CFA UK is a member society of

Executive Pay Discussion Paper
Business Environment
Department of Business, Innovation and Skills
1 Victoria Street
London SW1H 0ET

21st November 2011

Dear sir/madam,

The Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to respond to the Department's consultation on executive remuneration. Much of our response is based on our responses to the Department's previous calls for evidence related to the Long-Term Focus for Corporate Britain[1] and the Kay Review. Consequently, we will only answer some of the questions.

CFA UK is concerned that given the desire for growth and prosperity the Department continues to focus on publicly listed companies in these consultations. There are more than four million businesses in the UK of which 2.6 million are companies; only a small proportion (9,950)[2] of these companies are publicly listed. All of these businesses should have the appropriate remuneration structures that ensure that senior executives generate economic value.

As can be seen from the evidence cited in the consultation this is the latest in a long historical series of assessments and light touch approaches to the issue of executive remuneration. Based on the publication of this latest document the previous initiatives have not been as successful as anticipated and so the Department requires an approach that understands the limitations of the current practices while aligning any policy initiatives to first principles and a thorough assessment of the root causes rather focusing on the symptoms.

This response has been prepared by the CFA UK's Market Practices and Professional Standard Committee, with support from the Financial Reporting and Analysis Committee on behalf of the CFA UK membership. The society has surveyed members in relation to key elements of the Kay Review and has included the relevant results regarding execute remuneration. Department's paper. We make observations and cite evidence that we believe to be important and which we hope will be useful in informing the Department when it comes to achieving its policy objectives.

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 9,000 leading members of the UK investment profession most of whom work as front office investment professionals (managing portfolios, researching securities and advising on asset management). The society, which was founded in 1955, is one of the largest member

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[1] CFA UK response to Long Term Focus for Corporate Britain
https://secure.cfauk.org/assets/2162/CFAUKDBIS_Long_Term_responseSENT.pdf

[2] Companies House November 2010

societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the chartered financial analyst (CFA) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has 111,000 members in 135 countries, of whom more than 101,000 hold the Chartered Financial Analyst® (CFA®) designation.

In December 2007 CFA Institute published "The Compensation of Senior Executives at Listed Companies: A Manual for Investors[3]. As a supplement to The Corporate Governance of Listed Companies: A Manual for Investors, this manual builds awareness of how executives are paid and describes the governance structures that help set compensation plans within companies. Although it is written from a U.S standpoint, it is valuable to gain insights into what investors are looking for when it comes to assessing the remuneration structures.

The regularity with which the issue of remuneration grabs the attention of policymakers demonstrates the unwillingness of policymakers to focus on the structural drivers of senior executive pay and to understand if these are appropriate.

Senior executive remuneration is dependent on the following factors-

1. Value generation – the extent to which the company generates economic profits
2. The robustness of the metrics used to establish a direct link between the performance of the executive team and the ability of the company to generate economic profits
3. The courage, expertise and independence of the Board to understand whether or not the senior executives generate economic value.

As we ask in our response to the Kay Review

- How many senior board members of UK publicly listed companies know the cost of capital for their companies?

- How many board members know the extent to which their companies generate returns that cover their cost of capital?

CFA UK is less concerned about the magnitude of the remuneration and more concerned with how this outcome is achieved. CFA UK agrees that failure should not be rewarded; likewise executives should not be penalized excessively when they fall short of their targets owing to material factors beyond their control. Furthermore, it is essential that the checks and balances provided by the Board and the remuneration committees are robust enough to act in the interests of the shareholders and demonstrate that their position is not conflicted. Enron had an exemplary Board on paper, but lacked the independence or awareness to raise pertinent issues.

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[3] The Compensation of Senior Executives at Listed Companies: A Manual for Investors, http://www.cfapubs.org/toc/ccb/2007/2007/8

The way forward is to

1) Align more closely senior executive (and potentially independent director) remuneration with value generation.

2) Ensure that the remuneration committee members have the appropriate skills, courage and expertise to ensure that remuneration is aligned with value generation.

3) Have in place effective governance mechanisms that ensure that should deviations arise in either or both of points 1 and 2 above, that the executives and non-executives responsible are held to account.

