Submission to OECD Public online consultation on Corporate Governance and the Financial Crisis

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This submission addresses the issue of executive remuneration by examining three of the questions raised in the issues paper:

1. The governance of remuneration
    a. Features of a well-governed process
    b. Role of shareholders in the process
2. Exercise of shareholder rights
    a. What role did institutional investors play…as investors and in their role as owners?
3. The implementation gap
    a. What needs to be done at national and corporate level to close the gap between formal compliance and effective implementation?
    b. Role of OECD

The submission relates primarily to the UK and Australia, although the regulatory framework presented can be adapted for use in other jurisdictions.

Based on my own research for the period 2003-2008[2] I conclude that the regulation of executive remuneration has been largely unsuccessful in achieving good remuneration outcomes despite government policies that set better remuneration outcomes as the goal of regulation. *The laws governments typically implement to achieve remuneration policy goals deal mainly with disclosure and voting, rather than with remuneration practice.* This in itself is not necessarily a problem: shareholders have either individually or through their representative organizations developed statements of 'good' or 'best' remuneration practice. The difficulty is that these statements of practice focus on processes and structures in detail, but outcomes in abstract principles.

I am able to provide the OECD with further information or evidence should this be required.

Yours sincerely

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[2] My research is not focused on financial institutions per se, but on a sample of 73 FTSE 100 companies and 109 S&P/ASX 200 companies.

Regulatory framework for executive remuneration

Executive remuneration regulation can be conceived as a framework within which a cycle of four activities occurs:

- *Remuneration* ***practice*****:** the actual practices of firms and individual executives in relation to remuneration. Remuneration practice includes setting remuneration policy, writing the remuneration contract, execution of the contract, namely the executive performs and the company makes payments according to the contract, and termination of the contract;

- *Remuneration* ***disclosure***: the disclosure of remuneration annually via the remuneration report together with ad hoc disclosures related to remuneration, such as share-transactions, margin loans, company loans;

- ***Engagement*** *on remuneration*: the engagement between the company and shareholders on remuneration. There are two types of engagement: proactive engagement of shareholders by the company and reactive engagement of the company by shareholders; and

- ***Voting*** *on remuneration*: the annual advisory vote on the remuneration report combined with all other remuneration-related resolutions.

This is illustrated below in **figure 1**, the regulated remuneration cycle, which shows the regulators and infomediaries (remuneration consultants and proxy advisors) involved in each of the four activities.

This figure illustrates some important aspects of the regulatory framework for executive remuneration:

- There are four distinct activities in the remuneration cycle: practice, disclosure, engagement and voting

- Each activity is regulated to some extent, even if primarily via market mechanisms

- Different rules are deployed in the regulation of the activity, with some rules aimed at giving content to the activity (content rules), whereas other rules facilitate the activity (facilitative rules).

