



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

Via email to: [executivepaydiscussionpaper@bis.gsi.gov.uk](mailto:executivepaydiscussionpaper@bis.gsi.gov.uk)

03 November 2011

## Response to Executive Pay Discussion Paper

Dear Sirs,

Our response to the Executive Pay Discussion Paper is given below.

Please note we would welcome the opportunity to visit you to discuss this matter as clearly these are very complex issues. Please suggest some convenient dates if you are agreeable to that suggestion.

It is also worth summarising our views on this subject which I have attempted to do in the following paragraphs:

1. We consider it unlikely that the inexorable rise in the pay of directors and other senior executives is going to be abated unless very firm and decisive changes are made to the legal, regulatory and corporate governance frameworks under which UK public companies operate.
2. In practice this means that directors must be stopped from determining their own pay. Instead shareholders (and possibly other stakeholders in the company) should determine executive remuneration.
3. Although appointing other representatives (such as shareholders) to a board remuneration committee is suggested in the Discussion Paper, we do not believe that will be effective in achieving substantial change. Instead a combination of Shareholder Committees (as explained below) and forward looking binding votes on pay by shareholders is the only solution that will finally close out this problem.
4. We suggest that bonus schemes, LTIPs, and share options as elements of total pay have become grossly excessive in recent years and the addition of these schemes, and their complexity has concealed the impact of the growth of total pay. Although we support the concept that executives should share in the rewards generated by a company, and agree that they should be able to build a stake in the company so that their interests are aligned with shareholders, we are doubtful that these provide significant incentives to senior management – at least not in the timescale that is likely to be relevant. We therefore strongly support the simplification of remuneration packages and the reduction in the percentage of total pay that is represented by performance related elements.

Many company directors take a dim view of the “incentives” they are given. Jeroen van der Veer, the former chief executive of Royal Dutch Shell, called into question the whole concept of incentive pay, suggesting that managers are motivated more by meeting the challenge of the job than mere money. *“You have to realise: if I had been paid 50 per cent more, I would not have done it better. If I had been paid 50 per cent less, then I would not have done it worse,”* he said. (Financial Times, June 9, 2009).

5. Of course one possible problem with relying on shareholders to oversee pay awards is that they must be “engaged”, i.e. have a direct interest in the matter, be willing to put in some time on the issues, and have the ability to vote when required. Shareholder engagement under the UK Stewardship Code has been promoted as a way of controlling pay. We are certainly not opposed to institutional investors having more engagement but it has proved remarkably ineffective in controlling pay. A recent example is Diageo where more than one institution has in the past objected to certain aspects of their remuneration structure. Did those complaints have any influence? Not obviously so with the result that they collected even more votes against the Remuneration Report at the last AGM. Engagement is a very weak tool to control pay because the board is aware that shareholders are generally not a co-ordinated and effective power and they are not likely to want to criticise the company in public.
6. Unfortunately many institutional shareholders also suffer from the “principal-agent” problem in that they are not the beneficial owners of the investments they hold. Indeed they may find it is in their interests to support high pay levels among directors because people move from investment institutions onto boards of companies and vice-versa. It is therefore important that individual shareholders have some say in these matters as they do not suffer from those difficulties, and of course that they have the ability to vote. Regrettably many of them are effectively disenfranchised at present and we will be making submissions on those issues to the Kay Review.
7. Some of the issues mentioned above are particularly relevant to fully listed companies that adhere to the Combined Code. But there is a particular problem with AIM listed companies where corporate governance is much weaker – not in all such companies perhaps but certainly in many. Consider the recent example of Intercede where an LTIP scheme was recently introduced without any performance targets being disclosed. When the targets were disclosed, they were not at all demanding. This scheme benefited to a large extent the Executive Chairman, and his wife, who was also an employee of the company, and involved the grant of nominal cost options when these persons already had substantial share stakes – indeed one of the justifications given was that this scheme was intended to maintain the stake held by the Chairman and his wife when further capital was raised because of their personal tax positions. In summary an over-generous LTIP scheme to an already highly paid Executive Chairman (considering the size of the company) which provided little real incentive and would almost certainly have been objected to by the wider base of shareholders if they had known about it in advance. There is of course no “Remuneration Resolution” vote in this company because it is not a “fully” listed company, so even in retrospect shareholders were unable to express their dissatisfaction when voting at the subsequent AGM. We suggest that any changes proposed to company law or to the Combined Code so as to control pay need to be extended to AIM companies.

8. We also emphasise the need for a binding and forward looking vote on pay. We would like to see a binding vote on the combined pay of all directors (effectively setting a "ceiling" on total pay). This system has been in use in investment trusts for many years so we know it is practical. It should be supported by an advisory vote on the future pay packages of individual directors.
9. Another aspect which we consider important to improve the control of pay is enhanced reporting. But this needs to be simplified rather than deluging shareholders with masses of information on multiple complex schemes as takes place in some companies at present. In addition we would like to see accurate information published on how the total pay of board directors, and the pay of the chief executive, compares with all other comparable listed companies – for example those with similar levels of profits and turnover and operating in the same market sector. Preferably this would be based on a "factorial" analysis so as to highlight those companies that were exceptional – for example, those paying more than 25% above the predicted level based on those factors, and an obligation in the Combined Code to explain why they were so far out of line. The collection and analysis of this information would obviously have to be performed by a public body however as it is too large a task for any voluntary organisation.

The opinions in this note are views that we have formed from discussions among our board of directors and two other members with a particular interest in this subject plus after consultation with our 1,500 members. It includes the results of a survey of members' opinions on two particular issues.

We urge that decisive action is taken on the issue of excessive pay and poorly designed remuneration schemes in public companies along the lines proposed in this note and in the Discussion Paper.

