstances and strategies. There may be circumstances where traditional performance-based incentives may continue to be appropriate. This may particularly the case in transformation or turnaround situations or distressed companies[19,31].

Package designs that meet the principles we suggest are likely to have features that go against many current corporate governance norms, for example:

- Pro-rating for time: reducing the value of long-term equity awards for good leavers simply means the timeframe of pay becomes shorter as CEOs approach retirement.

- Making buy-outs in the form of performance-based awards: in fact, making buy-outs in the form of shares provides the perfect opportunity to accelerate stock-holding as a balance to future performance-based incentives.

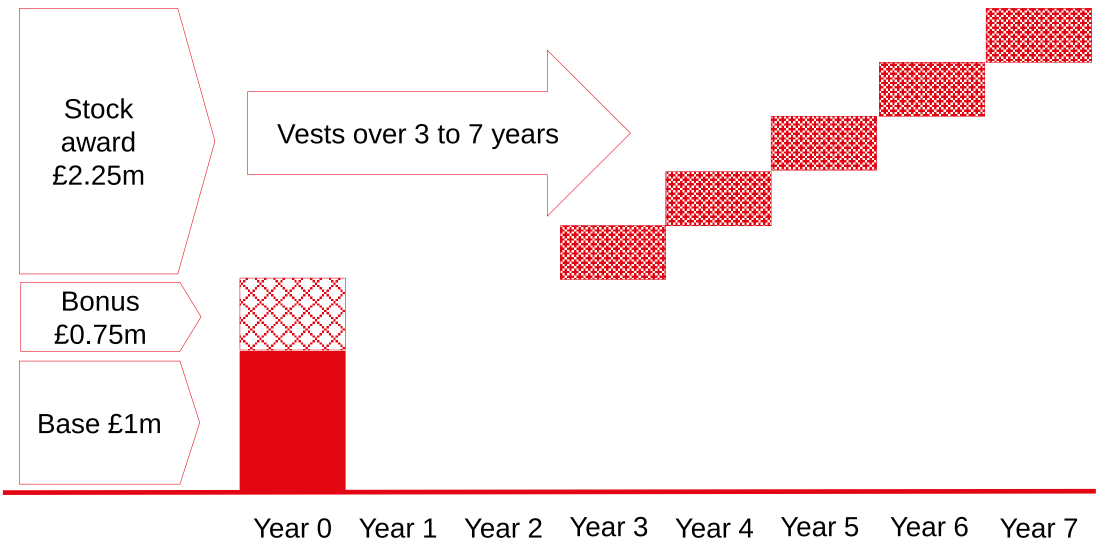
- Heavy weighting to target based incentives: packages should be rebalanced towards long-term stock awards to avoid short-term behaviour.

However, we believe these norms should be set aside, as they militate against development of packages that support long-term, purposeful behaviour. We set out in Appendix A suggested redrafting of the relevant sections of the UK Corporate Governance Code to achieve the objectives set out in this Section. Noting that current median FTSE-100 CEO total compensation comprises roughly £1m of fixed pay (base plus pension) and £4m pa total compensation, the following packages would deliver broadly a market competitive level of value, while meeting the principles set out above.

Figure 3: Example package delivering competitive median FTSE-100 CEO total pay

Component	Design and level
Fixed Pay	£1m pa
Bonus	£0.75m pa, in cash, based on building intangibles, £1m max
Stock award	£2.25m pa, vesting 20% a year over 3 to 7 years
Total Pay	**£4m pa, in line with median FTSE-100 total pay**
Shareholding target	200% of fixed pay in vested stock
Depending on the risk and leverage of the company, the stock award could be partly delivered as long-dated debt. The stock awards (after tax) build to the target level of 2x the bonus opportunity within two years. Over time the stock awards would build up to a natural ongoing net of tax stock exposure of £6m through unvested stock. This is why a shareholding target on vested stock is added, to ensure that the total stock exposure is £8m, or 200% of total compensation.	

Annual package illustration



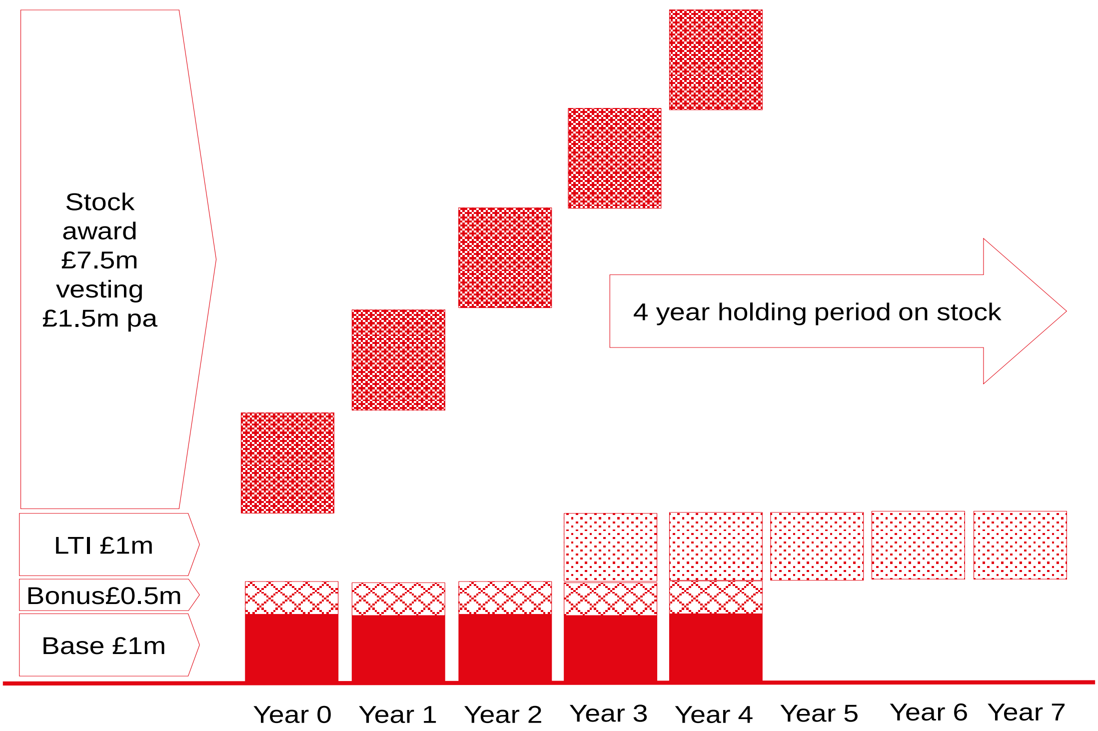
Note that fixed pay has been consolidated into a single figure. We do not see the rationale for high levels of pension contribution or other benefit allowances for senior executives, and support, for simplicity and transparency, use of a simple cash-based fixed pay amount.

There are various different ways in which the goal may be achieved of focusing packages on higher and longer-term shareholding. Figure 4 shows how target-based incentives could be retained for part of the package, balanced by an upfront stock award.

Figure 4: Example package delivering competitive median FTSE-100 CEO total pay

Component	Design and level
Fixed Pay	£1m pa
5 year stock award	£7.5m awarded on joining vesting 20% a year over 5 years with each tranche subject to a subsequent four year holding period (so shares are released over 5 to 10 years) – equates to £1.5m pa
Annual bonus	£0.5m pa paid in cash based on strategic and non-financial goals
Long-term incentive	£1m pa based on operating profit growth and return on capital employed over three years, paid in shares
Total Pay	**£4m, in line with median FTSE-100 total pay**
Shareholding target	Not applicable, as share exposure is achieved through stock award
The package would be renewed with a further five year stock award on the fifth anniversary of joining. Making block share awards ensures that high levels of shareholding are maintained throughout the period, balancing the shorter-term incentives provided by target-based awards.	

5 year package illustration



The purpose of these example packages is to show that a reformed model is perfectly achievable. As well as achieving better incentives for purposeful, long-term behaviour, the proposal also simplifies pay, reduces maximum levels of total compensation, and avoids the potential for outsized, and apparently random, rewards.

2. Strengthen Board Accountability for Pay Fairness

The Case for Change

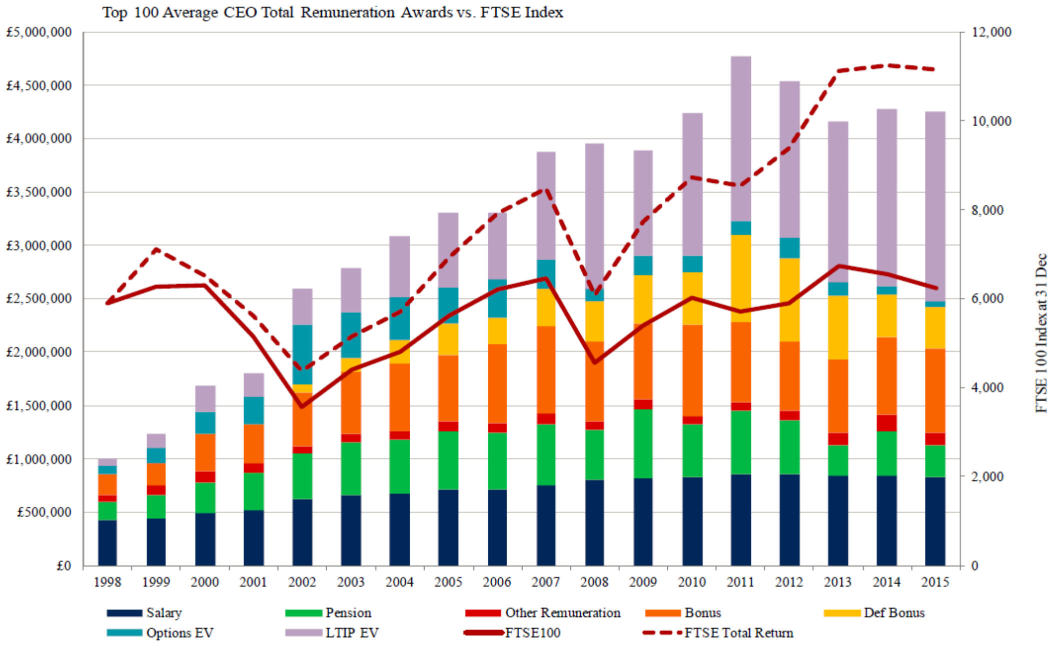
In this Section we address the challenge that recent growth in executive pay seems disconnected both from performance and from the increase in pay of the ordinary worker. We will find that trends in levels of CEO pay are more capable of rational economic explanation than is generally believed. However, the economically rational outcome is ever less acceptable to the public. Therefore, action must be taken to restore trust in the fairness of pay.

