Financial Reporting Council

October 2013

Directors' Remuneration

Consultation Document

The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

The Financial Reporting Council Limited is a company limited by guarantee. Registered in England number 2486368. Registered Office: 5th Floor, Aldwych House, 71-91 Aldwych, London WC2B 4HN.

Contents

Page

INTRODUCTION

1. In June 2012 the FRC agreed to a request from the Government to consult on whether to amend the UK Corporate Governance Code ("the Code") to address a number of potential issues relating to executive remuneration. The FRC decided that the consultation should be conducted after the Government's legislation on voting and reporting on executive remuneration had been finalised. That legislation has now been enacted and came into force on 1 October 2013[1].

2. The Government asked the FRC to consult on three specific proposals: relating to clawback arrangements, whether non-executive directors who are also executive directors in other companies should sit on the remuneration committee, and actions companies might take if they fail to obtain a substantial majority in support of a resolution on remuneration. These proposals are discussed in more detail below.

3. The FRC has not yet taken a decision on whether, in principle, changes to the Code are required. The FRC is committed to ensuring that any changes to the Code are supported by strong evidence demonstrating the need for change. It is particularly important that we ascertain the views of investors and companies. We encourage both to respond to this consultation.

4. We hope that respondents will develop their views on whether there is any need for Code changes in the light of the new legislation, the guidance on implementing the new reporting requirements produced by the GC100 and Investor Group[2], and the Financial Conduct Authority's current consultation on consequential changes to the Listing Rules[3].

5. In addition to the three specific issues on which the FRC is consulting, we would also welcome views on whether there is a need for any other changes to the remuneration sections of the Code. The relevant sections of the Code are appended to this consultation document.

6. If any changes to the Code are ultimately proposed, they will be subject to consultation in the first quarter of 2014. The new Code would then apply to accounting periods beginning on or after 1 October 2014.

Financial Reporting Council

October 2013

[1] New requirements related to voting on remuneration policies have been enacted in the *Enterprise and Regulatory Reform Act 2013*. Details of the information companies must disclose in their remuneration reports are set out in the *Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013*.
[2] *The Directors' Remuneration Reporting Guidance* was published in September 2013.
[3] *CP13/7 – Changes to the Listing Rules resulting from new regulations being implemented by BIS*.

HOW TO RESPOND

Comments on the questions set out in this consultation document are requested by Friday 6 December. Responses should be sent by e-mail to remcon@frc.org.uk

or in writing to:

Catherine Woods
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

It is the FRC's policy to publish on its website all responses to formal consultations unless the respondent explicitly requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure. The FRC do not edit personal information (such as telephone numbers or email addresses) from submissions; therefore only information that you wish to be published should be submitted.

ISSUES ON WHICH VIEWS ARE SOUGHT

Extended Clawback Provisions

7. Announcing the Government's proposed legislation in January 2012, the Secretary of State for Business, Innovation and Skills said: "We must deal with the specific issue of payments for failure. Some of our consultees have argued that all quoted companies, not just financial services companies, should have a clawback mechanism in place, and we will be asking the Financial Reporting Council to revise the Corporate Governance Code to require all large public companies to adopt clawbacks".

8. The Code currently states (in Schedule A) that "consideration should be given to the use of provisions that permit the company to reclaim variable components [of remuneration] in exceptional circumstances of misstatement or misconduct".

9. The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013 ("the Regulations") that came into effect on 1 October 2013 require companies to disclose in the directors' remuneration policy "whether there are any provisions for the recovery of sums paid or the withholding of the payment of any sum" (Part 4 paragraph 26(e)). In the annual remuneration report (Part 3 paragraph 8(2)) companies are required to disclose details of any sums recovered or withheld, and the reason why. The terminology used in the Code does not explicitly distinguish between recovering and withholding of variable pay.

Is the current Code requirement sufficient, or should the Code include a "comply or explain" presumption that companies have provisions to recover and/or withhold variable pay?

Should the Code adopt the terminology used in the Regulations and refer to "recovery of sums paid" and "withholding of sums to be paid"?

Should the Code specify the circumstances under which payments could be recovered and/or withheld? If so, what should these be?

Are there practical and/or legal considerations that would restrict the ability of companies to apply clawback arrangements in some circumstances?

Remuneration Committee Membership

10. Announcing the Government's proposed legislation in January 2012, the Secretary of State said that where remuneration committee members are executives in another FTSE 350 company "there is a perceived conflict as these individuals have a personal interest in maintaining the status quo in pay setting culture and pay levels. I will ask the Financial Reporting Council to amend the UK Corporate Governance Code to put an end to the practice of serving executives sitting on the remuneration committees of other large companies."