Yours sincerely

Roger W. Lawson  
Chairman

### **About the UK Individual Shareholders Society (ShareSoc)**

ShareSoc represents and supports individual investors who invest in the UK stock markets. We are a mutual association controlled by the members with "not-for-profit" articles and incorporated as a company limited by guarantee. The organisation is financed by member subscriptions, donations from supporters and by its commercial activities. More information on ShareSoc can be obtained from our web site at [www.sharesoc.org](http://www.sharesoc.org) (our objects are fully defined on this page: [www.sharesoc.org/objects.html](http://www.sharesoc.org/objects.html) ).

**Executive Remuneration: Discussion Paper. Response form**

Please send your response by: 25 Nov 2011

About You	
Name: Roger W. Lawson	Organisation (if applicable): ShareSoc (UK Individual Shareholders Society)
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I am responding on behalf of (please tick)	
<input type="checkbox"/>	<b>Yourself : Quoted company</b>
<input type="checkbox"/>	<b>Other company</b>
<input type="checkbox"/>	<b>Investor or investment manager</b>
<input type="checkbox"/>	<b>Business representative organisation</b>
<input checked="" type="checkbox"/>	<b>Investor representative organisation</b>
<input type="checkbox"/>	<b>Non governmental organisation (NGO)</b>
<input type="checkbox"/>	<b>Trade Union</b>
<input type="checkbox"/>	<b>Lawyer or accountant</b>
<input type="checkbox"/>	<b>Other (e.g. consultant or private individual)</b>

# 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
YES	
Comments	
<p><b>Yes: such a principle has been applied successfully for many years by investment trusts.</b></p> <p><b>A retrospective and non-binding vote (which is what we have at present) is clearly ineffective in stopping abusive practices and the gradual escalation of pay to levels that are unjustified. In addition, it does not apply to all public companies (AIM companies are not bound by it and often do not have Remuneration Resolutions). Too many over-generous pay schemes get through Remuneration Committees, and neither they nor the Remuneration Resolution votes stop the upward trends in the pay of the directors of companies that have become a consistent feature in recent years.</b></p> <p><b>Company directors should ultimately be accountable to shareholders (who are the company owners). At present pay recommendations come mainly from remuneration consultants and by the formation of a consensus of board members via the remuneration committee. But Ruth Bender of Cranfield Business School has written widely on this subject if you want more background on how it operates in practice including a very revealing paper entitled “The Platonic Remuneration Committee” available on the internet. It is clear that neither directors nor remuneration consultants have any direct incentive to control or moderate pay, and most are involved in a “ratcheting-up” process where new elements of pay are added, and general rises implemented, that are unrelated to the profitability of companies.</b></p> <p><b>Not all publicly listed companies have inappropriate pay levels, but it is very difficult for any individual shareholder (whether institutional or private) to determine what the total pay package is and how it relates to market rates in comparable companies. Even so it is clear that there are many examples where shareholders are unhappy about one or other aspects of the remuneration. More votes are being cast against Remuneration Reports even though institutions are very reluctant to do so in case it damages their relationship with a company.</b></p>	

The larger the company, the more complex the pay structure tends to be, and shareholders do not of course see the advice given by the remuneration consultants at present. But a binding, and forward-looking vote on remuneration would, in our view, help to moderate pay increases and ensure that the directors would have to be able to justify proposed pay changes when the Remuneration Report resolution was put to shareholders.

Of course there is an issue here if a vote on Remuneration is taken in advance (or during the current financial year as happens in practice) in that directors may change, or additional ones be recruited, during the forthcoming year. We suggest this be handled by a vote on the total remuneration (combining all elements of pay including bonuses, LTIPs, share option schemes and pension benefits) of all directors as a binding resolution, in addition to a non-binding one on the remuneration packages of existing individual directors.

It is pointed out in the consultation document that a possible issue is the requirement for a second vote on Remuneration (implying another General Meeting) if a Remuneration Resolution was voted down. The simple answer to this is that if the above proposal is adopted, the total board pay would simply remain as at the level agreed in the previous year unless another General Meeting was called. It would of course ensure that the board does sound out their major shareholders before the vote is taken to ensure that it is likely to be accepted.

Another alternative which would avoid annual or repeated votes on remuneration of the board as a whole is that used by investment trusts. In this case an annual ceiling level is set and remains in place until a resolution is approved to amend the ceiling level. We would expect companies, in proposing such a resolution, to propose a figure that gave considerable headroom above their immediate requirements, thus allowing the remuneration committee flexibility in dealing with changing circumstances. It would therefore not be necessary for such a vote to be held every year. If a resolution to raise this level were put to shareholders and rejected, the level would simply remain at the existing level. We do not see any practical problems with introducing both a binding and advisory vote along one of the lines specified above, and as pointed out in the consultation document, other countries have adopted such systems.

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

#### Comments

**We suggest that although many of the proposals discussed in the Executive Remuneration Discussion Paper are worthy ones, they do not get to the heart of the problem. It is always going to be difficult to control board pay (which also sets the precedent for other executive remuneration within a company) when in essence the directors determine their own pay. Remuneration Committees are not independent bodies. The members of them have to work with other members of the board, their own pay is intrinsically linked to that of other board members and because their appointment (and dismissal) is determined by other board members, they are not going to act independently – they will always be thinking about the impact their decisions are likely to have on their own position. It is ridiculous to suggest that their own pay will ever be restrained by the directors of a company.**

**We take the view that shareholders should determine the pay of the board directors, and also determine their appointment. This should be done via the use of Shareholder Committees and we have recently published a paper that outlines why these are needed and how they might work which is appended to the end of this submission.**

**In essence we wish to have the pay of the directors determined by a truly independent body (and in terms of its membership, more diverse), i.e. a body independent of the directors, and that body should consist of shareholders – and other stakeholders if deemed appropriate.**

**In addition more information (but in simpler and more comparable form) needs to be supplied to shareholders so that they can judge the trends in overall remuneration versus the performance of the company. Some of these aspects are covered later in the questions below.**