The concerning growth in CEO pay

This growth in CEO wages, and wage disparities, has become a visible symptom of the perceived disconnect between 'elites' and ordinary people in the UK. The Government's Green Paper on Corporate Governance Reform highlights the perceived issue. Comparing a quadrupling of average executive pay since 1998 against a broadly flat FTSE-100 over that period (see Figure 5) they note that "A number of shareholders and other stakeholders have queried whether this very significant increase in FTSE 100 CEOs' pay has been matched by increases in the long term value of the companies they manage."

The chart overleaf from Manifest is commonly cited as showing the disconnect between CEO pay and company performance. Manifest note that this chart is based on average pay, which is significantly distorted by outliers. Median pay is consistently around 20% lower. However, the fact that CEO pay has multiplied in value since 1998 cannot be denied.

Figure 5: FTSE-100 average CEO pay over time§



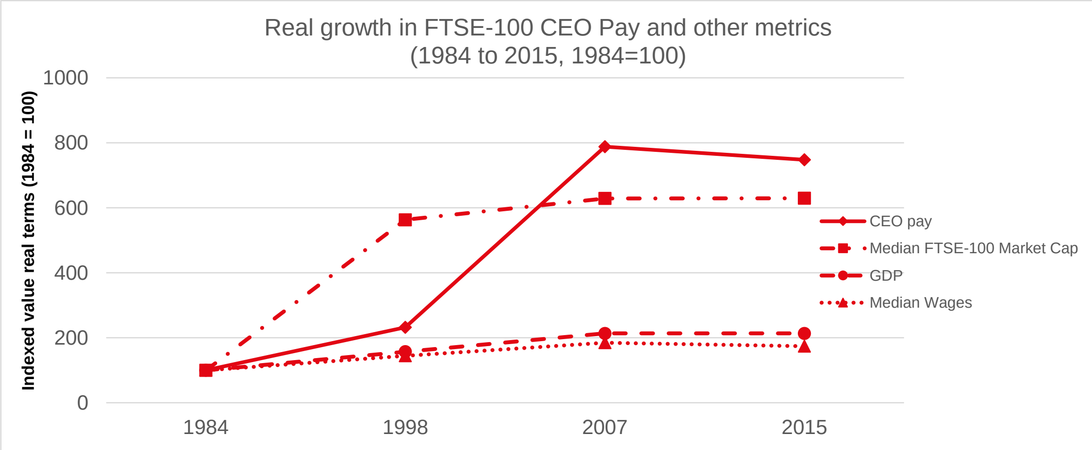
This time period is often chosen for CEO pay comparisons as 1998 is the first year for which complete executive pay and pension data is available. However, when pay is analysed over longer periods a different picture emerges. An analysis of executive pay by PwC[48] starts in the early 1980s, which reflects the point at which developed western economies took a marked turn towards more free market policies. They analyse the development of executive pay into three main time periods since the FTSE-100 came into being in 1984:

- The period 1984 to 1998 reflecting rapid globalisation of business, and the start of more market oriented approaches to executive pay, including the practice of granting stock options to senior executives.
- The period 1998 to 2007 which was a period of global convergence of pay, and also the growth of the 'pay governance era' commencing with the Greenbury report in the UK and enhanced disclosure rules, leading to more use of complex long-term incentive plans and increased use of benchmarking.
- The period 2007 to date, reflecting post-crisis stagnation and toughening of pay rules.

§ From Manifest (2016), 'The Executive Director Total Remuneration Survey', July 2016 edition. Data for 2015 includes year ends up to 31 December 2015. Pay definition is Total Remuneration Awarded, comprising salary and benefits, actual bonus, expected value of actual LTI. Pay amount shown is average not median pay.

The growth in CEO pay over this period is shown in Figure 6, alongside growth in company size, GDP and wages.

Figure 6: Growth in CEO pay, company size, GDP and wages 1984-2015[**]



Real growth (% pa)	1984-1998 Globalisation of Business	Period analysed in Green Paper (Figure 5): 1998-2007 Globalisation of Pay	Period analysed in Green Paper (Figure 5): 2007-2015 Post-crisis Stagnation	1984-2015 Whole Period
Med FTSE-100 CEO pay	6.2	9.1	(0.4)	6.7
Med FTSE-100 Market Cap	13.1	0.8	0.0	6.1
GDP	3.3	2.2	0.0	2.5
Wages	2.7	1.8	(0.4)	1.8

Over this period, median CEO pay of companies in FTSE-100 Index increased around 7.5x in real terms. Over the same period, the declining share of wages in GDP means that wage growth has fallen behind economic growth by around 20%. In combination these factors mean that the ratio of FTSE-100 CEO pay to UK median earnings has increased from approximately 33x when the FTSE-100 Index was launched in 1984 to over 140x in 2015.

The development of executive pay and company size was not even over the whole period. Growth in company size vastly outpaced the growth in pay over the period 1984 to 1998. Executive pay caught up over the period since 1998, during which the median company size has grown very little.

It is the period from 1998 that is focused on by many commentators, as 1998 marks the start

[**] There is less ready availability of pay data for 1984, given disclosure rules operating at the time. PwC have estimated median CEO pay in the FTSE-100 at approximately £200,000 pa in 1984 based on a range of academic and data sources[48].

of improved pay disclosure rules in the UK, meaning data is easier to come by. Over this period, and in particular 1998 to 2007, the growth in pay indeed outstripped the growth in company size by a wide margin. However, it is arguably misleading to look at this period in isolation, ignoring the decade and a half that went before.

It should not be a surprise that the growth in pay lagged the growth in company size. Significant changes in CEO pay levels only happen every few years at a company and are particularly triggered by CEO recruitment. At the same time, introduction of enhanced disclosure rules in 1998 would have given a clearer view as to market levels of pay, triggering a clearing of the market price in the subsequent years.

This analysis suggests that over three decades, executive pay growth has not been so detached from the growth in size of companies, although from 1998 it has been.

Nonetheless, the reasons for the increase in executive pay are hotly contested[34]. Factors that may reasonably be seen as justifying an increase in the pay ratio include the following:

- As noted above, the constituents of the FTSE-100 have changed enormously since 1984. In particular the median value of a FTSE-100 company has grown 6.3x in real terms, whereas the economy has broadly doubled in size[48]. FTSE-100 companies have, therefore, become over 3x more valuable relative to the size of the economy over the last three decades. Research suggests we can expect a strong positive relationship between company size and pay levels, so a significant proportion of the increase in executive pay may be explicable in terms of increased size and complexity of the largest companies[49].

- CEO pay has become more risky, through the decline of final salary pensions and the growth in performance based pay. This has led to performance-based pay increasing from perhaps 25% of the package 30 years ago to more like 75% now. At the same time contractual protection and CEO tenure have reduced, so part of the increase in pay can be explained by compensation for extra risk.

- Finally, the CEO skills required to lead large companies have shifted from firm specific skills to more general managerial and leadership skills. This has opened up a more competitive market for executive talent with greater external and international hiring, leading to stronger market mechanisms in pay determination.

However, other less acceptable factors may also have contributed to the increase:

- Executive pay disclosure rules may have led to a ratcheting effect in executive pay through chasing of benchmarks – while this may partly have led simply to acceleration of trends already underway, there is evidence that this has also had a causal impact[50].

- Research and theory suggests that executive pay is subject to contagion effects[51], where overpayment by a few companies or in a particular segment of the economy can result in an increase in levels of pay across the market. The financial services sector, where there was a well-documented pay bubble in the run up to the financial crisis[52], may have had a significant contagion effect in the UK and US.

- The spread of target-driven performance pay, combined with the relatively low cost of CEOs relative to the value of companies they lead, may have led to a culture in which almost any payment can be justified: if upper quartile performance by a typical FTSE-100 company adds £10bn over three years, then even £100m can be articulated as a "small price to pay" for that success. Equally, performance-based pay plans can inhibit understanding of the true value of pay being awarded to CEOs.

- Pay regulation (disclosure, tax, deferral rules etc) may have had unintended consequences, leading to pay increasing[53,54].

- Excess managerial power and weak governance may have led to excessive growth in CEO pay[55].

There is further evidence pay at listed companies has increased no faster than pay across a number of high skill occupations (private companies, private equity, professional services, medicine, media, sports, and so on). Furthermore, there is evidence that increases in pay simply reflect the growing complexity of the world's largest companies, higher returns to scarce talent, and growing convergence in international executive pay markets[49,56-57]. When hedge funds and private equity take control of companies they make many changes to the operation of the company, including potentially firing the CEO, but they do not tend to cut pay, and indeed frequently increase it[31,59] If pay in listed companies were so out of line, we would expect to see changes when the listed company governance environment is replaced by close private supervision.

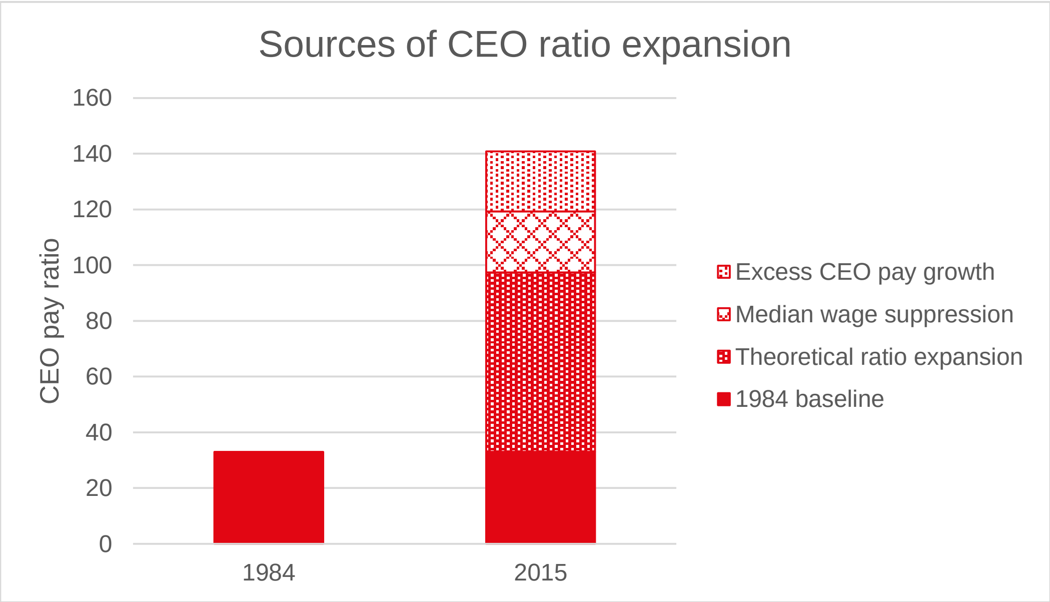
Overall, across all the evidence it would appear that the majority (but by no means all) of the increase in executive pay over the last three decades is due to rational factors (increased size and complexity of companies, increased importance of managerial talent, increased risk-profile of CEO roles and pay) as opposed to factors that might be regarded as market weakness or 'failure'.