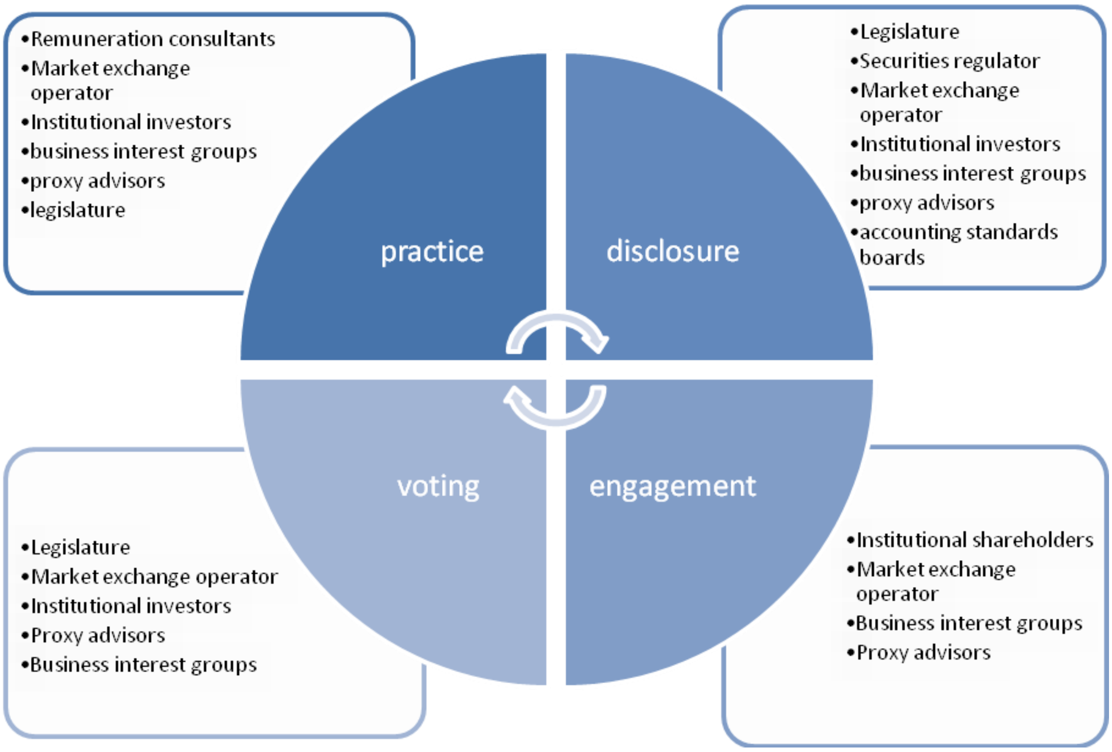
- Some rules are mandatory, whereas others are only voluntary, with the corollary that different consequences will attach to each;

- A variety of organisations act as a regulator: the legislature, the executive (in the form of the securities regulatory or some other government agency or department), the accounting standards maker, the market exchange operate, the industry body, even the individual investor and the individual firm;

- A variety of legal persons are targeted by the regulation: listed companies, boards of directors, remuneration committees, individual executives/directors, institutional investors, shareholders;

- There is an iterative process in the regulation of executive remuneration practice and thus the potential for evolution in executive remuneration practice will be influenced by evolutions in the activities of disclosure, engagement and voting.

Figure 1: the regulated remuneration cycle



Thus the regulatory framework for executive remuneration has to provide rules for each activity. Ideally individual regulators will consider the other regulators, the whole cycle, and the time lags implicit within the cycle when making new rules or amending existing rules.[3]

To understand how the rule-making on executive remuneration is iterative, it is useful to understand the internal company process of firm budgeting and financial reporting and how the regulated remuneration cycle fits within these processes.

Each year the board makes two major decisions in relation to remuneration: what to award the executive for the financial year that has concluded, given the firm's performance (total actual remuneration, TAR) and what potential award to offer to the executive for the next financial year, given the firm's financial goals and targets (total potential remuneration, TPR). These decisions happen in conjunction with the board's sign-off of the previous year's financial results and the sign-off for the new financial year's budget. This is illustrated below in **figure 2**, the company's budgeting, reporting and remuneration cycle.

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[3] The time lags implicit in the cycle are those surrounding the company's ability to respond to evolving views of good practice.

