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Response to Green Paper (Nov 2016) - Corporate Governance Reform

The CFA Society of the UK (CFA UK) represents about 12,000 investment professionals working across the financial sector including portfolio managers, buy-side analysts, sell-side analysts and credit rating analysts, among others. Our mission is to educate investment professionals, to promote high ethical and professional standards and to explain the profession to our stakeholders. For advocacy purposes, our members are represented by several committees including the Market Integrity and Professionalism Committee and the Financial Reporting and Analysis Committee. Given that corporate governance is an important topic to both these committees they have provided a joint response on behalf of CFA UK members.

As the introduction of the green paper states "the behaviour of a limited few has damaged the reputation of the many". This suggests that on the whole corporate governance in the UK works reasonably well although the public's perception is less positive. We agree that UK corporate governance is of a high standard, particularly in comparison with some other European countries. As such we do not believe there is a need for significant change to the existing policies regarding corporate governance. Nonetheless, we are happy to see some tightening up of the existing rules. In particular, we would welcome a strengthening of the corporate governance framework for the UK's largest, privately-held businesses in order to level the playing field between public and private equity capital markets.

Both the Prime Minister's and the Secretary of State's comments in the Green Paper list executive pay – and the need to align executive pay with long-term performance - as the first item on which they comment. This is telling. There are reasons beyond executive pay that a Green Paper might have been considered, but it is clear that the desire to improve the ability of investors and remuneration committees to affect executive pay has significantly influenced the Green Paper's timing.

CFA UK recently supported research undertaken by Lancaster University Management School that suggests that the link between performance-related pay structures and economic value creation is weak.

The research is based on an analysis of Chief Executive Officer (CEO) pay structures and their alignment with corporate value creation for FTSE-350 companies over the period 2003-2014/15. Companies create value when they generate economic profits, defined as returns to all capital providers in excess of the weighted average cost of raising funds. Economic profits differ from accounting profits and share returns because the latter metrics do not include a charge for the full cost of invested capital.

The report's key findings are summarised below:

- Total annual realized pay for the median FTSE-350 CEO during the sample period is £1.5 million measured at 2014 prices. Total pay for the median CEO has increased by 82% in real terms over the period, with an otherwise linear trend halted only by the financial crisis in 2008-2009 when pay levels slipped back to 2006 levels.
- The level of value creation over the same period has been low in absolute terms and erratic from year to year. The median FTSE-350 company generated little in the way of a meaningful economic profit over the period 2003-2009 (i.e., after adjusting for the full cost of funds), and although performance improved from 2010 onwards the median firm generated less than 1% economic return on invested capital.
- Simplistic metrics of short-term performance such as earnings per share (EPS) growth and total shareholder return (TSR) are the dominant means of measuring performance in CEO remuneration contracts. Worryingly, these metrics correlate poorly with theoretically more robust measures of value creation that relate performance to the cost of capital.
- Pay is correlated with value generation at a primitive level: CEOs generating positive economic profits receive 30% higher median total pay than their counterparts generating negative economic profits. Pay outcomes also distinguish between value creation realized in share prices and value creation that remains unrealized.
- Despite relentless pressure from regulators and governance reformers over the last two decades to ensure closer alignment between executive pay and performance, the association between CEO pay and fundamental value creation in the UK remains weak.

A copy of the research paper is attached with this response as Annex A.

Remuneration committees have spent more time than ever before this year in reaching out to shareholders and stakeholders to discuss compensation structures. There is an intense focus on pay levels coupled with calls to find better ways of aligning senior executives' incentives with long-term value creation. We welcome the Green Paper as an opportunity to extend and advance that debate.

Executive pay

Q1: Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

According to table 2 in the green paper (page 21) since 2013 only 4 out of 272 annual remuneration reports by FTSE 100 companies were rejected by shareholders. None of the 645 remuneration reports of FTSE 250 companies were rejected and only 2 of the 697 FTSE Small Cap reports were rejected. Furthermore, the average percentage of votes in favour of the Annual Remuneration Report was 90% or higher for all three groups (FTSE

100, 250, Small Cap). It is indeed clear that the issue is the behaviour of a limited few, not of the many.