The evidence suggests that the growth in listed company CEO pay is part of a broader economic phenomenon relating to returns to talent where there is scarcity, as opposed to a market failure. This makes the political problems created no less difficult – if anything more so. But it does suggest that an excessive focus on CEO pay levels at listed companies as opposed to broader drivers of inequality may not yield the desired results. Indeed there is evidence that public concerns about inequality relate as much to their own insecurity about future employment prospects as to the level of inequality in society of itself[60].

A widening pay gap

The increase in CEO pay relative to average earnings has caused a significant increase in pay ratios. The ratio of median FTSE-100 CEO pay to national average earnings has increased from around 33x in 1984 to around 140x today[48]. As noted above, part of this increase can be attributed to the fact that the median FTSE-100 company has become around 3x more valuable relative to the economy than in 1984. PwC note that if the pay ratio had simply increased in proportion to the relative size of FTSE-100 companies since 1984, the ratio today would be 97x. The difference between this 'theoretical' ratio expansion due to company size and the actual outcome of 140x is due in broadly equal parts to CEO pay increasing faster than company size ("excess CEO pay growth") and to wages growing slower than GDP ("median wage suppression"). This is shown in Figure 7.

Figure 7: Growth in CEO pay ratio, 1984 to 2015[48]



Source: PwC

As companies become bigger and more complex, the role of the CEO becomes more valuable to shareholders, whereas the role of the typical employee does not. The CEO of a retailer with 7,000 stores can add ten times the value to shareholders than one with 700 stores. Yet the role of the store manager, and their pay, is similar in both companies.

CEO actions can scale in a way that those of the typical employee cannot. If the CEO of a typical FTSE-100 company takes action to enhance its value by just 1%, this is worth around £100m to shareholders, a vast multiple of the value a typical employee can add. So to the extent that the size of large firms grows faster than the economy, it should not be surprising to see CEO pay at those firms increase relative to average earnings. This is indeed what has happened.

A damaging disparity?

It is often assumed that the widening pay gap must be harmful to company performance and productivity. In fact, the evidence on this is mixed, and indeed is overall suggestive of a positive relationship between higher pay differentials and performance. There is a significant body of large-scale research (i.e. studies across many companies) in highly respected peer-reviewed journals that would suggest high pay differentials are associated with higher performance. See for example the empirical analysis of Kale, Reis, and Venkateswaran in the Journal of Finance[61] and of Faleye, Reis, and Venkateswaran in the Journal of Banking and Finance[62]. The abstract of the latter paper summarises its conclusions as follows: 'We do not find a negative relation between relative pay and employee productivity...We also find that firm value and operating performance both increase with relative pay.'

These studies were based on US data. A comprehensive study by Mueller, Ouimet, and Simintzi[63], soon to be published in the Review of Financial Studies, has replicated this result also for UK data. These authors find that '...firms with higher pay inequality...have higher valuations and stronger operating performance.' These studies, in some of the most respected journals, support the concept that paying more for better top talent leads to companies attracting better managers, who then deliver better performance.

The evidence is not all one-way however[64]. Connelly et al[65] find on a US dataset that impacts are different over the short and long term, and state that: '...although pay dispersion may initially result in positive short-term firm performance gains, those gains are fleeting and are soon replaced by negative long-term performance over time.' However, their measure of long-term performance is future profitability growth, and so the higher growth of low-ratio companies is somewhat mechanical given their starting point is low profitability (which may explain why the current pay ratio is low). They also do not control for size, industry, or other potentially important factors. In addition, we are not aware of a secondary confirmation of this finding. There is also survey-based evidence that high CEO pay creates negative employee attitudes. For example a CIPD[66] survey of employees found 59% agreed that CEO pay levels in the UK demotivate employees. However, such survey-based approaches suffer from the serious weakness that they simply record how people feel, not what the actual result on motivation firm performance is in practice.

The research overall points to a tendency for higher differentials to be associated with higher performance, reflecting the concept that paying more enables firms to attract better management talent. But it is far from a perfect correlation and is likely to be situational. In some companies, restrained executive pay can be part of a strong sense of fairness that beneficially reinforces a company's purpose and culture. Employee owned or mutual organisations might fit in this category. But equally, there will be companies where low pay differentials reflect lack of competitiveness, which inhibits the ability to attract and retain talented managers, leading to a negative spiral of declining performance. Conversely, high pay differentials can be part of a culture of excellence, which does not conflict with performance or purpose at all. A number of technology companies might fit this mould.

Conversely there are companies where high pay differentials can reflect a culture of weak governance and self-interested management, detached from the needs of stakeholders.

Overall we should be very cautious about assuming that high pay differentials per se are either good or bad. It depends on the circumstances. The balance of evidence does not suggest that systematically lower pay differentials in the UK will be beneficial for the performance of companies. If anything the balance of evidence points in the opposite direction. Therefore a policy that actively pushes for lower differentials in all cases could be economically damaging. At the same time, pay differentials that are unjustified are likely to be corrosive to the corporate social fabric.

This discussion has an important implication for policy. It suggests that there is unlikely to be a cost-free solution to the perceived problem of CEO pay levels and relativities. If there were a significant market failure in executive pay, then a technical solution could be sought to address that failure, in terms of enhanced shareholder powers for example, which could be expected both to reduce pay and increase market efficiency. However, the evidence does not suggest the existence of such an easily resolvable market failure. Therefore, we may face a difficult trade-off between economic effectiveness of policy and public acceptability.

Pay ratios

It is our view that societal concerns on pay fairness cannot be ignored. Moreover, given the tendency towards inflation in the CEO pay market, disclosure requirements that 'nudge' boards to pay more active attention to pay inflation and relativities are desirable. However, we believe that a disclosure that focusses on pay relativities over time, rather than within a single company at a point in time, is likely to be the better way to meet the policy objective, as opposed to snapshot pay ratios.

Pay ratios have been suggested as a disclosure by the Investment Association[38] and Legal & General[42], as well as Chris Philp MP[67] and the High Pay Centre[68]. It is worth noting that pay ratios were withdrawn from the draft text of the EU Shareholder Rights Directive and look increasingly likely to be withdrawn in the US, as part of the announced review of Dodd-Frank, before the disclosure requirement is due to come into force at the end of this year.

Although well-intentioned, snap-shot pay ratios by themselves have the potential to create misleading comparisons and perverse incentives. For example, retailers will inevitably appear to do worse on the ratio than, for example, specialist financial services firms. Yet this does not suggest that retailers are less fair. A hotel company with a franchise model will inevitably have a lower ratio than one that owns and manages its own hotels. How to calculate the ratio for international companies is complex - should it be the UK workforce only, or the global workforce? Each has pros and cons and difficulties of comparison. The cost of calculating the ratio for an international company is non-trivial; the SEC estimates a first-year implementation cost of $1.3bn and ongoing annual costs exceeding $520m resulting from the US requirement to disclose pay ratios. Pay ratios can also penalise companies that offer higher non-monetary benefits, favour companies that outsource low paid work rather than keep it in-house, and act against troubled or start-up companies where the employee proposition may involve aspects other than pay. These issues show that the ratio could be reduced in ways that are quite counterproductive.

Furthermore, the public concern relates to inequality within society. This is a matter of public policy in relation to taxation, redistribution, regional development, education, and training. It is not clear that a focus on inequality within companies is the valid starting point for addressing inequality within society. Indeed as noted above it should also be noted that the evidence that inequality is bad for companies is at best mixed.

All this suggests that pay ratio disclosure is misguided. There are several criticisms of such disclosure. Many of these relate to lack of comparability. A pay ratio calls out to be compared across companies when really it cannot be, even within sectors. Comparisons between companies are almost certain to be misleading and to create more heat than light. But the discussion above highlights another problem with pay ratios: such a disclosure inevitably creates an expectation that lower is better, when the evidence does not support that contention.

Policy Recommendation

Overall, our view is that there are some very legitimate reasons that can justify a significant proportion of the increase in executive pay, without recourse to accusations of market failure or weak governance. However, at the very least, the CEO pay market has particular characteristics that make it prone to bursts of inflation, namely: the relatively low cost of CEOs relative to company value; the high degree of transparency around executive pay levels, which can cause contagion effects; and asymmetric incentives for boards, given the potential costs of losing or not hiring the right CEO compared with the value they can add.

The result of these characteristics is that the market is producing an answer that is ever less acceptable to the public. The evidence from moral philosophy and behavioural science is that fairness should be defined as a due rewards, proportionate to the contribution made. Accordingly, fairness should not be understood as simply being about equality of outcome. An individual's efforts and actions affect their due deserts, and human beings strongly distinguish between deserved and undeserved gains, between luck that is genuinely chance and good fortune that arises from application of skill through hard work and contribution[69].

Recent polling evidence consistently shows majority opinion that executive pay is undeserved, too high, or symptomatic of self-interested managerial elites[60,66,67] . Studies across the world show executive pay to be around a factor ten higher than the public thinks it should be[70]. Some views on executive pay are doubtless due to misunderstanding of the scale, demands, and potential impact of the job, which has been transformed in large companies in the last few decades. However, this chasm in expectations cannot be ignored, and much of the concern about executive pay in the public's mind is that rises are seen as disproportionate, undeserved, and therefore unfair.

However, we do need to be realistic about the impact reducing CEO pay would have on public opinion. Research shows that public concerns about inequality across countries are not correlated with actual levels of inequality in each country, but are strongly correlated with concerns about employment prospects[60]. Indeed concerns about executive pay were less in the decade preceding the financial crisis, when the pay ratio grew from around 50x to 140x, than in the decade since, when it has reduced slightly in real terms. Some polling evidence suggests that people are less concerned about what the CEO is paid provided all employees are paid fairly[60].

All of this leads to five key conclusions:

- Public concern about executive pay and inequality cannot be addressed just through focus on pay at the top, but also require a focus on pay growth for ordinary workers.
- Given the characteristics of the modern executive pay markets, robust frameworks are required to control pay and prevent re-emergence of unjustified pay inflation.
- A focus by boards on pay fairness is essential to rebuild trust in executive pay.
- Employee engagement is necessary to create accountability, build understanding, and rebuild confidence in pay processes within organisations.
- Pay transparency needs to be improved to provide better information on both the link between pay and performance and on the comparative movements in CEO and employee pay over time.

What is required is a change in attitude, and greater rigour, in boards relating to pay fairness. We believe that this change in behaviour is best achieved through a combination of expanded oversight accountability for Remuneration Committees, disclosure requirements through a Fair Pay Report within the Remuneration Report, and meaningful engagement with employees.