11. The Code currently states that "the board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition the company chairman may also be a member, but not chair, of the committee if he or she was considered independent on appointment as chairman" (Provision D.2.1). Executive directors of other companies would normally be classified as independent unless they "hold cross-directorships or have significant links with other directors through involvement in other companies or bodies" (Provision B.1.1).

12. The percentage of FTSE 350 companies whose remuneration committees include individuals who are also executive directors on the boards of other companies in the FTSE All Share Index ('ENED's) is as follows:

YEAR	FTSE 100	FTSE 250
	Has ENED	Has ENED
2003	45%	42%
2004	49%	42%
2005	46%	39%
2006	41%	35%
2007	35%	33%
2008	28%	25%
2009	23%	27%
2010	29%	23%
2011	28%	21%
2012	31%	15%

Source: Manifest – The Proxy Voting Agency

13. The FRC has analysed the levels of shareholder dissent in terms of votes against the remuneration report of FTSE 350 companies over the same period.

YEAR	FTSE 100		FTSE 250	
	Has ENED	No ENED	Has ENED	No ENED
2003	6.63%	5.22%	7.17%	5.74%
2004	4.40%	3.44%	4.06%	6.89%
2005	3.45%	3.92%	3.18%	4.83%
2006	3.84%	4.22%	3.89%	3.26%
2007	4.33%	3.78%	3.08%	3.53%
2008	3.81%	9.02%	4.12%	4.90%
2009	4.12%	6.57%	8.23%	5.38%
2010	4.75%	5.46%	5.33%	6.44%
2011	7.21%	7.38%	4.43%	7.69%
2012	5.42%	5.59%	6.55%	6.57%

Source: Manifest – The Proxy Voting Agency

Are changes to the Code required to deter the appointment of executive directors to the remuneration committees of other listed companies?

Votes Against the Remuneration Report

14. In June 2012 BIS, the CBI and the FRC agreed that views should be sought on whether companies should engage with shareholders and report to the market on the outcome in the event that they fail to obtain at least a substantial majority in support of a resolution on remuneration. While no time period or methods of reporting to the market were specified, the proponents of this suggestion envisaged that reporting should happen relatively quickly after the AGM.

15. The FRC considers it to be crucial for effective corporate governance and investor stewardship that there is on-going engagement between companies and their shareholders. For investors, the Stewardship Code sets out how they should engage with companies, which includes a specific recommendation that investors should inform the company in advance if they intend to vote against a resolution and explain the reasons why.

16. For companies, the Code states that the board, and in particular the chairman, should understand and respond to shareholder concerns, and says that “the chairman should ensure effective communication with shareholders” (Principle A.3). It specifies that “the board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company” (Provision E.1.2), and that “the chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration” (Principle D.2). However, the Code does not explicitly state how boards should respond in the event they fail to obtain at least a substantial majority in support of a resolution on remuneration.

17. Under the Regulations, companies must include in the annual remuneration report details of the vote on the previous year’s report and, where there was a significant percentage of votes against either resolution, give “a summary of the reasons for those votes, as far as known to the directors, and any actions taken by the directors in response to those concerns” (Part 3 paragraph 23(c)). However, as this only requires companies to report yearly, it has been suggested that an additional, earlier disclosure, explaining how the company intended to respond to the concerns raised might be helpful.

18. The Regulations do not stipulate a figure for ‘significant percentage’, but the GC100 and Investor Working Group’s guidance suggests “companies may wish to consider votes against in excess of 20 per cent as being significant, although there may be reasons why, for some companies, a higher or lower level might be more appropriate” and that “companies may wish to consider disclosing in the annual remuneration report the level of votes against that they deem to be ‘significant’.”

19. The guidance also suggests that “where the board considered the outcome to be a ‘significant’ vote against, or otherwise showing a significant lack of support for the resolution that they plan to address, the company may also wish to consider including a statement to that effect in the RIS announcement relating to the results of the AGM.”

Is an explicit requirement in the Code to report to the market in circumstances where a company fails to obtain at least a substantial majority in support of a resolution on remuneration needed in addition to what is already set out in the Regulations, the guidance and the Code?