Evidence

Publicly listed companies, like any business, generate value when they generate economic profits - returns that meet or exceed the cost of capital. To ensure company managers focus on value generation, they are exposed to other market participants that are focused on generating returns for themselves or their investors. As the evidence in the UK indicates, corporate managers are prone to focus on accounting profit and use metrics to determine their remuneration that may not be aligned with value generation.

In general, greater transparency over director's pay would enable shareholders to make more informed decisions when exercising their advisory vote over remuneration packages. Moreover, greater clarity in remuneration disclosures and over corporate governance practices in general may encourage investors to take a more active role with respect to exercising their rights. The current opacity in disclosures – largely a function of complexity and use of boilerplate – deters investors from seeking to exercise their rights.

Investors have a role to play in exerting market discipline although this may not always be possible given that the UK capital markets are not frictionless and incomplete. Limits to arbitrage are a significant barrier for market participants to reduce mis-pricing or express a positive or negative view about a company. The evidence on limits to arbitrage is extensive and in the Kay Review we have cited the most recent empirical study.

In a recent survey conducted by CFA UK of members that analysed or invested in equities -

1. 88% of respondents agreed (or strongly agreed) that to generate economic value a publicly listed company should at least cover its weighted cost of capital (equity and non-equity). 56% of respondents disagreed (or strongly disagreed) that remuneration structures at UK listed companies were focused on delivering economic value.

2. 63% of respondents felt that the Board and senior executives of UK listed companies paid too much attention to short term share price movements.

Setting the right targets for performance measurement is the fundamental challenge behind incentive schemes. Using less than robust performance metrics related to share price and earnings per share (EPS) encourages gaming, promotes short-term behaviour and encourages the practice of earnings management. Remuneration committees should have the skills, courage and expertise to counter such practices. We set out extensive evidence in our Kay Review response about the issue of earnings management, which can be summarized as follows[4] –

- UK firms that have low profitability or high leverage are more likely to use earnings management.

- Earnings management is also used by firms that are seeking debt or equity capital or on the verge of debt covenant violations.

- Earnings management is more likely when it will support compensation arrangements and to meet/exceed analysts' forecasts.

The practice of inappropriate earnings management is not mitigated by equity ownership even if the non-executive directors own equity in the firms they oversee.

Despite the lack of robustness of performance metrics related to share prices and EPS they continue to dominate the structure of remuneration packages for UK listed companies (please see Charts 1 and 2) as reported by Pricewaterhouse Coopers.. This raises the question as to why remuneration committees continue to allow such metrics to be used. In addition, this also raises questions about the expertise and independence of remuneration committee members that allow these contracts to be implemented.

Chart 1 highlights the dominance of total shareholder return (TSR) and EPS as metrics for assessing performance of Chief Executive Officers of FTSE 100 companies for their deferred bonuses, share option schemes and long term incentive plans (LTIPs).

To some extent the PwC report identifies growing frustration with the use of TSR and ESP and there have been more use of other measures. However, it appears that there may be challenges with calibrating these other measures with performance and so companies use relative TSR.

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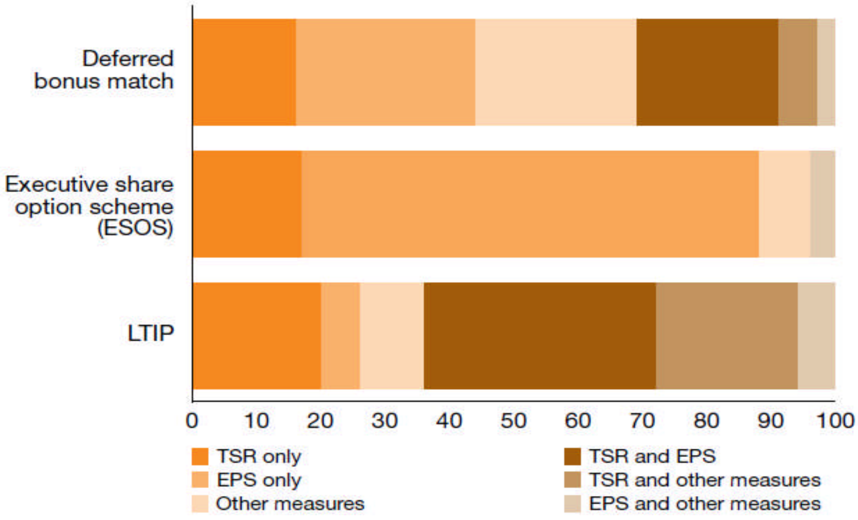
[4] Bos, Sebastian, Pendleton, Andrew and Toms, Steve, Earnings Management in the UK: The Non-Linear Relationship Between Managerial Ownership and Discretionary Accruals (January 25, 2011). Available at SSRN: http://ssrn.com/abstract=1747919