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

Yes	No
Comments	
<p><b>This question goes to the heart of corporate governance – and reminds us (in case we had forgotten) that shareholders are the ultimate owners of the company, and that directors are appointed by the owners to ensure that the company balances its requirement to generate shareholder return with operating ethically and fairly. But introducing one shareholder representative on a Nomination Committee is unlikely to have a major impact on its decisions. This will only happen if shareholder representatives (and possibly other stakeholders) are in a majority on such committees - in which case they would be more like “Shareholder Committees” that we have described elsewhere in this document. We suggest Shareholder Committees are a much better solution to get some external influence on board nominations and on pay.</b></p> <p><b>In practice having shareholders appointed to a Nomination Committee which is in essence a “board” committee (Nomination Committees are committees of directors at present) introduces some potential legal and regulatory issues. For example, they may become “insiders” (given price-sensitive information) and hence might be unwilling to serve as a result. They also are at risk of being seen as “shadow” directors in law we suggest.</b></p> <p><b>Although the operation of shareholder based Nomination Committees in Sweden (equivalent to our proposed Shareholder Committees) is mentioned, the possible concerns about how these operate and their applicability to the UK do not seem to us to be impossible to overcome. There should be no great difficulty in our view in establishing such committees in the UK.</b></p> <p><b>It is important to increase the “engagement” of shareholders with the management of companies and we do not believe that the “Stewardship Code” will have a major impact on that without other supporting changes to UK corporate governance.</b></p>	

## Role of remuneration committees

4. Would there be benefits from 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	
<p>The overall objective should be to ensure that remuneration is fair – to the senior executives themselves, to shareholders and to the staff who deliver the strategic objectives and contribute to the success of the company.</p> <p>An independent shareholder representative, who is a long term investor in the company, might add value to this process of ensuring that the growth in value of the company is shared fairly between investors / company owners, company leaders and employees. We are sceptical though of the benefits of adding people without a wide business background (e.g. “public sector, academia or professionals” as suggested in the consultation document) to a remuneration committee.</p> <p>Moreover, the same comments apply as we made in response to Question 3 above concerning Nomination Committees.</p>	

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

Yes	No
YES	
Comments	
<p>A more balanced remuneration committee, with representatives of shareholders, employees, independent non-executive directors and possibly other experienced people with wide business experience, would reduce the risk of any conflict of interest. However, we suggest that Shareholder Committees are still a better solution.</p>	

6. Would there be benefits from 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	
<p><b>Employees might find it difficult to vote against the remuneration packages of their bosses (who might even be sitting on the same committee), and there would be the issue of how employee representatives were selected unless the company was already heavily unionised. We suggest this approach would only work if the division between directors and employees (the “us” versus “them” attitude) was suppressed and a more “consensus” approach adopted so that it was clear that the decisions by board committees had to be agreed and supported by everyone in the company – in other words a more consensual approach to management of a company than has historically been applied in the UK. This requires a “cultural” change in the attitude of both directors and employees.</b></p> <p><b>There are other practical problems with this suggestion (and the same objections arise with co-opting people onto board nomination committees):</b></p> <ul style="list-style-type: none"> <li>- <b>The representative can easily be outvoted by the majority of the other members who are Directors.</b></li> <li>- <b>Committee members may be bound by a collective responsibility to agree to the meetings decision even if they disagree with it.</b></li> <li>- <b>At an AGM, the representative will not be able to discuss the detail because the business of the committee will be confidential.</b></li> </ul> <p><b>Again we suggest that a “Shareholder Committee” approach is more likely to introduce more independent thought and a consensual approach than simply introducing employees onto remuneration committees. A Shareholder Committee could both determine the appointment of directors and their initial remuneration (the two are closely linked of course in the recruitment process).</b></p>	

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

Comments
<p><b>The main disadvantage of this proposal is that employees might vote for higher levels of remuneration for senior management, simply because it effectively sets a benchmark for lower levels of management. There might be a general escalation of pay to the disadvantage of the company's owners, i.e. the shareholders. After all directors could say to their staff, even the lowest level ones, "you support our remuneration packages and we'll agree a pay rise for everyone".</b></p> <p><b>Therefore we are opposed to this proposal.</b></p>

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

Yes	No
Yes	
Comments	
<p><b>Directors should be reporting on the use of remuneration consultants to company owners. Owners should be entitled to receive a copy of the advice received and to be advised whether or not it is being followed. Without this accountability process in place, how can shareholders ensure that the directors are acting in the best long term interests of the company?</b></p> <p><b>Too often we see boards justify their proposed pay by reference to "the advice received from remuneration consultants" without disclosing the details of that advice.</b></p> <p><b>We would expect the remuneration committee to be able to utilise these services to assist them in their decision making, but it must be appropriate, as with other procurement, to obtain a number of quotations for such a service and identify any relationships between the remuneration consultants and other parts of the organisation or third parties.</b></p>	

## Structure of remuneration

9. Could the link between pay and performance be strengthened by moving away from TSR and EPS as the key measures of performance?

Yes	No
YES	
Comments	
<p><b>Whatever measures are used, they need to be relevant to the company at its stage of growth, and clearly understandable by all company stakeholders. They also need to be transparent and fair to shareholders and to employees, who also contribute to the long term success of the company.</b></p> <p><b>Total Shareholder Return (TSR) is generally a bad metric to use because it can be very volatile, lead to attempts to manipulate share prices and encourage more limited disclosure of bad news.</b></p> <p><b>EPS also has some disadvantages and in general we think that companies should be free to determine the best metric to use.</b></p> <p><b>Note that we are concerned that there are no specific rules about the adjustment of options if a company changes its share capital – for example by a significant restructuring, a tender offer, or share buy-backs. This is an area where unscrupulous directors can exploit the complexity of pay systems to benefit unreasonably.</b></p>	