If yes, should the Code:

- **set criteria for determining what constitutes a 'significant percentage';**
- **specify a time period within which companies should report on discussions with shareholders; and/or**
- **specify the means by which companies should report to the market and, if so, by what method?**

Are there any practical difficulties for companies in identifying and/or engaging with shareholders that voted against the remuneration resolution/s?

Other Possible Changes

20. The FRC does not intend to revisit matters that have been addressed in the Enterprise and Regulatory Reform Act 2013 and the Regulations. However, there are some areas of overlap between the Code and the Regulations, for example, disclosures on advisers to the remuneration committee.

    Is the Code compatible with the Regulations? Are there any overlapping provisions in the Code that are now redundant and could be removed?

21. The current text of the Code is appended to this consultation document. It primarily addresses:

    - some aspects of the design of performance-related remuneration for executive directors (for example, the linking reward to the long-term success of the company and to its risk policies, notice periods and vesting periods for deferred remuneration);
    - the process by which remuneration should be set (for example, the remit and composition of the remuneration committee and requirements for shareholder approval for certain forms of payment, including share options for non-executive directors and long-term incentive schemes); and
    - some disclosure requirements, primarily related to the activities of the remuneration committee (for example, stating the Terms of Reference and the use of remuneration consultants).

    Should the Code continue to address these three broad areas? If so, do any of them need to be revised in the light of developments in market practice?

APPENDIX – Extracts from the UK Corporate Governance Code

D.1: The Level and Components of Remuneration

Main Principle

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

Supporting Principle

The performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company.

The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

They should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.

Code Provisions

D.1.1. In designing schemes of performance-related remuneration for executive directors, the remuneration committee should follow the provisions in Schedule A to this Code.

D.1.2. Where a company releases an executive director to serve as a non-executive director elsewhere, the remuneration report should include a statement as to whether or not the director will retain such earnings and, if so, what the remuneration is.

D.1.3. Levels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role. Remuneration for non-executive directors should not include share options or other performance-related elements. If, exceptionally, options are granted, shareholder approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the board. Holding of share options could be relevant to the determination of a non-executive director's independence (as set out in provision B.1.1).

D.1.4. The remuneration committee should carefully consider what compensation commitments (including pension contributions and all other elements) their directors' terms of appointment would entail in the event of early termination. The aim should be to avoid rewarding poor performance. They should take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss.

D.1.5. Notice or contract periods should be set at one year or less. If it is necessary to offer longer notice or contract periods to new directors recruited from outside, such periods should reduce to one year or less after the initial period.

D.2: Procedure

Main Principle

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

Supporting Principles

The remuneration committee should consult the chairman and/or chief executive about their proposals relating to the remuneration of other executive directors. The remuneration committee should also be responsible for appointing any consultants in respect of executive director remuneration. Where executive directors or senior management are involved in advising or supporting the remuneration committee, care should be taken to recognise and avoid conflicts of interest.

The chairman of the board should ensure that the company maintains contact as required with its principal shareholders about remuneration.

Code Provisions

D.2.1. The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition the company chairman may also be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, they should be identified in the annual report and a statement made of whether they have any other connection with the company.

D.2.2. The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of ‘senior management’ for this purpose should be determined by the board but should normally include the first layer of management below board level.

D.2.3. The board itself or, where required by the Articles of Association, the shareholders should determine the remuneration of the non-executive directors within the limits set in the Articles of Association. Where permitted by the Articles, the board may however delegate this responsibility to a committee, which might include the chief executive.

D.2.4. Shareholders should be invited specifically to approve all new long-term incentive schemes (as defined in the Listing Rules) and significant changes to existing schemes, save in the circumstances permitted by the Listing Rules.

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

The remuneration committee should consider whether the directors should be eligible for annual bonuses. If so, performance conditions should be relevant, stretching and designed to promote the long-term success of the company. Upper limits should be set and disclosed. There may be a case for part payment in shares to be held for a significant period.

The remuneration committee should consider whether the directors should be eligible for benefits under long-term incentive schemes. Traditional share option schemes should be weighed 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.

In normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities.

Any new long-term incentive schemes which are proposed should be approved by shareholders and should 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.

Payouts or grants under all incentive schemes, including new grants under existing share option schemes, should be subject to challenging performance criteria reflecting the company’s objectives, including non-financial performance metrics where appropriate. Remuneration incentives should be compatible with risk policies and systems.

Grants under executive share option and other long-term incentive schemes should normally be phased rather than awarded in one large block.

Consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct.

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.

Financial Reporting Council
5th Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN

+44 (0)20 7492 2300

www.frc.org.uk