Under recommendations 3 and 4 we address the questions of improved pay-performance disclosure, and enhanced shareholder voting powers. The current recommendation seeks to address understanding of, and trust in, pay fairness through a three-pronged approach of enhanced board accountability, increased transparency, and employee engagement.

Recommendation 2: Strengthen board accountability for pay fairness

The UK Corporate Governance Code should be amended to broaden the role of the Remuneration Committee to oversee that business purpose is being translated into behaviour and decisions around reward, including in relation to pay fairness. The Remuneration Report should include a Fair Pay Report explaining the company's approach to pay fairness, and including specified metrics including relative movements in CEO and employee pay over time. The company should establish a meaningful process for engaging with employees on the Fair Pay Report.

The Fair Pay Report should replace existing remuneration report disclosures relating to the wider workforce and should cover, supported by data where appropriate:

- The company's philosophy and principles on pay fairness across the population (including how fairness is defined, see Figure 8, page 38), the approach taken to internal and external comparisons, covering the structure and level of pay, and the approach taken to linking pay with performance, including the principal characteristics of incentive plans used.

- Explanation of how the policy on pay for the wider UK workforce differs from that for the CEO and other executives in terms of the elements of pay offered, the quantum of opportunity under those pay elements, and the target positioning of pay against the market together with justification for such differences.

- Explanation of the extent to which it is the company's policy and practice to pay living wages in the territories in which it operates and how these are established, statutory disclosures on Gender Pay, and broader approach to equal pay issues.

- Explanation of the approach by which the company engages with employees on the Fair Pay Report and a summary of any themes emerging from the feedback on the prior-year's Report.

- Tabular disclosure over the last five years (building to ten over time) of the maximum annual pay opportunity for the CEO; the actual amount paid (on a statutory single figure basis) and average pay for all other employees, or an appropriate subset representative of at least the general UK workforce.

- Graphical representation of the above tabular disclosures formed by rebasing each pay element to 100 at the start of the period, and a narrative explanation of the comparative trend over time (see Figure 9, page 39).

Detailed Policy Discussion and Rationale

The rationale behind the Fair Pay Report is to respond to the significant and legitimate public disquiet about inequality, and to encourage Boards to discuss the issue of fairness in relation to pay, which is relevant to creating an engaged workforce and purposeful company. The experience from the banking industry[71] has been that greater Board involvement in overseeing, monitoring, and reporting on company-wide pay outcomes has enhanced the level of rigour and scrutiny of pay decisions within the company. This would be reinforced by the requirement to engage with employees on the Fair Pay Report.

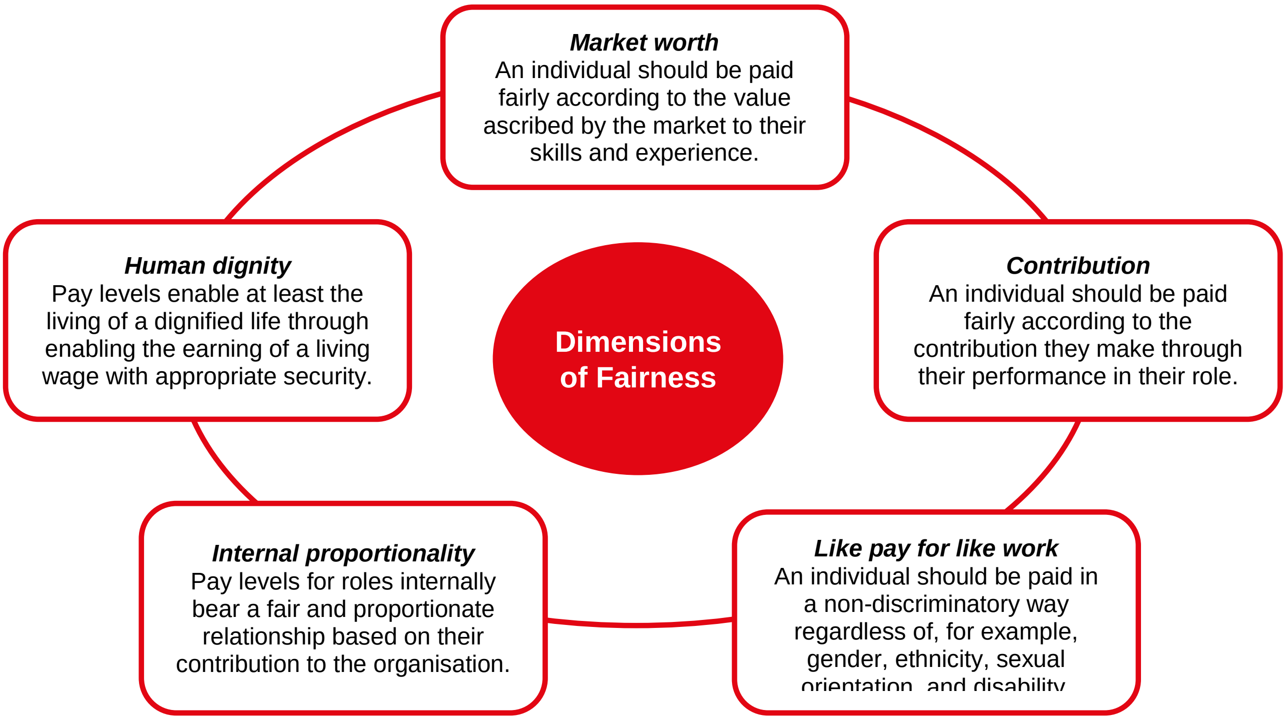
Contents of the Fair Pay Report

The current reporting regulations require a directors' remuneration report to include disclosure of: the percentage change in pay for the CEO compared with an appropriate employee group; an explanation of any differences in remuneration policy between executive directors and the general employee population; a statement of how pay and conditions for employees were taken into account in setting director remuneration; a statement of whether and how employees were consulted when drawing up the policy; and description of any comparative data used to inform decisions made. The resulting disclosures made by companies have generally been compliance-based and disappointing[72].

We therefore recommend that these requirements should be replaced by the requirement to publish, and engage with employees on, a Fair Pay Report, which would be the responsibility of the Remuneration Committee and would form part of the Remuneration Report.

In drawing up the Fair Pay Report, Remuneration Committees could usefully consider the different dimensions of fairness that may be relevant (see Figure 8).

Figure 8: Dimensions of pay fairness



All dimensions of fairness are likely to have a role to play in most organisations. However, the emphasis may be different. For example, co-operative societies place a high value on internal proportionality. Technology companies, where wages are in any cases generally high, may operate a highly market-based approach while being consistent with their purpose. Global companies may be particularly concerned about ensuring human dignity is reflected in pay practices, and minimum wages, particularly in developing world operations and supply chains. What is most important is for the board, through the Remuneration Committee, to hold management accountable for developing a clear philosophy on fairness that supports the company's purpose and can be explained to stakeholders, particularly employees.

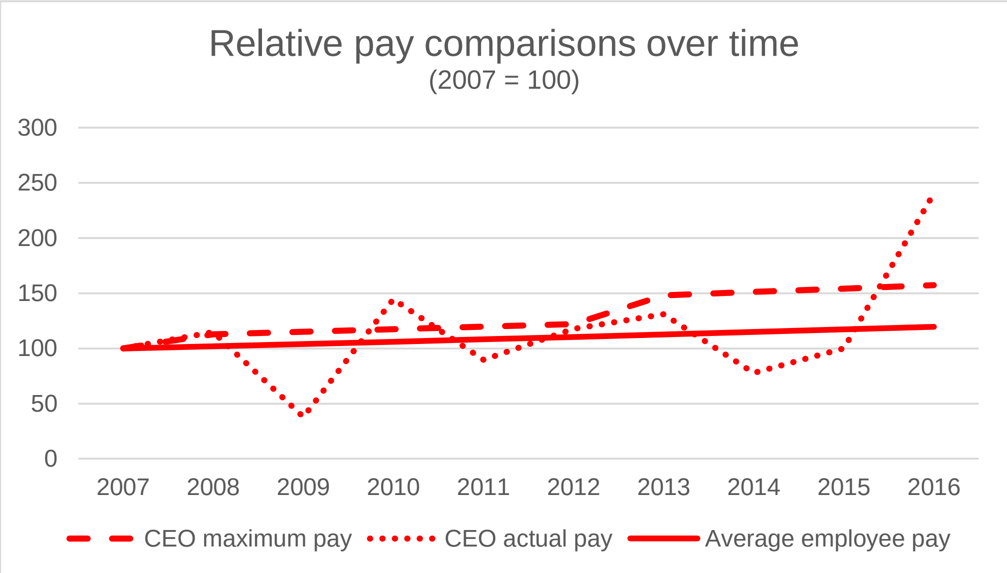
Pay comparisons over time, in the context of a holistic view of fairness

However, it cannot be denied that the differential between high pay and ordinary worker pay is a significant political issue. Pay ratios between CEOs and the average worker currently exceed what the public deem to be acceptable by a wide margin[60.70] across the world.

Therefore we do believe that there is a compelling case for requiring companies to disclose information on their approach to pay fairness. Fairness can be defined in a number of ways and the onus should be on the board to articulate their position on the issue. Importantly "more fair" is not the same as "more equal". But comparison of pay trends between CEO and workers is part of the equation.

However, for the reasons outlined above, we prefer comparisons between CEO pay and worker pay that focus on trends in actual and maximum pay over time, through disclosure of a relative pay index, rather than on the snapshot ratio at a given point in time. Hence our recommendation focusses on comparing indexed pay for CEO, and the average employee over 5 years or more, building to ten over time, and rebased to 100 at the start of the period. We propose disclosing CEO pay both as maximum opportunity and actual paid. See Figure 9.

Figure 9: Example tabular and graphical disclosure



£000s	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Maximum CEO pay	3325	3749	3823	3900	3978	4057	4927	5025	5126	5229
Actual CEO pay	3263	3749	1237	4719	2927	3842	4272	2539	3266	7843
Median employee pay	40	40.8	41.6	42.4	43.3	44.2	45	45.9	46.9	47.8

The Fair Pay Report therefore combines defined quantitative disclosures and meaningful narrative disclosures to require companies to give a full account of their approach to pay fairness. Note that the link between pay and performance for the CEO is already covered in the Remuneration Report and would not be duplicated in the Fair Pay Report, although companies may wish to cross reference in the explanatory narrative.