10. Should more companies be encouraged to adopt vesting periods of more than three years?

Yes	No
	NO
Comments	
<p>The best pay incentive schemes, in terms of those that provide real incentives, are those that result in rewards within a short time period of the effort or achievement. Very long vesting periods do not provide any incentives whatsoever.</p> <p>The key issue here is that in reality the size of bonuses are now grossly excessive as a component in pay packages so they encourage risky behaviour. We would like to see the maximum additional remuneration receivable from bonus schemes or LTIPs (whether in cash or the value of shares obtained) be limited to 50% of base pay. Any awards should preferably be in shares which have to be held for a minimum period of time (i.e. several years).</p>	

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
YES	
Comments	
<p>A small, growing company will undoubtedly need to review its incentive plans and remuneration packages more frequently than a larger, more established company. This would also reflect the different skills required in growing a company to leading an established company. But in general, there are too many changes which confuse comparability and make it difficult to understand remuneration trends.</p>	

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

Yes	No
YES	
Comments	
<p><b>Yes, provided the shares are bought by the directors or earned as a result of out-performance rather than given to them. We agree that the very complex remuneration packages that are now common have been an element in the upward direction of pay levels in recent years as the end result makes it difficult for shareholders to examine pay levels or compare them with similar directors in similar companies, i.e. it reduces comparability.</b></p>	

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

Yes	No
YES	
Comments	
<p><b>Bonus payments for all directors, and remuneration for non-executive directors, could be used to buy shares in the company, rather than paid as cash. Such a move would align director remuneration with growth in value of the company.</b></p> <p><b>With regard to share options, the granting of these, and the reporting of take up / non take up by directors, should be clearly reported to shareholders in the Annual Report. Reporting should be simple and easy to understand – and directors should be prepared to account to shareholders if an option is not taken up.</b></p> <p><b>We would also like to see a simple measure reported of “forecast pay” – including the benefits of all bonus and share option schemes for the next three years based on the likely growth of the company (R.P.I. plus so much percentage related to the historic growth in real terms). That should be directly comparable across companies.</b></p>	

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

Yes	No
YES	
Comments	
<p>In general we support this proposal, although we have some concerns about the complexity of implementation.</p>	

### 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
<p>A newly formed NGO, equivalent to the Low Pay Commission, could be established to provide independent research and benchmarking information for remuneration committees. Such an organisation could also assist shareholder representatives in fulfilling their independence function on remuneration committees.</p> <p>It is possible, that had such a body been in existence, then the disparity in the advance in pay for senior directors and employees would not have arisen.</p>

## Supporting Survey Information

Note that ShareSoc performed a survey of our 1,500 members recently (over 300 have responded to date) which covers some of the issues raised in the Discussion Paper. The questions asked were:

*1. Do you agree that too much emphasis is placed on performance related pay elements in director remuneration (such as bonuses, LTIPs and share options) and that this encourages risky behaviour and short term thinking? It is also one of the reasons why overall pay has grown so rapidly.*

83.2% of survey respondents strongly agreed or agreed with that statement.

*2. Do you agree that the "Shareholder Committee" proposals, as developed by ShareSoc, are a good solution to tackling the problem of insufficient engagement by investors with companies?*

86.4% of survey respondents strongly agreed or agreed with that statement.

Note that almost all of our members are individuals who invest directly on their own behalf in the stock market and often have large portfolios of investments. They are sometimes also company directors (or have been in the past) and/or employees of institutions so they are looking at these issues often from wide experience.

# SHAREHOLDER COMMITTEES



A way to improve shareholder engagement

This document explains how shareholder committees might be used in the UK to improve corporate governance and the oversight of companies by their shareholders.

Published by the UK Individual Shareholders Society (ShareSoc)

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# Shareholder Committees

## A WAY TO IMPROVE SHAREHOLDER ENGAGEMENT

### FOREWORD

It is widely acknowledged that there are a number of problems with the governance of public companies at the present time. Despite the introduction of the Combined Code, the presence of nominally independent directors, the annual re-election of directors and of other changes in recent years, there are still frequent failings by boards. For example, the excessive and rapidly rising pay packages of directors in some companies has been highlighted by many commentators as an example of the difficulty that shareholders have in influencing the board of directors of companies. Indeed, although improved “engagement” with companies by institutional investors has been promoted in the Stewardship Code, in practice it still seems to be ineffective. That is not just because investors do not try to have some influence, but because ultimately they can be ignored.

“It is not just because investors do not try to have some influence, but because ultimately they can be ignored.”

The reason for this is because directors in essence appoint themselves and are not directly accountable to shareholders other than at an Annual General Meeting which has become rather a formal ritual where no real scrutiny of the affairs of the company takes place (most shareholders, particularly the major institutions, do not attend). As regards board remuneration for example, although there is a vote on the Remuneration Report, which is only “advisory” of course, this is a retrospective review of past decisions by the board and has little real influence on future pay trends except in extremis.

More explanation of the nature of some of the problems that result is given in our Policy Manifesto (in the Section entitled “Why these policies are needed”) – see [www.sharesoc.org/policies.html](http://www.sharesoc.org/policies.html) for our full policy manifesto. One of our proposals in the Manifesto which we see as key to solving these problems is the introduction of “Shareholder Committees”. Such Committees could enable shareholders to regain ultimate control over the business which they own, without affecting the operational management of the company in any way.

Continued....

This document has been written to explain how Shareholder Committees could solve the perceived problems, and how in practice they might work, without laying down all the detail which would have to be subject to further work and debate. But the key aspect is that they might bring about a change of corporate culture where the boards of companies recognize they are the stewards of the company on behalf of the shareholders, and should work with them, rather than them perceiving their role as the only competent body to oversee the affairs of the company. In other words a more “consultative” approach.

“The key aspect is that they might bring about a change of corporate culture where the boards of companies recognize they are the stewards of the company on behalf of the shareholders, and should work with them.....”