Gore, Pelham; Pope, Peter F.; Singh, Ashni K. "Earnings management and the distribution of earnings relative to targets: UK evidence." Accounting & Business Research, 2007, Vol. 37 Issue 2, p123-149, 27p

Graham, John, R., Harvey, Campell, R., Rajgopal, Shiva, "Value Destruction and Financial Reporting Decisions," Financial Analysts Journal, vol. 62, No. 6 (November/December 2006): 27-39

Iatridis, George; Kadorinis, George , "Earnings management and firm financial motives: A financial investigation of UK listed firms." International Review of Financial Analysis, Sep2009, Vol. 18 Issue 4, p164-173, 10p; DOI: 10.1016/j.irfa.2009.06.001

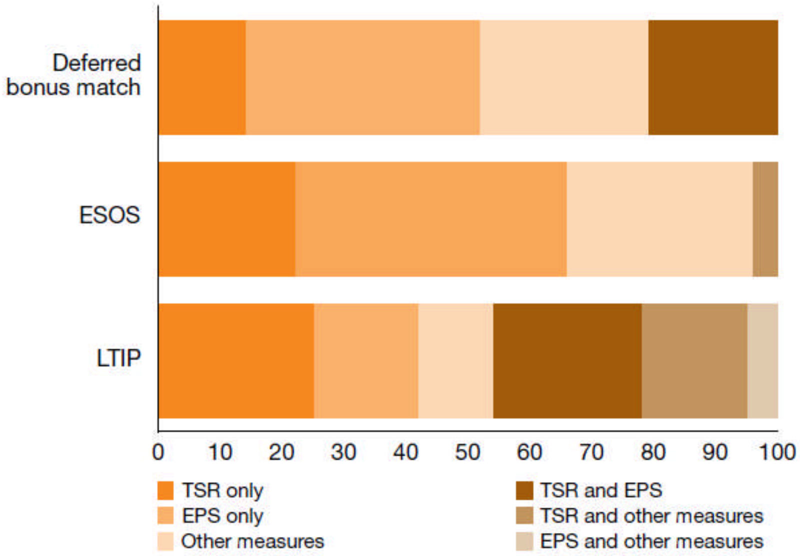
Chart 1 metrics used for FTSE 100 CEOs



Source: Annual reports, PwC-Monks database, IVIS

Chart 2 shows that for FTSE 250 CEOs the metrics are little different. Other measures remain a minority among the metrics used.

Chart 2 remuneration metrics for FTSE 250 CEOs



Source: Annual reports, PwC-Monks database, IVIS

Conclusion

CFA UK remains concerned that the UK Government has a partial approach to remuneration. The topic of the magnitude of remuneration for the senior managers of publicly listed companies is not new and recurs with alarming regularity and what is more surprising is that the previous policy pronouncements of the past have had little impact.

CFA UK suggests that these failings are because the issue is not examined in a way that understands the root causes of the perceived problem.

A review of the drivers that determine senior executive remuneration is required. This should consider –

1. To what extent is remuneration aligned with value generation?

2. The extent to which independent directors have the expertise, courage and objectivity to fulfill their duties.

3. The efficacy of the Code on Corporate Governance.

4. How senior executives and remuneration committee members are held to account.

Unless the structural drivers are addressed, little progress will likely be made in resolving the issue of apparently inappropriate senior executive remuneration.

Executive Remuneration: Discussion Paper.
Response form

Please send your response by: 25 Nov 2011

About You	
Name:	Organisation (if applicable): **CFA Society of the UK**
Email:sradia@cfauk.org	Address: 2nd Floor 135 Cannon Street London EC4N 5BP

I am responding on behalf of (please tick)	
	Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
√	**Investor representative organisation**
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant
	Other (e.g. consultant or private individual)

Questions

Role of shareholders

1. Would a binding vote on remuneration improve shareholders' ability to hold companies to account on pay and performance? If so, how could this work in practice?