The focus of the quantitative pay disclosures in the Fair Pay Report is on relative pay trends over time. This would identify whether the Remuneration Committee is structurally increasing the CEO's pay opportunity relative to employees, as well as showing any divergence in pay-outs that would need to be justified by performance. This disclosure meets the intent of increasing scrutiny on pay inflation, but also on pay fairness, and would provide an effective trigger for board discussions and external challenge. We believe this is a more effective implementation of the policy intent than annual spot pay ratios. The latter would place focus on potentially highly misleading comparisons between companies as opposed to within a company over time. Moreover, the implication that lower ratios are always better is not supported by the best recent evidence from the UK and the US which suggests that, on average, higher ratios are in fact associated with higher performance, consistent with the idea that paying more to secure higher quality management can be beneficial[61-63]. The Fair Pay Report would give anyone wishing to calculate a pay ratio easy access to the relevant information. However, we believe the statutory disclosure should focus on relative trends as above.

Enhancing engagement

The Remuneration Committee should be required to report that it is satisfied that there has been effective engagement with employees on pay arrangements at all levels. The Remuneration Committee is responsible for only a sub-set of pay decisions so employee engagement should be undertaken by the executive team in the same way that the Board should expect customer insight to be undertaken via market research led by management. The exception to this is that there should be an opportunity for appropriate engagement with the Chair of the Committee to hear an explanation of decision making relating to Executive Director pay.

Engagement would have two benefits. First, increased understanding of the company's approach to pay fairness can help increase employee engagement. But also, the accountability created by engagement would itself influence the nature of debate and decision making in the board, and ensure fairness considerations were given appropriate weight.

We do not recommend that the mechanisms for employee engagement should be legislated. It suggests that partnering with employees on such an important issue of well-being is bad for firm value so we need to pass a law to achieve it. This is not true, many companies already voluntarily engage directly with their employees and employee representatives on issues impacting well-being. Robust evidence also shows that focusing on employee wellbeing (which involves consultation) improves firm value by 2-3% pa[33].

At the same time, models for employee engagement will vary by the circumstances of each firm, including its geographic reach and the nature of its workforce, as argued by David Macleod and Nita Clarke in the government sponsored report into employee engagement[73] .

To satisfy themselves that employee consultation around Pay practices has been done effectively Remuneration Committees should look to assure themselves that that the consultation undertaken by the executive team passes the five tests of effective engagement, see Figure 10.

Where there is existing machinery for staff insight either via management teams the use of external research capability or with trade unions then this can be used. In recent years there has been a steady increase in the systematic consultation of employee in response to statutory rights for employees to be informed and consulted in an increasing range of areas, which has led to development of consultation mechanisms. As part of the Government's wider review into enhancing stakeholder voice, we are likely to see board sustainability committees taking a greater role in ensuring mechanisms exist for taking on board stakeholder views. These mechanisms could be used for consultation on the Fair Pay Report.

Figure 10: Tests for effective engagement

1. Intentional	• Change comes when company buys into value of employee welfare, engagement, fairness. • Consultation undertaken in spirit of commitment rather than compliance. • Requires CEO leadership and Remuneration Committee scrutiny.
2. Systematic	• Effective engagement to create actionable insight is an ongoing process. • Remuneration Committee needs to satisfy themselves that the method used is systematic. • Companies should draw on existing engagement mechanisms where
3. Authentic	• For employees to engage constructively they need assurance their views will be heard. • There should be the same commitment to identify genuine views of staff as customers. • Honest search for the truth is required.
4. Impactful	• Insight from engagement should be turned into action. • Remuneration Committee oversight should challenge whether real insight has been sought and acted on. • This requires bravery from management.
5. Comprehensive	• Holistic view of reward is required across financial and non-financial dimensions. • This may include training and development and non-monetary benefits e.g. flexible working.

This process may not be easy for the executive team - particularly if there are trade-offs to be made. Employees may, for instance, have an interest in protecting their rights or preserving the status quo regardless of customers' needs, or maximising their compensation as possible, against the interests of shareholders. But, as with listening and acting on customer feedback, the value that can be created is significant. Moreover, in order to rebuild trust in pay, to the benefit of all UK business, decisive action is required. Despite the undoubted practical difficulties of engaging on the Fair Pay Report, we believe such engagement would strongly reinforce Remuneration Committee accountability in this area. Therefore there should be a determination to overcome these difficulties.

3. Enhance Executive Pay Disclosure

The Case for Change

In previous sections we have addressed the questions of whether executive pay is incentivising the right behaviour (it is not) and whether the increase in executive pay in recent decades can be justified (to a significant degree it can be, although this is not accepted by the public and trust needs to be rebuilt). We now turn to the question of whether pay outcomes across companies are aligned with performance. In simple terms, do the strongest performing CEOs get paid the most?

Pay for performance comparisons

This question has been given prominence by an MSCI study that claimed to find, if anything, a negative correlation between pay levels and performance in the US[2]. This is an important claim. CEO pay is a lightning rod for the public's distrust in big business. If CEOs are making huge sums regardless of performance, then this can be highly damaging to efforts to rebuild trust. However, given the complexity of executive pay, it is worth scrutinising such claims carefully.

The current UK disclosure regulations[74] attempted to improve the disclosure of pay versus performance through two disclosures:

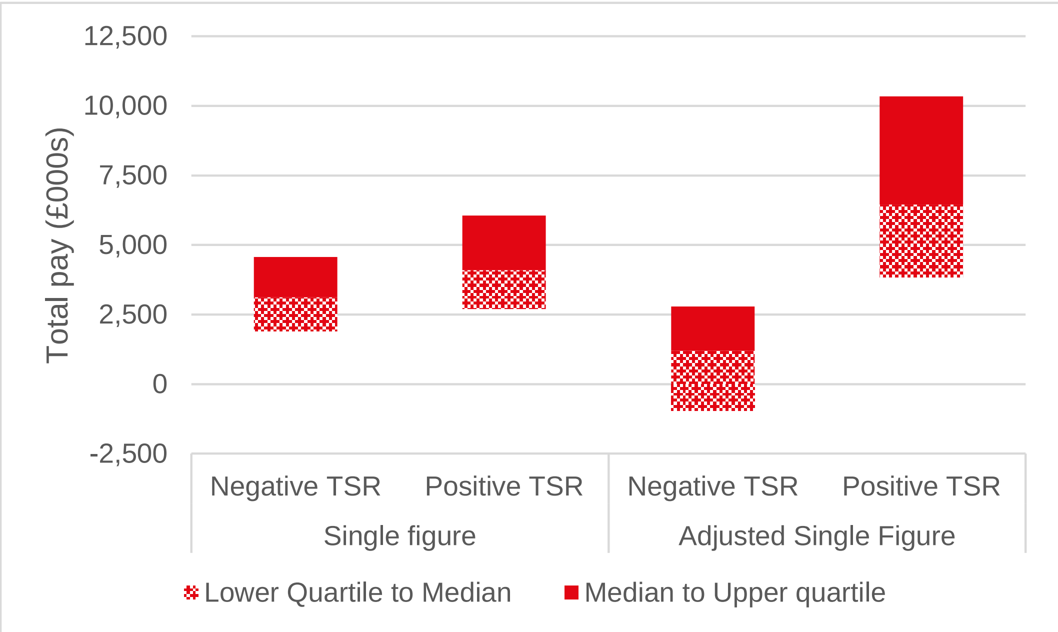
- Definition of a "single figure" of pay showing the total amount crystallising for an executive by virtue of satisfaction of performance conditions in the year, including the impact of any share price growth since the grant of share awards.

- A requirement to disclose over up to ten years this single figure of pay, the rate of vesting of short and long-term incentives as a percentage of maximum, and the TSR of the company.

The 'single figure' disclosure of executive pay looks at pay elements crystallising based on performance in the reporting year. As such it ignores the impact on the CEO of changes in value of previously granted equity. This is like analysing investment returns based on dividends but disregarding capital gains. High quality academic research always looks at the combined sensitivity of pay and wealth to performance, including previously granted equity. Given that the median FTSE-100 CEO has an after tax equity exposure of around £6.5m, a 20% share price fall is equivalent to a pre-tax pay cut of around £2.3m. This cannot be ignored.

Figure 11 overleaf demonstrates the importance of including the impact of previously granted equity. It compares the single figure of pay for CEOs in the FTSE-100 for their most recent reporting year. This comprises base salary and benefits, bonus for the year, and long-term incentive pay-outs. The companies are split between those that delivered a positive Total Shareholder Return (TSR) over the year and those where TSR was negative (just over 1/3rd of the companies). The left-hand bars show the reported single pay figure. The right-hand bars show the reported single figure plus or minus the pre-tax change in value of previously granted equity (vested shares still held by the executive and unvested deferred awards).

Figure 11: FTSE-100 CEO pay for positive and negative TSR companies, before and after adjustment for previously granted equity



Source: PwC

Companies delivering positive TSR over the year had a slightly higher median single figure of pay: £4.1m as opposed to just over £3m for those companies that delivered negative TSR. This is a difference of one-third at the median, however, there is significant overlap between the quartiles of pay for the positive and negative TSR companies. While this analysis has not been subject to detailed controls, note that the median market capitalisation for both the negative and positive TSR groups was almost identical, so there is no obvious size affect distorting the results.

The right-hand set of bars adds the change in value of previously granted equity. The impact of declining share price on the negative TSR companies reduced the pay of the CEOs of these companies by nearly one-half at the median, or about £1.5m. Indeed for nearly one-third of the companies delivering negative TSR, the fall in value of shares more than offset the single figure of pay received in the year, meaning that those CEOs in effect received negative pay.

Using the adjusted figures the difference between the pay of the negative and positive TSR companies increases to nearly a factor five and there is no overlap in the quartiles. This analysis demonstrates the importance of ensuring CEOs are significant shareholders in their business, but also shows the importance of developing a pay disclosure that includes changes in the value of previously granted equity.

Correcting pay for performance analysis

The shortcomings of the MSCI analysis are well-recognised in academic circles[75]. In summary the analysis suffers from three key shortfalls.

- First, the analysis is based on target pay rather than realised pay, so it does not allow for the impact of share price movement on stock option awards.

- Second, the analysis does not adjust for size. Yet one of the most robustly verified findings in executive pay is that if a company has twice the value of another than on average its CEO's pay will be around 25% higher. Therefore, the analysis quite likely just reflects the fact that over the period of the study small caps (who pay less) outperformance large caps (who pay more). Any pay for performance analysis that fails to adjust for size will almost certainly lead to misleading results.

- Thirdly, the analysis does not adjust for previously granted equity, which as shown above has a very significant impact on the pay-performance relationship.

More detailed analysis shows that making these adjustments significantly increases the observed correlation between pay and performance in the FTSE-100. This analysis shows that the measured correlation between pay and performance increases from broadly zero when no adjustments are made (in line with the MSCI study) to nearly 80% when appropriate adjustments are made for size and previously granted equity[76].