Obviously this document has been written by an organization that promotes the interests of private shareholders, who have been particularly abused by developments in recent years. Although directly or indirectly they represent a substantial proportion of the shareholders in most public companies, their views are generally disparaged and their voting rights have been lost. But the proposals contained herein are not intended to give them or anyone else a privileged position, but to generally improve the lot of all investors in public companies. In addition the proposals should improve the health and vitality of the UK commercial scene so that the UK can effectively compete in world markets.

Roger W. Lawson

Chairman

## Shareholder Committees – What Are They?

Shareholder Committees can take many forms. But as discussed in this document we suggest **they should primarily take on the role currently taken by board sub-committees that recommend on the appointment on new directors and that recommend on board remuneration.** They would also have a role in reviewing the appointment of auditors.

Their recommendations would be made to the board who would then put them to the Annual General Meeting in the form of appropriate Resolutions. It is important to emphasize that they would have no binding authority or statutory position in Company Law – at least not as initially envisaged. This means that no changes are required to legislation to implement such a concept. They might be adopted in the Articles of companies if the shareholders desired it, although that is not a pre-requisite, or as recommendations for good practice in the Combined Code.

They could be applied to all kinds of public companies from the largest to the smallest – indeed in any companies where the shareholder base is so diverse that they lack effective means of communication with the board and the ability to influence its decisions on the three matters mentioned above.

Such a Committee would not be dictating to the directors how they managed the affairs of the company, and neither would they be determining company strategy. They would simply be advising the board on the three specific areas and would normally expect the board to follow their recommendations in those areas – as the board does at present from existing board sub-committees in general.

Clearly there might be some debate if the board did not agree with the recommendations so as to achieve a consensus. However, just as companies consult their major shareholders at present before making important decisions, the board could consult such a Committee on anything they chose simply on the basis that this would be a convenient forum from which to take advice.

We envisage one Shareholder Committee for each company covering all the three issues mentioned, not separate ones for each function, simply on the grounds of keeping the arrangements as simple as possible.

## Who Would Sit on a Shareholder Committee?

In essence, shareholders should dominate these Committees (or in the case of corporate shareholders, their representatives, of course). But it would be important for the board of the company to be able to present information and put proposals to the Committee so we would anticipate that at least one board director would sit on the Committee – probably the company Chairman.

Should there be other stakeholder representatives on the Committee? We suggest there might be, subject to the discretion of the board and the Committee. For example, it may be a good way to introduce an employee representative, or a representative of the local community where a company has a major impact on local affairs. The more varied voices and the wider spread of views the better in achieving a consensus on many issues. Employees might have a lot to say about levels of board pay for example, but we see such non-shareholder representatives as being in a minority even if they were introduced.

## Is This a New Idea?

Shareholder Committees are not a new idea, and ShareSoc cannot take credit for inventing the concept. Indeed a shareholder “Nomination Committee” for the appointment of directors and determining their pay has been in use in Sweden for some years, and how this system operates in practice was well described in a report from Tomorrow’s Company entitled “Tomorrow’s Corporate Governance” – see [www.tomorrowcompany.com/publications.aspx](http://www.tomorrowcompany.com/publications.aspx)

That report suggested that such a system could evolve in the UK, just as it did in Sweden, given some commitment from companies to improve shareholder representation. Otherwise the use of such a system in Sweden seems to have had a positive effect on shareholder engagement. Note that the structure of shareholdings in listed companies in the Swedish stock market is somewhat different, though not now enormously different, to that of the UK market. Likewise main board operation and company law is of course different in minor ways. But in essence there are more similarities than differences and these are not sound arguments for dismissing such examples as irrelevant.

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There have been past attempts to introduce shareholder committees in the UK (for example there was a private bill introduced by an M.P. in Parliament). These were aimed to improve shareholder engagement and improve the influence of minority shareholders so they had broader objectives than those contained herein. The proposals also contained some obvious practical difficulties, and as a result did not gain widespread support at the time.

## How Would Committee Members be Selected?

It is important that the Committee Members are representative of a broad section of the shareholder base. Likewise the largest shareholders should have more representation (if they so wish of course) so that their views are adequately represented. It is also wise that Committee Members should have some knowledge of the affairs of the company concerned and the market in which it operates (i.e. they should be "informed" investors), and that they have some general background in financial and business affairs.

Within those general parameters there are many ways that Members could be selected. For example, the four or five largest shareholders could be invited to nominate members, with other members being co-opted from smaller shareholders as necessary so as to provide a broader representation.

The shareholder base of a UK listed companies is often now very diverse with no one shareholder holding more than a few percent and a "long tail" of smaller institutional holdings. In addition there are often many holdings from foreign entities (who should certainly be encouraged to participate but might have practical difficulties in doing so). In addition there are often significant numbers of private shareholders although their apparent representation might be less than in reality because they are concealed behind a few nominee accounts (see below for discussion of private shareholder representation).

In reality, it may not matter exactly how Members are selected because most shareholders are likely to have a common interest in promoting the long term success of their investment (and hence the company). Those who are short term holders or traders in the shares may not have an interest in participating in any case.

The key differentiation between the proposed arrangements and the existing one is that the Committee will have the interest of the shareholders as their main concern, unlike at present where the directors might have their own self-interest at heart on matters such as pay. A Shareholder Committee would be truly independent of the company board of directors and its executive management. Hence any advice they give is likely to be unbiased. But they would need to justify any such advice to the company board and to a general meeting of shareholders.

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Shareholder Committees should themselves establish how members should be identified and selected. There may be different approaches for different companies – clearly larger companies with more diverse shareholdings may take a different approach to those where there are more concentrated shareholdings. Institutional shareholders would clearly need to identify people who could represent them on a Shareholder Committee – although they would not necessarily have to be employees of the institution.

The success of such a system does depend on the engagement of shareholders and their need to act as “owners” which has been one of the things lacking in recent corporate history. The problem of “absentee landlords” who do not pay close attention to the interests of shareholders has corrupted shareholder democracy. For example institutions who manage funds on behalf of other investors but have no direct interest in a company may act very differently to direct shareholders.