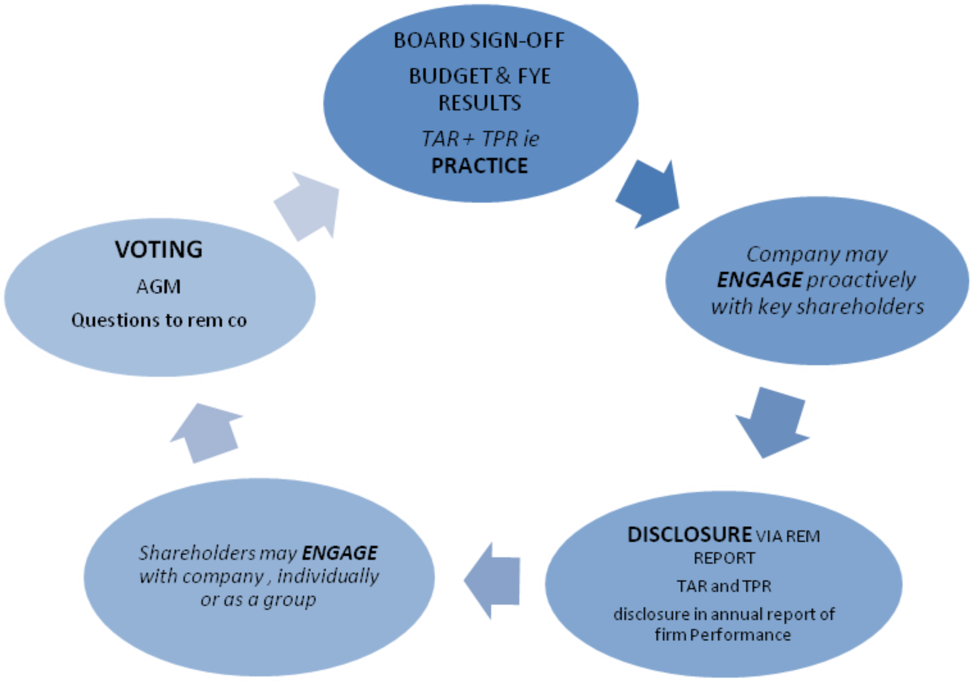

Figure 1: the company's budgeting, reporting and remuneration cycle

This figure mirrors the regulated remuneration cycle, with the addition of an extra opportunity for engagement, after the board's decisions but prior to disclosure. This is engagement of the shareholders by the board. Such engagement is proactive and is seeking typically to 'sound out' shareholders on issues the board knows are likely 'red flags' for the shareholders. The other time for engagement is after disclosure of remuneration (TAR and TPR), but prior to shareholder voting. Engagement at this time is usually initiated by shareholders and is reactive to the company's remuneration disclosures.

Organisations such as the Association of British Insurers (ABI) in the UK and the Australian Council of Superannuation Investors (ACSI) regularly issue up-to-date statements of good practice. In the case of the ABI, these are usually issued just prior to the new financial year (December) so that boards making TPR decisions can take this advice on board. ACSI typically issues its statements bi-annually, immediately prior to the voting season (August/September). In both instances, but especially in Australia, this can be a source of delay. Companies are already into the new financial year and TPR decisions have been made for that year. While both timings would appear to allow the board to respond for the following year, the constant restatement of what is good practice can have some implications for companies trying to structure remuneration policies over a three to five year cycle (especially for long term incentive schemes or share-based remuneration schemes). It is important to note that not all short-term views of remuneration stem from companies.[4]
Thus the iterative process is the relationship between market practice, firm practices and statements of good practice. Codes of good practice operate as an observational schema.[5] Companies will watch how the market responds to practices in other companies before

[4] Cf Patrick Durkin, 'ASIC mulls quick end to short-selling ban' *The Australian Financial Review* (Melbourne) 30 September 2008, 3 (quoting a spokesperson for ACSI on executive remuneration).

[5] David Seidl, 'Standard setting and following in corporate governance' (2007) 14 *Organization* 705, 707-709.

adopting the same practice. When the market response to a new practice is positive, other companies will adopt this practice and report that they have done so. This, in turn, will encourage further companies to consider adopting the practice. However, by the time such companies consider the practice, the statement of good practice may have evolved further. **Figure 3** below illustrates this process for statements of good remuneration practice.

Figure 3: iterative rule making

It is unclear whether the statements of good practice made by institutional investors are merely responding to prevailing practices or are identifying new practices for individual firms and ultimately the market to adopt. In other words, who is leading the development of good practice: particular firms acting on advice from their remuneration consultants or institutional investors?

The criteria by which these practices are deemed to be 'best' or 'good' are also unclear as they are not specified in the statements of practice issued by these investors. A number of remuneration committee chairpersons and remuneration consultants I interviewed as part of my PhD studies argue that best practice for the individual firm is the one which will deliver the desired performance for that firm. In other words, 'best' is highly context specific.

1 Governance of remuneration

The issues paper asks for comments on what features constitute a well-governed remuneration process. As the issues paper noted under ‘the implementation gap’, many companies formally complied with the relevant corporate governance requirements, yet ultimately failed as companies. This suggests that form has prevailed over substance. That this is so has been shaped by how remuneration practices are described, disclosed and enforced. A good process for setting remuneration is a necessary but not sufficient cause of good remuneration outcomes.