These statistics do not suggest to us a high degree of dissatisfaction among shareholders with the current system. As such many of the proposals suggested by the green paper appear to be unduly forceful. The option that appears most proportionate is (ii 1.22) where a company that does lose its annual advisory vote on remuneration should be required to hold a binding vote on the remuneration policy the following year, perhaps with a supermajority voting threshold. This would lead to a greater tension in the dialogue between investors and companies and so effective change to remuneration structures and approaches, without making structural alterations to the relationship between board and shareholder.

Q2: Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

We find the percentage turnout for annual remuneration report votes of 72% for FTSE 100, 71% for 250 and 60% for Small Cap disappointing, and would like to see higher turnouts.
We believe that the majority of institutional shareholders already exercise their voting powers on behalf of the clients who invest in their funds. Some of this voting is undertaken by in house corporate governance teams and some is outsourced to proxy advisers. Retail investors are less likely to vote but only have a collective shareholding in UK listed companies of around 12%.

Option (i), mandatory disclosure of voting records, is unlikely to increase voting by institutional investors. Most major institutions already make full voting disclosures. Those investors who currently choose not to vote clearly do not see voting as important to their business model and marketing, hence mandatory disclosure of their non-voting is only likely to cause mild embarrassment.

Option (ii), the senior shareholder committee, is unlikely to increase voting turnout as the largest shareholders are highly likely already to exercise their voting rights.

Option (iii), encouraging retail shareholders to vote, is admirable but may be hard to realise in practice. Retail shareholders are unlikely to want to pay to cover the costs for brokers to enable their electronic voting. Moreover, as mentioned above, retail investors only hold 12% of UK shares.

Q3: Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

Undoubtedly there is room for improvement in the effectiveness of remuneration committees and their advisers.
Option (i), requiring the remuneration committee to consult shareholders and the wider company workforce, is worthy but care needs to be taken to avoid a box ticking exercise with little impact. The level of engagement between shareholders and companies is

extremely high, and the degree of existing consultation is one reason why there is general support when the time comes to vote on proposals – we would also argue that it is one reason why increases in pay in the UK have been markedly more restrained than elsewhere in the past few years. Quite how the workforce's views on executive pay would be taken on board, if at all, is unclear, but we believe that this could be worth exploring, to provide some useful input to board thinking.
Option (ii), requiring the chairs of remuneration committees to have served for at least 12 months on a remuneration committee before taking up the role, seems sensible and we support this proposal.

Q4: Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

Reporting the ratio between CEO compensation and median worker pay would not add much value to investors. Annual reports often contain the total employee costs and number of employees so an average worker pay (usually similar to the median) can already be calculated. Combined with the single annual pay figure for each member of the executive board that quoted companies have had to disclose since the 2013 pay reforms, investors are already able to calculate such ratios and compare across companies and different industries. The comparison across companies and sectors of this ratio is limited, given differences in business models and employee structure. The value-add might be to discourage companies from increasing the ratio over time and to provide a discipline to board thinking on the issue.

On the other hand, the suggestion by the Investment Association to require the disclosure of the pay ratio between the CEO and the rest of the executive team would provide some incremental insight which would be of interest to investors.

Q5: Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

We do not believe that the bonus targets for the top executives are likely to be commercially sensitive as these are usually based on group wide earnings. We believe the sensitivity over revealing the targets is more likely to relate to investor expectations' management (consensus earnings).

We support the ongoing increase in non-legislative pressure on companies through the Investment Association and other shareholder advisers to provide full disclosure of performance targets. We would like to see the FRC strengthen its remuneration guidance in this area. As a compromise to commercial sensitivity we would be happy for companies to make retrospective disclosure of all bonus targets with a one-year delay.

Q6: How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

With their vote on remuneration policy, shareholders already have a voice in the use and structuring of LTIPs. However, we favour any efforts to simplify executive remuneration (e.g. using restricted share awards instead of LTIPs) so that shareholders might better understand what it is they are voting on, and executives have a clearer line of sight between their actions and the reward they receive. The simplest form of compensation is cash. One proposal would be a cash bonus combined with a requirement for executives to use a portion of their cash award to buy shares with a minimum holding period.

Increasing the holding period for share options from three to five years is unlikely to have a significant impact on short-termist behaviour, but we would certainly not oppose it.