One issue that might arise, and hence is worth mentioning, is the problem of becoming an “insider”. Committee members might become aware of “price sensitive” information. For example, although board pay is not likely to be a particularly price sensitive matter, the appointment of a new chief executive might be. Institutions may be reluctant to participate if they were barred from trading in the shares of the company as a result of becoming an “insider”. The solution to this is to establish a protocol or “Chinese wall” between Committee members and the trading arms of the body they represent.

This issue is already present in that companies do consult their major shareholders about important decisions, without such discussions necessarily becoming public knowledge. This whole subject probably requires further consideration because it is unclear at present how shareholder democracy can be supported if the board of a company, or any proposed Shareholder Committee, cannot discuss strategic options.

One person on the Committee should be a board director who can act as the communication channel between the board and the Committee, but they should not act as the Chairman of the Committee who should be appointed by the Committee Members from their number.

Note that the shareholders in General Meeting should approve any selection method that is to be used to appoint members of a Shareholder Committee.

It is important to emphasize at this point before moving on that the quality of people on any such Committee would be very important. No board, and neither will shareholders, respect the views of a body whose members cannot speak from knowledge and experience and promote their views in a logical manner. It should not be difficult to identify the kind of personal background that would qualify people to be Committee members, and document those parameters in corporate governance guidelines. We would like to see such Committees dominated by people with a broad knowledge of business affair rather than by those with academic or professional qualifications. We also suggest that anybody proposing someone for members of such committees should ensure that they had suitable training and mentoring (as ShareSoc would do for private investors).

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## The Role of Private Shareholders?

Individual shareholders are often long term investors who have a strong personal interest in the success of a company. They often have lengthy business backgrounds and are frequently very experienced investors in a wide range of companies. On the other hand, some will have limited experience of financial and stock market regulations and practice, plus they do not always have the right personal attributes to take part in Committee meetings. Also of course they might similarly be reluctant to accept becoming an insider of a company in which they hold shares. So any involvement of private shareholders in a Shareholder Committee would have to be carefully considered. The best solution would be if they could be represented by a person nominated by a recognized body such as ShareSoc who have taken on the task of generally promoting the interests of such shareholders. They could bring the views of individual shareholders to the table.

ShareSoc would have to ensure that anybody that they put forward as a representative was suitably qualified, trained and experienced to take on the role.

## How They Might Work and Why They are Needed – Board Appointments

One of the reasons why it is very important to give shareholders more say in the appointment of board directors is because, without that, shareholder “engagement” can ultimately be defeated. There are many examples of major shareholders disagreeing with the strategy of a company, or taking a dim view of the existing Chairman or Chief

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Executive of a company. One only has to look at the campaigns mounted by “activist” institutional investors or by private shareholder “action groups” in recent years to see that “engagement” is often pursued initially to no effect. A board can be immune to shareholder influence (directors who have been there a long time can be resistant to change), and most shareholders have insufficient votes by themselves to be seen as having enough influence. But they cannot easily communicate with other shareholders. Only the company can easily do so and they can “manage” the process by speaking to their shareholders individually and emphasizing the widespread support for their own views, whether there is or not.

The end result is that one of the few options for activist investors if their views are ignored is to escalate the matter to a full blown public dispute, and try to put an appropriate resolution to a General Meeting. That can be very damaging to the interests of the company, and consume a large amount of management time, much to their annoyance.

A good example recently of this “negative” approach to shareholder engagement was the attempt by Laxey Partners to encourage a more active discount management approach at Alliance Trust. Ultimately it was successful, but not without a public airing of the competing views with allegations from both sides that became quite forceful.

That of course is an extreme example of where the board might not have been representing the views of some shareholders as they wish. But even more problematic is engineering a change of Chief Executive or Chairman. A person already in those roles may have a very dominating influence on a board, from a long standing involvement in the company and his personal relationships with the other directors. In theory one could approach the Senior Independent Director, or the Nomination Sub-Committee and express one’s concerns but a single shareholder speaking out is likely to have little impact.

One of the problems is that the directors appoint themselves via the nomination board sub-committee. This creates problems with the “independence” of directors and the diversity of boards – two problems that are well known. Non-executive directors do not frequently challenge the executive directors, as was very evident when looking at the recent history of banks and their involvement in risky business and investment strategies. Non-executive directors are keen to retain their positions and they realize that their continuance on the board depends on the views of the nomination sub-committee – in other words of other directors. So a culture of “conformance” results. Likewise nomination sub-committees tend to select new board members who they know will “fit-in” with the existing board and not dispute their past decisions. So boards tend to become in-bred with similar backgrounds. If shareholders perceive that substantial change is required, this can often be defeated as a result.

“One of the problems is that directors appoint themselves via the nomination board sub-committee”.

Obviously it would be wrong to ignore the views of existing board members, or the current consultants they might employ to review board appointments, but the existing system is a recipe for conflict with shareholders rather than consultation. The use of Shareholder Committee to ensure that the broader views of shareholders were taken into account in the appointment of new directors, or any general restructuring of the board, would solve many of the perceived problems.

It is worth quoting from the Tomorrow’s Company report mentioned above where they discuss the view that company Chairmen and Non-executive Directors may feel they sense the needs of the company and know the dynamics of the board better than a Shareholder Committee ever could. What the report says is: *“It is true that chairs and NEDs are closer to the board members, knowing them better and seeing them in action at close quarters. But it is precisely this closeness that becomes the issue, exposing boards to the risk of group-think, a lack of objectivity, an excessive sense of loyalty to established colleagues, and a tendency to recruit ‘people like them’.”*

In essence a Shareholder Committee would take over the role of the existing board nomination sub-committee and operate in the same way. It would take advice from the company executives, board members, and recruitment consultants as needed.

Chairmen of companies might complain that their role might be undermined if they did not have the current level of control on board composition, but that might be a good thing in some companies as it would prevent the excessive dominance of boards by their Chairmen. In any case the Chairman could make his views known to the Shareholder Committee on any board changes.