Figure 12: Correlation between pay and three year TSR with and without adjustment for size and previously granted equity

Pay definition	R-Squared*
Target pay	9%**
Single figure	19%
Single figure adjusted for size	48%
Single figure adjusted for size and previously granted equity	77%

Source PwC

*Correlation between pay rank and three-year TSR rank

**The correlation with target pay is in fact negative

Note that this analysis does not mean that executive pay design is without problems. This analysis was only carried out over a relative short-term three year period. Moreover, the correlation is only as high as it is because awards are denominated in shares and because CEOs have significant shareholdings. The alignment with performance happens in spite of, rather than because of, the high usage of target-driven plans. The behavioural risks associated with these plans are significant, as outlined in Section 1, and so pay should be reformed.

Nonetheless, the analysis above shows that, properly analysed, the misalignment between pay and performance under current constructs is much less severe than commonly assumed. Also, the analysis demonstrates the importance of high levels of shareholding in creating a long-term link between pay and performance.

Disclosure regulations should, therefore, be reformed, better to show the link between pay and performance, taking account of previously granted equity. To effect this, as well as disclosing the single figure of pay, the company should show the wealth impact: the pre-tax change in value over the reporting year of previously granted vested and unvested[††] equity awards. The absolute £ value of the total shareholder return over the year should also be disclosed. These items should be disclosed for the last ten years alongside the current requirement to disclose the single figure and vesting history.

Explaining the maximum pay level in the policy

The current UK reporting regulations for directors' remuneration require the maximum for each element of remuneration to be defined in the directors' remuneration policy, and the regulations then require a shareholder vote to pay above that maximum. The maximum potential payable under the policy must be illustrated in a scenario chart at the time the policy is approved.

There is currently no requirement to explain why the Remuneration Committee chose this maximum amount as appropriate. It would create good discipline on Remuneration Committee thinking for them to have to justify this decision, including any market reference points used. This would also help stakeholders understand why the maximum pay is reasonable.

Beyond rebuilding trust in the policy regime, there is a further reason why clarity on the maximum pay level is justified. There is some evidence that very high CEO pay relative to norms or relative to other executives within the company can be correlated with lower firm value[77, 78]. These findings may be reflective of situations of entrenched CEOs or hubris,

[††] Note that changes in the value of unvested awards would only be included once those awards had counted towards the single figure in a prior year – for example a deferred bonus. This ensures no double counting of the share price impact on award values over time.

which create knock-on problems. Furthermore, the potential for high pay levels to cause contagion across the market is another reason for significant focus on outliers[51]. This evidence suggests that it is reasonable for shareholders to receive a full explanation of why the maximum within the policy is deemed appropriate by the Remuneration Committee.

Clarifying the maximum pay level in the policy

The regulations allow the maximum to be expressed "in monetary terms or otherwise". In practice this has led to the maximum being defined in different ways for different components. For example salary has frequently not had a formal maximum; final salary pensions have been defined in terms of the benefit rather than the maximum value; for long-term incentives the maximum is typically defined in terms of the initial face value of the shares awarded rather than the value of shares when they pay out.

Although there is a good rationale behind these variations, in aggregate they have resulted in shareholders not actually voting on a clear pay maximum within the policy, and have arguably led to loss of public faith in the effectiveness of policy to restrain payments. Cases where the disclosed annual pay has exceeded the maximum set out in the policy scenario charts have been cited as an example of the policy regime being ineffective or cicumvented[66].

In practice there are "good" and "bad" reasons why the maximum may have been exceeded:

- The typical "good" reason is that the maximum in the scenario chart normally excludes share price growth. Given that long-term incentive awards are denominated in shares, a strongly increasing share price combined with good levels of achievement against performance conditions can result in pay-outs ahead of the initial maximum face value of awards. Shareholders are generally supportive of pay-outs in such cases as they reflect performance – unless the grant was made at a temporarily suppressed price.

- "Bad" reasons may include a significant contribution to the single figure from a final salary pension when an executive receives an unusual pensionable salary increase, or a large salary increase that is beyond what was envisaged in the modelled policy. In some cases this has led to disclosed pension values in many millions of pounds when the scenario chart in the policy suggested a value of hundreds of thousands. In some cases this can lead to the stated maximum being exceeded in a way that would not realistically have been foreseen by shareholders.

We believe that changes are required to give shareholders clear control over maximum payments under the policy, and to enable full transparency of the extent to which it is share price growth that has caused the maximum pay in the scenario chart to be exceeded.

Policy Recommendation

We believe that changes are required to the remuneration reporting regulations in order to:

- Allow a more complete view of the relationship between pay and performance
- Give clarity over the maximum pay allowed under the policy

Recommendation 3: The Directors' Remuneration Reporting regulations should be updated to enable greater stakeholder understanding of a company's maximum pay and relationship between pay and performance.

- The single figure table should disclose how much of the single figure arises from growth in share price on share incentives between the date of grant and measurement of performance and should show a separate total single figure excluding this amount.
- The single figure table should include the wealth impact on CEOs of the pre-tax change in value over the year of previously granted equity over the year. This item should also be shown in the ten year history together with the absolute total shareholder return achieved by the company over each year.
- Disclosure of share interests should include weighted mean period to release for each of shares beneficially held, shares subject to service, and shares subject to performance.
- Within the remuneration policy a clear monetary maximum should be stated and justified for each element of remuneration other than those linked to the value of shares, in which case the limit should be based on the initial value of shares awarded.

Detailed Policy Discussion and Rationale

For any remuneration element where the value in the single figure does not depend on share price growth, there should be a clear monetary maximum under the policy. This should also be true, for example, for defined benefit pension plans. Where the value of a benefit is unpredictable (as with a final salary plan) the company will be forced to make a realistic assessment of the maximum amount, and would then be required to obtain shareholder approval for any excess payment over that amount.

The exception would be awards based on shares. It would be counterproductive to impose a limit on value that arises purely from share price growth, as this is directly aligned with shareholder returns. Therefore, the maximum value of share awards would, as now, be defined by reference to their face value at date of grant.

Although the maximum pay-out from share-based plans should be based on the face value at grant, we believe that it would be helpful for shareholders and other observers to understand the component of the single figure of pay that arose from share price growth as opposed to fixed pay or achievement against performance conditions. Therefore we suggest the addition of two columns to the single-figure table to show:

i. The single figure with share awards valued based on the share price at date of grant of those awards.

ii. The additional amount within the actual single figure disclosure that arises because of share price growth.

The amounts under (i) and (ii) above would by definition add up to the total single figure. This would help readers of the report to understand any cases where the single figure has exceeded the maximum in the scenario chart at the time the policy was approved. This disclosure is already included on a voluntary basis by some companies, and can help reduce misunderstandings about the drivers of pay and how it compares with the policy limits.

To help give full understanding of the link between pay and performance it is important to have an additional disclosure to show the net (£ sterling) change in company wealth of the CEO over the year comprising both remuneration crystallising and the change in value of outstanding equity. This should then be compared to the (£ sterling) change in value of the company over the same period. While current focus is only on the cost of the CEO (their pay), fairness depends on the comparison of costs and benefits. This disclosure aims to present a more balanced picture. While the entire increase in company value is clearly not solely due to the CEO, stakeholders could multiply it by their perceived assessment of the CEO's contribution and compare this number against the CEO's pay to assess fairness. Companies would be permitted to show other measures of value in addition.

The time series disclosure would enable a user of the report to aggregate and analyse the wealth impact over any period. Summing the single figure and wealth impact over every year of a CEO's career would yield the total change in wealth they had experienced as a result of being CEO. This could then be compared easily to the aggregate value created.

Finally, given the importance of lengthening the term of equity exposure, we recommend requiring the weighted mean term of share awards and shares held to be disclosed. Where there is a shareholding requirement, then the term of any holding under this requirement should be calculated assuming the CEO gave notice at the financial year end and that any post-retirement share-holding requirements apply from the end of that notice period.

4. Toughen Shareholder Voting Powers

The Case for Change

There is substantial evidence that “say on pay” regimes have been effective in improving alignment between executive pay and shareholder interests[77]. In the UK.I Introduction of say on pay in 2003 has been followed by a range of features sought by shareholders including: reduction in notice periods; removal of retesting of performance conditions; generally tougher performance conditions; less generous leaver and change of control treatment on LTIPs. This experience has been backed up by comprehensive analysis of say on pay regimes globally[78]. This analysis shows that say on pay regimes have been associated with reduced rate of increase in CEO pay, and improvement in the sensitivity of CEO pay to performance, and introduction of shareholder-friendly pay features, with the changes particularly concentrated on those firms with the weakest governance and most problematic pay policies.

As noted by a number of authors, the market for executive pay is not perfect. Non-executive directors face asymmetric incentives in relation to CEO pay packages: CEO packages are trivial relative to the finances of the company in most cases, and the desire to avoid creating disgruntlement amongst management teams is clear. Say on pay has undoubtedly created a potential for reputational risk that has added steel to Remuneration Committee decision making, and created a counterweight to the fear of executive dissatisfaction that can affect Remuneration Committee behaviour.

It is too early fully to analyse the overall impact of introducing a binding vote in the UK as most companies have only had one policy approval so far. However, even the initial round of binding votes brought about clear limits on recruitment remuneration that had not previously existed and which would appear to have had a dampening impact on joining packages for CEOs compared with some of the more extreme practices of the past. Moreover, anecdotally it seems clear that the binding nature of the policy has brought with it a harder constraint on what can be offered to executives when they leave in certain circumstances. The international evidence[78] suggests that, if anything, non-binding regimes have been more successful than binding regimes in influencing pay outcomes. However, the researchers caveat this conclusion by noting the wide degree of variety between different regimes (for example binding votes on policy, as in the UK, versus binding votes on quantum of payments, as in Switzerland).

Associated with the binding policy vote there has been more active use of the advisory vote by shareholders over the last few years which has brought about a number of further advantageous changes including: widespread disclosure of annual bonus targets (now adopted by two-thirds of the FTSE-100); introduction of malus and clawback; and introduction of post-vesting holding periods (by over half of the FTSE-100) to increase total LTIP terms to 5 years.

It should be noted that some of these changes have arisen from changes to the UK Corporate Governance Code, whereas others have arisen from shareholders using their voting powers under the advisory regime as they have been able to do since 2003. Therefore, while particular market developments cannot always be directly associated with a single regulatory development, overall the current system appears to produce a well calibrated set of powers for shareholders that create a feedback loop. This in turn leads to evolution in practices in the market over successive AGM seasons. There was strong support for the new system in a qualitative research exercise carried out in 2014 following the first round of reporting and AGMs under the new system[72].

Binding votes

The evidence suggests that the existing voting regime has been broadly successful. However, there have been concerns in some quarters that while the vote on policy is binding, the vote on how that policy is implemented is non-binding. This means that there is felt by some to be no direct consequence of losing the advisory vote, and in particular losing the vote does not stop the contentious payments being made to executives.