Strengthening the employee, customer and wider stakeholder voice

Q7: How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

Existing UK legislation (Companies Act 2006) already requires the directors of a company have regard for the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and others, and the impact of the company's operations on the community and the environment.

Unfortunately, there are some, albeit rare, examples of companies that operate with little regard for employees or the environment. However, rather than introducing new legislation these cases are perhaps best dealt with by more fully enforcing existing laws.

Few companies are in the position where they can operate without putting their customers' interests foremost and hence we see little need for advisory panels to protect consumers' interest. A competitive market is the consumers' champion. Just as there are few monopolies, there are also few monopsonies in an efficient market. Where companies do have significant buying power and their suppliers are highly dependent on them, it is generally in the best interests of a company that is managed for the long term to foster long term win-win trading relationships with its suppliers.

Option (i), stakeholder advisory panels, is a reasonable idea but we see no need to mandate for companies.
Option (ii), NEDs to represent interest groups (e.g. employees), is an interesting idea, but we regard the unitary nature of the Board as an important characteristic of a well-functioning Board. As a consequence, we are opposed to individual NEDs having a mandate to represent specific stakeholder voices. We believe it is important that the Board should have access to these views and suggest that it might be helpful for reporting requirements to be extended to ask companies to comment on how the Board has engaged stakeholders so that their views are incorporated into the Board's decision-making.

Option (iii), appointing individual stakeholder (e.g. employee) representatives to company boards, seems to be an unwelcome change given that directors' main duty is to the members of the company (its shareholders), while having regard for the interest of the employees (and other stakeholders).
Option (iv), as we comment above, we support strengthening reporting requirements related to stakeholder engagement in principal, but are concerned that these requirements should be relatively specific and not open ended. We would be reluctant to impose more reporting requirements on companies only to get boiler plate disclosure in return.

Perhaps rather than mandatory changes these proposals could be put forward as options for companies to choose from in order to give effect to their Companies Act obligations. This comply or explain mindset might argue for this to be given effect through a change to the Corporate Governance Code, as per our response to Question 9.

Q8: Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

Any steps to strengthen the stakeholder voice should apply equally to all companies, not a particular "type". If additional requirements are imposed, then we would suggest this only be for companies of a significant size, for example over 1,000 employees.

Q9: How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

We would prefer any reform to be voluntary in the first instance or code-based, for example as part of the FRC's Corporate Governance Code.

Corporate governance in large, privately-held businesses

Q10: What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

The institutional fund management industry invests in privately-held business via private equity and corporate bonds. They therefore have an interest in the strong corporate governance of these businesses. As such we would generally welcome a strengthening of the corporate governance framework for the UK's largest, privately-held businesses.

Q11: If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

According to table 6 of the green paper (page 56) there are 2,660 privately-held companies with more than 1,000 employees in the UK. This could be an appropriate, though arbitrary, threshold for any strengthening of corporate governance.

Q12: If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

In the first instance we would suggest a voluntary approach. As enhanced corporate governance is increasingly seen to add value we would expect it to become a condition of loans, bond issuance and private equity fund raisings.

Q13: Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

That presumably depends on what the requirements are. Generally, we would expect the most stringent requirements to apply to large, publicly listed companies where ownership and control are normally separate. Shareholders of privately-held companies usually have greater ability to influence the company and therefore do not generally need the same protections.

Other issues

Q14: Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

Corporate governance standards in the UK have improved significantly since the early 1990s and are generally among the highest in the world. At the same time, we do not believe that the costs to meet these standards are particularly onerous for companies. While examples of poor corporate governance do surface from time to time we feel that on the whole the UK has struck the right balance and we would urge the government to take care not to upset this with any radical changes to the existing legislation. If changes can be identified that demonstrably add value for shareholders these should be effected through the provisions of the FRC's corporate governance code.

CFA Society
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We trust that these comments are useful and would be pleased to discuss them in person.

Yours sincerely,

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<u>About CFA UK and CFA Institute</u>

The CFA Society of the UK (CFA UK) represents the interests of more than 10,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member 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 more than 135,000 members in 140 countries, of which more than 120,000 hold the Chartered Financial Analyst (CFA) designation.