The key here is to evolve into a more consultative approach and restore more power to the shareholders who after all are the owners of the company. But it is not so abrupt a change as some might perceive.

“The key is to restore more power to the shareholders who are the owners of the company”.

### How They Might Work and Why They are Needed – Board Remuneration

It would be wrong to suggest that the pay of all directors in all public companies is excessive. But it has clearly been growing much faster than the pay of other employees in some companies. Indeed it has reached levels where some people think it has become socially divisive. A good report on this has been produced by the High Pay Commission (see <http://highpaycommission.co.uk/>).

So far as shareholders are concerned, their main concern is that the pay of directors can actually reach the point where it reduces the returns to shareholders – for example by reducing the available cash distributable via dividends, or diluting their share interest by excessive grant of “free” or low cost shares via LTIPs or via share options. In addition, if pay at the top of a company rises, then it does tend to have some impact on the pay of senior management generally (even if not at the bottom of the company) which can divert profits to employees as opposed to shareholders. Or shareholders might believe that a very wide disparity in pay within an organization can undermine social coherence – it encourages employees to think that the senior management are solely motivated by their own personal financial interests rather than the good of the company as a whole. Indeed some directors can obtain so much wealth via remuneration in so few years, that they might be assumed to be motivated to take a very short term view of a business whereas other employees and shareholders have longer term interests.

Why has director pay been increasing so rapidly in the last few years? One reason is the problem already covered where shareholders have lost influence over the board. Pay is now set by a Remuneration board sub-committee, after they have typically taken advice from remuneration consultants. They have little motivation to reduce recommendations and boards tend to take the view that they should all be in the top quartile of comparator companies – so as to enable them to attract the best people. As a result there has been repeated “leap-frogging” of pay levels, or as one writer recently called it – a “trickle-up effect”.

Annual General Meeting resolutions to approve Remuneration Reports were introduced a few years ago in the UK to try and establish some control over pay, but to little effect. Such resolutions are only advisory and are voted on in retrospect (which is rather equivalent to shutting the stable door after the horse has bolted). Despite the sharp growth in total pay, very few such Resolutions are voted down. Perhaps that’s not surprising because in the case of major institutions, the board will know who voted against such a Resolution and that might lead to a significant freezing in the relationship between the board and that investor (for example access to the board by the institution might become more restricted).

Of course there are good reasons why Remuneration Sub-Committees do not work to control pay (Ruth Bender of Cranfield Business School has written widely on this subject if you want more background including a very revealing paper entitled “The Platonic Remuneration Committee” available on the internet). One problem is that such sub-committees now have members who are directors and whose pay tends to reflect the pay of other directors. So it is hardly in their own personal interests to exert downward pressure on pay levels. In addition, as their retention as a director tends to depend on the views of their fellow directors, they will hardly want to stand out against the views of other directors on what the latter’s pay should be.

“There are good reasons why Remuneration Sub-Committees do not work to control pay”.

A Shareholder Committee would simply act in the same way as the existing board Remuneration Sub-Committee. In other words, it would take advice from the board and from Remuneration Consultants before putting recommendations to the board (and subsequently to the AGM perhaps). It might be possible therefore to enable a Remuneration Resolution that defined future pay to the AGM, but clearly there would need to be the ability to change remuneration, or to set it for new appointments, during the year. Moving pay determination into a independent forum such as a Shareholder Committee is not the only change that might be required to bring pay under control, but it would certainly be a major step in the right direction.

One difficulty at present is the complexity of pay arrangements such that the total remuneration package, and how it relates to levels in other companies, can be very difficult to both determine and to comprehend. This might have to be solved in other ways.

## How They Might Work and Why They are Needed – Auditor Appointments

A Shareholder Committee could also recommend the appointment of auditors and their remuneration. The role of auditors has come under scrutiny of late because of their failings to identify significant accounting abuses, particularly in the USA which led to onerous legislation being introduced. However their role in the UK banking crisis has also been criticized for allowing banks to operate with apparent imprudent levels of reserves, to produce accounts which most people had difficulty in understanding and failings in their valuation processes on complex financial instruments. In smaller companies (and an example was AIM listed Aero Inventory), there seem to be more basic and quite common failings in the scrutiny of accounts and the reliance on the opinions or statements of directors - which of course is why shareholders and not directors might be best to scrutinize such matters.

The role of auditors in sometimes acting as consultants to companies on non-audit matters has also been questioned (there is a suggestion that such revenue might bias their audit role), and the lack of apparent competition between audit firms and the low level of switching which builds an incestuous relationship between audit firms and their clients has been criticized.

Even more than with Remuneration Resolutions, the impact of the need for shareholders to vote on a Resolution to approve the appointment of auditors has been minimal. It is a very exceptional case where there is any significant vote against the board's recommendation on auditors, and we cannot recall a single instance where such a resolution has been voted down. For example PIRC recommended recently to vote against the appointment of PwC at TUI Travel, for possibly good reason, but the result was only 7% against with 6% abstaining. Introducing an independent body into the audit relationship will surely avoid some of these problems.

However, the discussions about audit matters can take a very technical slant and a Shareholder Committee might not have many financially qualified members on it. We therefore propose that a Shareholder Committee only gets involved in reviewing the work of the Audit function if there are concerns about the financial accounts of a company, or an obvious need to consider a change of Auditor. In other words, there is no proposal to change the role of the board Audit Sub-Committee in essence, but the Shareholder Committee should have the ability to review the work of the board Audit Sub-Committee and the role of the auditors, and recommend a change of Auditor if necessary.

This might enhance the accountability of auditors to shareholders, which has been seriously undermined by the Caparo judgment and other trends in UK audit law. Again though it is important to emphasize that the role of the Shareholder Committee would be advisory on the board and to the shareholders convened in General Meeting.