Yes	No
	No
Comments	

2. Are there any further measures that could be taken to prevent payments for failure?

Yes	No
Yes	
Comments	
Have a more effective set of independent directors and align remuneration of senior executives with value generation rather than using metrics that are unreliable and can be gamed. Make remuneration committee members just as accountable as the executive directors.	

3. What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

Comments
As long as these representatives had the expertise, skills and were impartial than the benefits would outweigh any costs.

Role of remuneration committees

4. Would there be benefits of having independent remuneration committee members with a more diverse range of professional backgrounds and what would be the risks and practical implications of any such measures?

Yes	No
Yes	
Comments	
Essentially an independent remuneration committee should demonstrate that it is free of conflict, impartial and willing to challenge when	

appropriate. As we observed at Enron and in some UK financial companies the impartiality of even the most cosmetically appealing Board members can often lack the substance required to overcome Groupthink. Perhaps all independent directors should abide by a professional code of ethics and standards of practice akin to the one required of members of the CFA Institute and CFA UK.

5. Is there a need for stronger guidance on membership of remuneration committees, to prevent conflict of interest issues from arising?

Yes	No
	No
Comments	
As we have seen in other areas where guidance is used, it often does not have the desired effect. The Code on Corporate Governance needs to be supervised more thoroughly and enforced effectively; if this is not possible then stronger regulatory requirements should be put into place to set out the duties and expertise required of independent directors.	

6. Would there be benefits of requiring companies to include employee representatives on remunerations committees and what would be the risks and practical implications of any such measures?

Yes	No
Yes	
Comments	
People with the appropriate skills and expertise should not be excluded from such committees especially if they have the capacity and courage to challenge. However, employees may run the additional risk of losing their jobs should they oppose such contracts and may be prone to support them.	

7. What would be the costs and benefits of an employee vote on remuneration proposals?

Comments

8. Will an increase in transparency over the use of remuneration consultants help to prevent conflict of interest or is there a need for stronger guidance or regulation in this area?

Yes	No
	No

Comments
CFA UK believes that there is a large gap between transparency and understanding. The key will be for those that can assess the rationale for the proposals put forward by these consultants and whether or not they align with value generation or another set of metrics that are not at all aligned with value generation.

Structure of remuneration

9. Could the link between pay and performance be strengthened by companies choosing more appropriate measures of performance?

Yes	No
Yes	
Comments	
As CFA UK has stated regularly in these related consultations, the link between value generation and remuneration needs to be established; in addition, such structures need to be supervised effectively and executives held to account. Furthermore the independent directors should have the skills and expertise to recognise and address gaming of the remuneration contracts. It is time that remuneration ceases to use weak, malleable metrics that have asymmetric pay-off profiles i.e disproportionate rewards regardless of the outcome.	

10. Should companies be encouraged to defer a larger proportion of pay over more than three years?

Yes	No
Yes	
Comments	

11. Should companies be encouraged to reduce the frequency with which long-term incentive plans and other elements of remuneration are reviewed? What would be the benefits and challenges of doing this?

Yes	No
Comments	
No comment	

12. Would radically simpler models of remuneration which rely on a directors' level of share ownership to incentivise them to boost share value, more effectively align directors with the interests of shareholders?

Yes	No
	No
Comments	
The evidence on this issue is clear. According to one UK study earnings management increases for equity stakes between 5% and 10%, but then accruals based earnings management is mitigated for ownership stakes above 15%. Furthermore, the study also finds that equity ownership by non-executive directors does not mitigate earnings management.	

13. Are there other ways in which remuneration - including bonuses, LTIPs, share options and pensions – could be simplified?

Yes	No
Yes	
Comments	
The components of remuneration are less of an issue than how they are triggered.	

14. Should all UK quoted companies be required to put in place claw-back mechanisms?

Yes	No
Yes	
Comments	
If it is discovered that during the tenure of senior management the company engaged in activity that was not connected with value generation then those responsible should be held to account. In addition, the independent Board members that allowed such activity to take place should also be held to account as they have failed in their duty.	

Promoting good practice

15. What is the best way of coordinating research on executive pay, highlighting emerging practice and maintaining a focus on the provision of accurate information on these issues?

Comments

CFA UK would be glad to meet with DBIS to discuss this issue further

We hope that the CFA UK's response is helpful to the Department and would be open to further discussions with the Department about any of the points we have raised.

Yours,

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