In response, some commentators have indicated that there should be binding votes on executive pay. This has been interpreted by some as annual binding votes on pay outcomes, and policy proposals have been prepared by at least one Member of Parliament on this basis[67].

Discussion with shareholders in the UK reveals split views on binding votes[28]. Some shareholders favour binding votes on outcomes, reflecting the frustration they feel that advisory votes against do not change the decisions made by the company that caused the negative vote. However, many shareholders are concerned about the unintended consequences of a binding vote on outcomes, a number of which were responsible for both Australia and the UK rejecting binding votes on pay outcomes in reviews of say on pay legislation since 2011[80]:

- Exactly on what is the binding vote to be held? The whole report or elements thereof? In practice the binding vote would need to be held on specific pay outcomes (for example annual bonus). However, shareholder dissent with Remuneration Committee decisions has often been in different areas, such as treatment of leavers for example.

- A binding vote results in a level of direct intervention by shareholders on a specific company decision that absolves directors of their responsibility to shareholders, and undermines their role, as a matter of principle.

* A binding vote undermines the reliability of contract between the company and executives, which could significantly affect the ability to of UK listed companies to attract and retain talent compared with overseas or private companies.

* Precisely what are the consequences and remediation required on losing a binding vote?

* There is a risk that shareholders will be less willing to cast a negative binding as opposed to advisory vote (e.g. would the BP report have been voted down if it was binding?) because of the potential destabilising consequences for CEO motivation and retention – this would weaken the feedback loop provided by the current non-binding regime.

* There is a concern about excessive consultation by companies seeking to ensure that they would not lose a binding vote.

* There could be issues with binding votes and contract law coming into conflict.

* A binding vote on executive pay arguably elevates pay to an unjustified level compared with other critical aspects of corporate action, and creates a level of forensic intervention by investors that is misaligned with their input in more important areas such as major investments, acquisitions, strategy and so on.

Taking all of the above into account, and given that the detailed international evidence does not suggest binding votes are more effective, we do not see a clear case for universal annual binding votes on pay outcomes at this time. However, as referenced above, a voting system that keeps the pressure on Remuneration Committees to act in shareholders' interests and to take tough decisions can have benefits in ensuring appropriate restraint is exercised.

Significant opposition short of losing the vote

There has been some shareholder frustration that a small number of companies appear to have largely ignored substantial non-binding votes against remuneration. Experience suggests that companies that actually lose a remuneration vote generally respond to shareholder concerns in the following year. However, some shareholders are concerned about the implications of companies that consistently tolerate higher levels of opposition, short of losing the vote. The fact that substantial minority shareholder opposition should lead to some Board accountability led to the following provision in the remuneration reporting regulations[74].

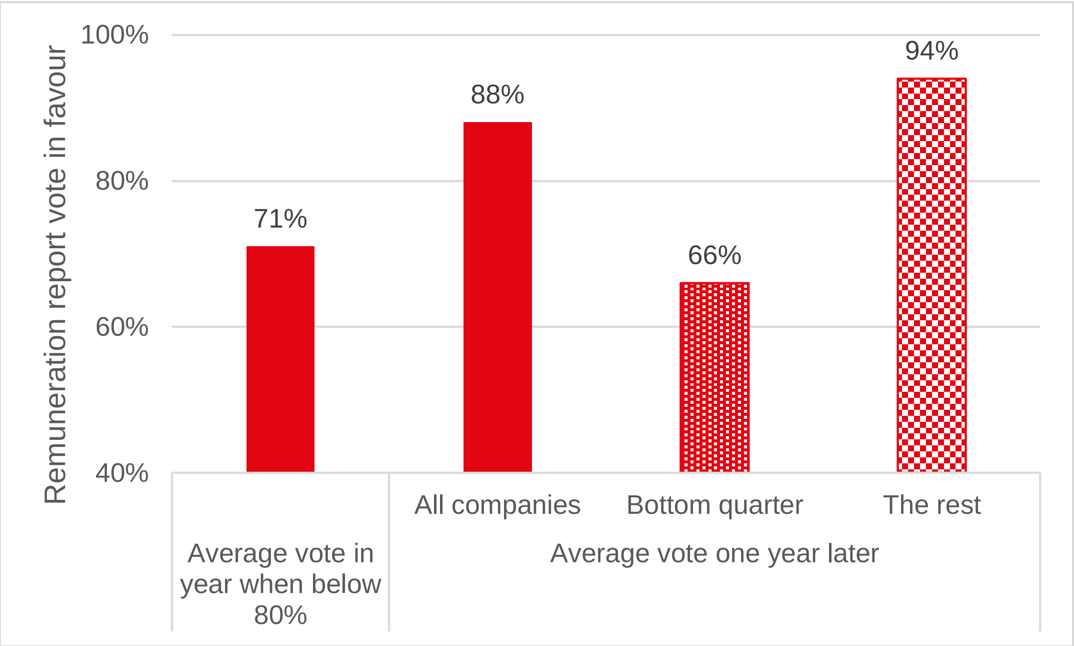
> *Where there was a significant percentage of votes against either resolution, where known to the directors, the reasons for those votes and any actions taken by the directors in response to investors' concerns [should be disclosed].*

This is also reflected in the broader guidance in the UK Corporate Governance Code that when, in the opinion of the board, a significant proportion of votes have been cast against a resolution at any general meeting, the company should explain when announcing the results of voting what actions it intends to take to understand the reasons behind the vote result.

The GC100 group has indicated[81] that 20% vote against should be deemed "significant" in the context of the regulations. Legal & General have also defined 20% as representing "large voting opposition", requiring the board to state what it is doing to address concerns[42].

Approximately one in ten FTSE-350 companies have received votes in favour of 80% or fewer (abstentions excluded) over the last three years[82], suggesting that 20% opposition represents broadly a lower decile level of support. These companies received an average vote in favour of 71%. The average vote for the remuneration reports for the same companies one year later was 88%, suggesting that they had achieved significant improvement and that they had responded to shareholder concerns (see Figure 12).

Figure 12: Shareholder votes for companies receiving "low" levels of support



Source: PwC, Proxy Insight

However, this aggregate data conceals a split population. Between a fifth and one-quarter of the companies receiving a vote in favour below 80% also received less than 80% in the following year, with their average vote even falling slightly from 69% to 66%. The remaining three quarters or so of companies improved their vote from an average of 71% to 94%, well into the levels suggesting substantially full support.

While this does not suggest an endemic problem of lack of responsiveness to shareholder votes, it does suggest that around 2% of companies are prone to persistently low levels of support, in addition to the 1% of companies or fewer who actually have their remuneration reports voted down. Moreover, detailed evidence suggests that outliers can have a significant impact on pay levels across the market, given the sensitivity of CEO pay market dynamics[51]. Ensuring there are robust sanctions to deter excessive behaviour could improve the operation of the executive pay market, and would leave the public in no doubt that shareholders have requisite powers.

Policy Proposal

The scale of this problem does not appear to us to warrant a wholesale change in the voting regime applying to all companies. Given the lack of evidence in favour of binding vote regimes, and the problems with a binding vote on pay outcomes outlined above, we do not support introduction of an annual binding vote on pay outcomes for all companies at this time. It appears to us to be a disproportionate response to the problem at hand, and in any case there is no evidence that it would have the desired impact. However, some development of the existing regime, with impact focused on this small number of companies, may be appropriate. Given the recent willingness of shareholders to use their own escalation mechanisms (for example voting against the Chair of the Remuneration Committee where remuneration votes are consistently low, it may be that any formal change to the voting regime could be deferred for a further period of two to three years, as practice develops.

A binding vote regime should be triggered when companies lose, or repeatedly fail to achieve a threshold level of support on, the advisory remuneration vote.

This could be implemented through legislation or through changes to the UK Corporate Governance Code. If a company loses the advisory remuneration vote in any year or receives 25% or more vote against the advisory vote two years in a row then:

- The company should bring forward their remuneration policy for approval at the next AGM of the company as a Special Resolution requiring a 75% majority to pass.

- At the same AGM a motion would be brought forward enabling shareholders to dis-apply, by simple majority, the requirement to pass the remuneration policy by a super-majority.

Where issuing recommendations based on benchmark policies, proxy voting agencies should:

- Give clear guidance during engagement with companies if proposals are likely to attract a negative voting recommendation and take into account the views, if made public, of major shareholders in a company when making voting recommendations on proposals where strategic fit is a strong element of the rationale.

Detailed Policy Discussion and Rationale

A proportionate response based on an escalation mechanism

Public trust in business is at a low point and perception of executive pay practices is a significant contributor to that. Polling evidence suggests that the public is supportive of greater shareholder powers to address the issue[60, 67]. Given that distrust on pay is creating a damaging negative externality across business as a whole, there is a case for taking active steps to demonstrate to the public that the issue is being taken seriously, while strongly encouraging business and shareholders to drive reform. However, any further regulation should be sensitive to the risk of potential unintended consequences.

We accept that further voting powers for shareholders are politically necessary and that this is likely to include binding votes. Our policy recommendation, however, is to create an escalation mechanism that focusses binding votes on those cases that warrant greater attention.

Our proposal is that a binding vote regime should only be triggered for a company if they lost an advisory remuneration vote or if they faced a vote against by shareholders above 25% two years in a row. We have chosen a threshold different from the 20% identified by GC-100 and Legal & General. We cannot see a case for any mandatory action on remuneration being triggered by a level of opposition that would be insufficient to defeat a Special Resolution. Note that the difference in impact between 20% and 25% as a threshold is not great, with 20% capturing around 1 company in 10 in a given year, and 25% capturing 1 in 12[82]. This appears to us to be an appropriate proportion of companies to capture – representing approximately lower decile support levels. A threshold of 25% of the register could also be considered (representing around a 33% vote against given typical rates of participation in AGM votes). However, in our view this is too lenient a threshold especially for a "two strikes" approach.

Given that only around 3% of companies achieve this level of opposition two years in a row or lose their remuneration report advisory vote, this escalation mechanism would focus additional attention on a proportionate number of companies, where the pay policies are viewed as most problematic by shareholders. Note that this approach is similar to the Australian "two strikes" approach[79].

Any approach that involves "special measures" being triggered by a 25% threshold could be argued to give undue influence to proxy voting agencies: for example a "vote against" recommendation from ISS is typically associated with a vote against of c. 30% in the UK. We believe this fear may be overstated. Proxy voting agency recommendations typically reflect concerns of major shareholders, with whom they regularly consult on their voting guidelines. Proxy agencies can be a helpful agent for marshalling coherence in investor views on key issues, and for enabling stewardship activities to be carried out at reasonable cost. Moreover, it could be argued that any concerns about the use of proxy agency recommendations should be laid at the door of shareholders rather than the agencies themselves: proxy agencies only advise, investors decide. It is important that this separation of responsibilities is kept clear.