## What Might be the Objections?

Some of the possible objections to Shareholder Committees have already been mentioned above. Such as the impact on the role of company Chairman – it might weaken their position – the difficulties some institutions might have in getting involved and the problem of recruiting competent individuals to become members of such committees. It has been pointed out that those institutions that typically have the largest stakes in UK companies might need to be represented on hundreds of Shareholder Committees, but this would not be essential, unless they had a particular interest in being so represented. What matters is that there are simply sufficient nominees from a broad spread of investors to be representative of them and of their interests.

The issue of recruiting sufficient competent individuals, and resolving conflicts of interest, do not seem impossible of solution to us, and the overall benefits of Shareholder Committees seem to strongly outweigh the possible disadvantages in a reduction in the power of boards and their Chairmen.

Indeed the whole point of these proposals is to slightly adjust the power of shareholders versus the power of boards, where the latter seem to have lost sight of the foundations of shareholder democracy.

The increased fragmentation of shareholdings, the use of nominee accounts (that disenfranchises most private shareholders and generally leads to low voting turn-outs), and the fossilization of Annual General Meetings has put much more power into the hands of board directors than the original limited company legal structure anticipated. Directors now have control over the communication channels to shareholders whereas the latter cannot communicate with one another easily. This needs rectifying by the introduction of new concepts and systems and a Shareholder Committee system would be one aspect that would assist.

## Complementary to the Stewardship Code

It could be argued that the engagement of shareholders with companies will be enhanced by the introduction of the UK Stewardship Code (refer to this web page for details: [www.frc.org.uk/corporate/investorgovernance.cfm](http://www.frc.org.uk/corporate/investorgovernance.cfm) ) and that it might be premature to introduce further changes until the impact of that Code has become obvious. However there are two points to make on this:

We see the Stewardship Code as complementary to the use of Shareholder Committees. The Stewardship Code is designed to encourage institutional investors to monitor companies in which they invest, to use their votes, to act collectively with other investors when necessary and more generally “engage” with company management. But without the presence of a Shareholder Committee, the extent of influence any investor might have is quite limited.

Certainly on matters of board appointments and pay, even if investors are adhering to the Stewardship Code, it does not mean that companies will be paying attention. In addition of course the Stewardship Code does not provide for any real engagement by private shareholders or smaller institutional investors as there is no obvious “platform” to enable their engagement with company management.

In reality, a Shareholder Committee would support the role of the Stewardship Code in improving the engagement of shareholders with the companies in which they invest.

### What Should be Done to Implement Shareholder Committees?

Any company could adopt a Shareholder Committee tomorrow if they so wished. A board of directors can take advice from anyone they choose including a committee of shareholders. But a large public company might not wish to do so without wider support for this approach – for example the presence of board sub-committees for nominations and remuneration is part of the Combined Code so removing them instantly would be problematic.

So it requires a lead from the Government or from standards bodies such as the FRC (and the FSA who have responsibility for the Listing Rules which reference the Combined Code). Alternatively it could potentially be imposed by a Resolution from shareholders - Company Law enables any shareholder to requisition such resolutions if they can garner sufficient votes.

Note that the board of directors would continue, as at present in UK Company Law, to prepare the required Resolutions to put to General Meetings of a company, based on the recommendations of the Shareholder Committee. Therefore they would of course need to support those recommendations – but this could be made an obligation under the Combined Code. We would certainly recommend that it be introduced gradually as a requirement so that experience could be obtained before it was widely introduced, and so that good practice for the role and membership of such Shareholder Committees could be established.

Note that we have not attempted to cover all the details of how Shareholder Committees would operate in this document. For example, how members would be selected, whether they were paid, whether they would report formally to shareholders or the board, and many other aspects. It would be best to establish such matters by debate among shareholders and companies so as to ensure a good practical system was established and to counter problems or objections that any parties can foresee.

A working group to establish some recommendations under the auspices of one of the bodies mentioned above would be one approach to take matters forward. But we also suggest that a wider political consultation on this matter be undertaken. The role of public companies, and the way they are governed is of wide interest not just to the financial community but also to the general public. Most people are employed by limited companies of which most are listed public ones, and pensioners are largely dependent on the wealth that such companies generate.

## In Conclusion

We hope that you have read this document with an open mind and can see the advantage that a Shareholder Committee might bring in improving the oversight of a public company. We see it enabling companies and their shareholders to move from a confrontational approach to a more consultative one, with less need for public disputes and quicker resolution of issues as a result.

Some companies have suffered from damaging boardroom battles when trying to change underperforming CEOs or Chairman (Marks & Spencer was an example). A Shareholder Committee could assist the directors of a company and their Chairman as such a Committee would provide a good and independent "sounding board" on a lot of matters. In addition it would enable a sharing of responsibility and a wider consensus to be easily achieved on the basic matters of board appointments, board remuneration and auditor appointment.

"It would enable a wider consensus to be easily achieved on the basic matters of board appointments, board remuneration and auditor appointment."

But if you think we have overlooked anything in these proposals then please let us know. Likewise if you have any questions then please contact us.

Send an email to [sharesoc@btconnect.com](mailto:sharesoc@btconnect.com) if you wish to contact us on this matter or contact us via post or telephone (see the last page for contact details).

### About the UK Individual Shareholders Society (ShareSoc)

ShareSoc represents and supports individual investors who invest in the UK stock markets. We are a mutual association controlled by the members with “not-for-profit” articles and incorporated as a company limited by guarantee. The organisation is financed by member subscriptions, donations from supporters and by its commercial activities. Associate Membership of ShareSoc is free and is open to everyone with an interest in stock market investment (go to [www.sharesoc.org/membership.html](http://www.sharesoc.org/membership.html) to register). More information on ShareSoc can be obtained from our web site at [www.sharesoc.org](http://www.sharesoc.org) (our objects are fully defined on this page: [www.sharesoc.org/objects.html](http://www.sharesoc.org/objects.html) ).

# ShareSoc

UK Individual Shareholders Society

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