The model of the regulatory framework in figure 1 above shows that shareholders play a key role in this framework through

- Describing remuneration practices as ‘good’ or ‘best’
- Engaging with companies on remuneration practices
- Voting on remuneration practices, either through advisory votes or through binding votes.

Analysis of the content of the various practice statements for executive remuneration reveals that the relevant guidance describes in some detail the process for setting remuneration (for example, an independent remuneration committee advised by independent remuneration consultants); the structural features of remuneration (for example, long term incentive schemes should use at least two measures, one of which is a market-based measure, such as total shareholder return); yet leave the outcomes described by way of high level principles (eg ‘don’t reward for failure’, ‘align pay with performance’). That shareholders have in the past largely support remuneration reports in both Australia and the UK, including the practices of some financial institutions, might suggest that they are unable to assess in advance what policies are most likely to misalign pay with performance in the future or will allow reward for failure.

The OECD can support better remuneration practices by leading an initiative to revise existing remuneration practice guidance to better identify the remuneration policies that are more likely than not to result in flawed remuneration outcomes. This exercise should also describe what information needs to be disclosed to shareholders and stakeholders to enable these groups to identify *in advance* poor remuneration policies. The disclosure needs should also identify how best to present the information so that it can be readily understood.

2 Exercise of shareholder rights

The regulatory framework for executive remuneration presented in figure 1 only works if shareholders fully play their role in describing, engaging and voting on remuneration practices. This is because the sanctions for bad remuneration practice are imposed by shareholders, not governments or courts. Of these three roles shareholders play, engagement and voting are the ways in which good remuneration practice is encouraged and bad practice sanctioned.

The relatively short timeframe within which a number of investee companies release their remuneration reports and hold the AGM on which the report is voted means that there is a limited window of opportunity within which a number of remuneration reports have to be assessed.[6] This presents a barrier to considered analysis and timely engagement.

Institutional investors rely heavily upon the input of proxy advisors to make decisions on the advisory vote. Some institutional investors subscribe to multiple proxy advisory services, compare the reports, then reach a voting decision in-house. The combined length of the various proxy advisory services' reports is longer than the original remuneration report. However, the value in proxy advisors' reports is in the comparative analysis of the report against criteria of good practice and against the practice of other companies/ the market.

To improve the operation of the framework for regulation of executive remuneration, a rule that facilitates the voting process by allowing a greater time frame within which shareholders can review the annual report and lodge proxy appointments might be effective in achieving both higher levels of voting on remuneration and more considered use of that vote.

In summary: governments seeking to regulate further in the area of executive remuneration may not need to make laws about remuneration practices.[7] Rather governments may need to make laws that ensure shareholders and other stakeholders can play their part within the regulatory framework by removing any barriers that exist to effective participation.

3 The implementation gap

As noted above under 'governance of remuneration' the chief problem with corporate governance guidance on executive remuneration to date has been its emphasis of form over substance. This emphasis comes not only from how remuneration practice is described but also from a suggestion that the analysis of remuneration reports might focus on satisfying a set of criteria for good practice rather than whether the remuneration policies and practices disclosed for that particular company warrant shareholder support.

Highly prescriptive disclosure requirements may likewise contribute to form over substance. If a legal consequence is attached for failing to meet particular disclosure requirements, companies may choose to focus on compliance with the requirements rather than seeing the remuneration report as an opportunity to communicate with shareholders and a broader stakeholder group on remuneration practices.

The OECD's role in reducing the implementation gap is two-fold: to provide guidance on executive remuneration that describes outcomes, not just processes and secondly, to provide guidance on the role shareholders play within the framework and to identify the relevant levers to ensure shareholders play that role.

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[6] Chartered Secretaries of Australia, *Better communication between entities and proxy advisory services*, (2008), 9-10. This means the cycle shown in figure 2 above might not operate as the framework suggests because the opportunity to engage after the release of the remuneration report but prior to the lodgement of the proxy appointment is severely restricted.

[7] Although this option may be necessary in limited circumstances to mitigate against related party transactions or excessive termination payments.