However, we do think that it would be good practice for some proxy agencies to have a more open approach to engagement on company-specific issues, particularly where they issue recommendations based on benchmark rather than tailored policies. There is evidence from the US that ISS recommendations do have a material causal impact on investor voting decisions[83]. In particular, we believe it would be good practice for proxy agencies issuing recommendations against benchmark policies to:

- Be open to engagement with companies and in particular to provide clear guidance, when proposals are likely to attract a negative recommendation;

- Take into account the views of a company's major shareholders, if public, when making voting recommendations, particularly, for example, when those shareholders are supportive of an unconventional approach taken by the company in the context of its strategy.

Equally, shareholders themselves should review whether, in their use of proxy voting agencies, they are taking their stewardship responsibilities sufficiently seriously.

We considered three possible remedies for companies triggering the binding vote regime.

Option (D) (i) – binding vote on incentive payments

A company triggering the binding regime could be required to bring forward their bonus and LTIP payments for binding shareholder approval for, say, each of the next three years.

The logic is that a company that had shown it was unable to operate its approved policy in manner securing the highest levels of shareholder support, would need to get binding shareholder approval for the key decisions made within that policy.

The proposal to require a binding vote on pay outcomes suffers from all of the disadvantages of binding votes outlined above. However, it would have the advantage that the costs of a binding vote would only apply to a small number of companies that had not been able to sustain high levels of shareholder support for how they implemented their remuneration policies. It is therefore a more proportionate approach than applying binding votes to all.

A further unsatisfactory feature of this approach is that the reasons for the shareholder opposition to the remuneration report may be quite different from the items subject to subsequent binding vote. For example, if a company has had its remuneration report voted down for over generous treatment of a departing executive (quite a common cause) it seems bizarre for the remedy to relate to bonus payments for the continuing CEO.

Option (D) (ii) – requirement to reapprove policy with a super-majority

A company triggering the binding regime could be required to bring their policy back for approval, at the next AGM requiring a super-majority of 75% to have it approved.

The logic here is that binding approval of a policy gives a company a licence to operate within that policy. A company that has shown an inability to maintain high levels of shareholder support for how they are operating the policy is required to come back to have that licence renewed.

The logic behind requiring a 75% majority on the policy vote when triggered in these circumstances is to create a clear deterrent for companies and Remuneration Committees. If the policy vote requires 75% vote to pass, this is likely to lead to a policy that is less flexible and written less in favour of executives. Therefore, when deciding whether to risk losing an advisory vote, or risk repeat opposition above the trigger level, Remuneration Committees would be clear that the downside would not just be the reputational consequences of the advisory vote itself, but potential practical reduction in future flexibility in the policy.

The main disadvantage of this approach is that it may be considered disproportionate ever to require a supermajority on a binding remuneration matter, given that much larger decisions relating to corporate activity, for example, can be taken on a simple majority. There is also a risk of giving undue influence to activist investors or proxy voting agencies.

To guard against this, the requirements could be implemented on a comply or explain basis through the UK Corporate Governance Code. If a company declined to bring forward a special resolution when a majority of shareholders wished them to do so, then shareholders could vote against re-election of Directors. Alternatively, if the proposal is implemented through legislation, then at the same AGM at which the policy is brought for re-approval, a parallel resolution could be tabled authorising the requirement of a super-majority. If this resolution were defeated, then a simple majority would apply to the policy vote. Therefore, if there were reason to believe that the vote could be subject to unintended consequences due to, for example, a large activist shareholder, it would be possible for a majority of shareholders to avoid being ‘held to ransom’ by a minority investor. This adds complexity, but is a necessary safeguard in extreme cases.

Option (D) (iii) – require a company to bring a binding vote of confidence in the work of the Remuneration Committee

A company that receives a vote in against of 25% or more on the advisory remuneration resolution is at risk of triggering our proposed binding regime at their next AGM. At that subsequent AGM a motion of confidence in the work of the Remuneration Committee would be tabled. If, at that subsequent AGM, the vote against the advisory resolution is again more than 25%, then the result of the vote of confidence becomes active and must be made public. If the vote of confidence is lost, then the Board must, within three months of the AGM make a statement as to the action they are going to take to rebuild confidence in the Remuneration Committee's work, which must, at least, include replacement of the Chair of the Remuneration Committee (although that does not imply the individual's removal as a Director).

Note that this approach bears some comparison to the Australian "two strikes" rule. Under that rule, following one vote of 25% against, the next AGM has a "spill resolution" such that if the remuneration report again receives votes of 25% or more against, shareholders can require an AGM at which the directors stand for re-election[80].

We are not recommending the Australian approach here for two reasons. First, the UK (unlike Australia) has annual re-election of directors in any case. Therefore shareholders can hold directors accountable if they wish at the next AGM (and indeed some shareholders have a policy of escalating to vote against the chair of the Remuneration Committee if they have to vote twice against the remuneration report). Second, the low incidence of votes against Directors (and the tiny number of cases there have been in Australia of the spill meeting being triggered) suggests that shareholders do not see this as a proportionate response to a remuneration matter.

The purpose of the trigger mechanism is to provide a deterrent against a Remuneration Committee tolerating repeated high levels of shareholder opposition. But the remedy should not be so great as to destabilise the company. This is why the approach suggested within this option in effect allows shareholders to bring about a change in the Remuneration Committee chair if the binding regime is triggered, without having to vote a director off the board. It could be argued that the reputational incentive to avoid this possibility will be sufficient to make companies more reluctant to drop below the 25% threshold, and thus to avoid being "repeat offenders".

Summary

The complexity of the approaches outlined above, and the potential unintended consequences show that it is not easy to improve on the UK's current regime. Indeed a case could be made that any further regulatory intervention in this area is unwarranted, given that shareholders already have escalation mechanisms available to them. However, the political context is such that a workable proposal for further binding votes is required, and on balance our preference is option D (ii), requiring companies subject to the escalation mechanism to bring their policy back for approval with a super-majority.

Although the current voting system works well, we believe that, at the cost of some complexity, our proposed policy could helpfully increase the impact of the existing non-binding vote, while focussing on the 3% or so of companies with the most problematic pay practices. The approach would not create additional cost or disruption for the c. 97% of companies who neither lose their advisory votes nor receive 25% or more vote two years in a row. Given the requirement to build public confidence in the shareholder voting system, we believe an escalation option is worthy of further consideration. The proposed approach works with the grain of, and strengthens, the current system.

Appendix: Implementation of Design Recommendations via Amendment of the UK Corporate Governance Code

We do not believe that the Government should be legislating for pay design. Ideally new pay guidelines would emerge through market mechanisms and update to investor guidelines. Indeed some progress has been made this year, with the work of the Investment Association Executive Remuneration Working Group[28]. However, the implementation of this group's work into the Investment Association guidelines[38] somewhat suggests that simplified plans based on long-term shareholding should be the exception rather than the rule. Our view is that encouragement could be given to the market through review of the UK Corporate Governance Code.

For example, the Main Principle D.1 of the Code could be amended as follows:

Executive directors' remuneration should be designed to promote the long-term success of the company. Packages should be structured so that exposure to the long-term value of the company counterbalances any shorter-term incentives created by performance-related elements. Performance-related elements should be transparent, stretching, and rigorously applied~~.~~

Schedule A of the Code could also be amended as follows.

Schedule A: The design of performance-related remuneration for executive directors

Balance

The Remuneration Committee should determine an appropriate balance between fixed and performance-related, immediate and deferred remuneration. Performance conditions, including non-financial metrics where appropriate, should be relevant, stretching and designed to promote the long-term success of the company and fulfilment of its purpose. Remuneration incentives should be compatible with risk policies and systems. Upper limits should be set and disclosed.

The Remuneration Committee should be aware of the potential for target-based plans, even long-term incentive plans, to encourage short-term behaviour to the detriment of long-term value creation. Particular consideration should therefore be given to the balance of incentives arising from target-driven plans and from exposure to the long-term value of the company through holding shares. The Remuneration Committee should consider whether the leverage or volatility of the company means that executives should be partly paid in the form of long-term deferred cash compensation, in effect unsecured debt.

~~The Remuneration Committee should consider whether the directors should be eligible for annuls bonuses and / or benefits under long-term incentive schemes.~~

Share-based remuneration

~~Traditional share option schemes should be weighted against other kinds of long-term incentive scheme. Executive share options should not be offered at a discount save as permitted by the relevant provisions of the Listing Rules.~~

Any new long-term incentive schemes which are proposed should be approved by shareholders and should have regard to the principle that remuneration should be simple and transparent ~~preferably replace any existing schemes or, at least, form part of a well-considered overall plan incorporating existing schemes~~. The total rewards potentially available should not be excessive.

The Remuneration Committee should consider the appropriate level of target-based performance incentives, having regard to the potential risks of short-termism that can arise. Mitigation of these risks can be achieved through ensuring that packages result in executives being exposed to high and long-term levels of shareholding. For share based remuneration, the Remuneration Committee should consider as a counterbalance to target-based incentives: appropriate levels of vested and unvested stock awards, requiring directors to hold a minimum number of shares and to hold shares for a further period after vesting or exercise, including for a period after leaving the company, subject to the need to finance any costs of acquisition and associate tax liabilities. In normal circumstances, packages should be structured to ensure exposure to the long-term share price over five to seven years depending on sector, and for two to three years after leaving the company. Shares should be released for sale on a phased basis rather than triggered for block-release, for example on retirement. ~~shares granted or other forms of deferred remuneration should not vest or be paid, and options should not be exerciseable, in less than three years. Longer periods may be appropriate. Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.~~

Pensions

The Remuneration Committee should consider the level of pension that is appropriate for executives in light of benefits offered to the wider workforce, and in light of the fact that pension benefits for high earners now have limited tax effectiveness. The Remuneration Committee should consider whether the principles of simplicity and transparency are better served by moving the value of pension into other elements of the package such as fixed pay, share awards, or long-term deferred cash compensation. Where pensions are offered, ~~In general~~, only basic salary should be pensionable. The Remuneration Committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

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Launched in September 2011, Big Innovation Centre is a hub of innovative companies and organisations, thought leaders, universities and 'what works' open innovators. Together we test and realise our commercial and public-purpose ideas to promote company and national innovative capabilities in a non-competitive and neutral environment. We act as catalysts in co-shaping innovation and business model strategies that are both practical and intellectually grounded. Our vision is to help make the UK a Global Open Innovation and Investment Hub by 2025, and to build similar initiatives internationally. For further details, please visit www.biginnovationcentre.com