4 DIRECTORS' REMUNERATION

I Introduction

4.1 The Listing Rules implementing certain Greenbury recommendations apply to company reports for periods ending on or after 31 December 1995. They have thus been in force for only one complete reporting cycle. It is too early to judge how the Greenbury code is working in practice or to consider the case for possible changes in it. But we wish to comment on a number of points.

4.2 Directors' remuneration is of legitimate concern to the shareholders. They are entitled to expect that remuneration will be 'sufficient to attract and retain the directors needed to run the company successfully'; and that 'the remuneration of executive directors should link rewards to corporate and individual performance'. (Chapter 2, principle B.I.) More generally, now that details of individual directors' remuneration are disclosed, they are liable to have an impact both on the company's reputation and on morale within the company.

II Remuneration Levels and Composition

A Levels

4.3 The remuneration needed to attract and retain executive directors of the required calibre will be largely determined by the market. For directors of international companies, the market is increasingly global. The board, through its remuneration committee, is best qualified to judge the appropriate level; the shareholders are entitled to information which enables them to judge whether remuneration is appropriate, and whether the structure of remuneration packages will align the directors' interests with their own.

4.4 Remuneration levels are oftcn set with the help of comparisons with other companies, including remuneration surveys. We urge caution in their use. Few remuneration committees will want to recommend lower than average salaries. There is a danger that the uncritical use of comparisons will lead to an upward ratchet in remuneration with no corrcsponding improvement in corporate performance.

4.5 Disclosure of individual director-s' remuneration has also lent force to the Greenbury recommendation that 'remuneration committees should be sensitive to the wider scene, including pay and employment conditions within the company, when determining annual salary increases' (code, C3). But it should also be recognised that ful1 disclosure of individual directors' total emoluments has led to an upward pressure on remuneration in a competitive field.

B Composition

4.6 We agree with the general view that a significant part of executive director-s' remuneration should be linked to the company's performance, whether by annual bonuses, share option schemes, or long-term incentive plans. This subject was discussed in detail by the Greenbury committee (report, 6.19.6.40), and it is clear to us that practice is still evolving quite rapidly. We are convinced that the success of such incentive schemes in stimulating performance **depends** less on the type of scheme chosen than on the detailed design of the scheme; the comparator companies; the yardstick (earnings per share, total shareholder retorn, etc.); and the quantitative relation between performance targets and benefit levels.

4.7 We have come to no general conclusion on the merits of tho various elements the remuneration package. In our view it is for the remuneration committee to ensure that the design aligns the interests of the executive directors with those of the shareholders, and that the Iev-els of achievrement which attract benefit are rralistic but challenging. We do not, therefore, recommend further refinement of the provisions of the Greenbury code relating to the form of performance-related remuneration. Instead, wc urge remuneration committees to use informed judgement in devising schemes appropriate for the specific circomstances of their company, and to bc ready to explain their reasoning to shareholders. They should ensure, as Greenbury recommended (report, 6.35), that total rewards from such schemcs are not excessive. The disclosures recommended by Greenbury will enable shareholders to monitor the arrangements in an informed way.

4.8 We considrr that payment of part of a non-cxecutive dircctor's remuneration in shares can be a useful and legitimate way of aligning the director's interests with tbose of the shareholders. We do not recommend what proportion of remuneration should be paid in this way, nor do we think that this need be universal practice. There will be some well qualified non-executive directors who, because of their personal circumstances, will need to be paid in cash. We recognise that Cadbury recommended that non-executive directors should not participate in share option schemes in case their indcpendence was undcsirably compromised (report, 4.13). We agree. We considcr that the scale of the potential benefit arising from thc leverage inherent in the award of share options is inappropriate for non-executive directors. But we do not think that the same objection applies to the payment of non-executive remuneration in the company's shares.

III Contracts and Compensation

4.9 Grcenbury recommended that 'there is a strong caso for sctting notice or contract periods. at, or rcducing them to, one year or less while rccognising that 'in some cases notice or contract pcriods of up to two years may be acceptable' (code, D2). Most companies have reduced director contracts from three years to two without cost to the company, and at considerable potential sacrifice to the individual. Many shareholders, however, continue to support a general reduction to one year. We agree with Greenbury that boards should set this as their objective, but we recognise that it cannot be achieved immediately, particularly where it might involve buying out existing contracts.

4.10 Much of the difficulty over compensation arises from the nced to negotiate it at the time of a director’s departure, whcn relation- may be strained for othrr reasons. We note the suggestions in the Greenbury report (code, D5 and D6) on the reconciliation of the various competing considerations.

The fundamental problem lies in the fiction of the notice period. Neither party seriously expects the typical notice period required from the emptoyer under a director’s service contract to be worked out. It is merely a mechanism for the payment of money. However, it is an inherently unsatisfactory mechanism because it hinges on a breach of the contract leading to damages for that breach. The damages are: (i) quantifiabte only at the time of termination; and (ii) subject to an obligation (which can be significant) to mitigate, for which it is impossible to provide a mechanical calcutation and this thcrcfore leads to uncertainty and hence controversy. A solution which brings certainty would be desirable.

This problem, and in particular the difficulty of applying the concept of mitigation in practice, is less significant in the contcxt of a general move to contracts of ene year or less. But, particularly where it is still necessary to agree a Ionger pcriod, wc see some advantage in a director’s service contract whicb would make detailed provision at thn outset for tho payments to which thr director would bc entitled if at any time ha was removed from office, except for misconduct. Such provision would be effective whether or not the director found other employment. This arrangcment would provide certainty for both sides, be operationally convenient for the employer, recognise the dislocation to the director inherent in summary dismissal, but avoid the problems of mitigation and inevitably subjective arguments about performance, conducted at the time of departure. Shareholders would of course see these provisions as they would be part of the director's service contract available for inspection.

IV The Remuneration Committee

4.11 Cadbury and Greenbury both recommended that the boards of listed companies should establish a remuneration committee to develop a policy on the remuneration of executive director-s and, as appropriate, other senior executives; and to set remuneration packages for the individuals concerned. We agree. We also agree with Greenbury that the membership of this committee should he made up wholly of independent non-executive directors. There will need to he attendance by executive directors for appropriate items.

4.12 Constitutionally, the remuneration committee is a committee of the board and responsible to the board. It is clearly wrong for executive directors to participate in decisions on their own remuneration packages, and the determination of these should be delegated to the remuneration committee. But the establishment of the bread framework of executive remuneration and its cost is in our view a matter for the ful1 board, on the advice of the remuneration committee.

4.13 We agree with Greenbury that the determination of remuneration packages of non-executive directors, including non-executive chairmen, should be a matter for the board as a whole; the individuals concerned would, of coursc, abstain from discussion of thrir own rcmuneration. lt may, however, prove convenient for the board to delegate this responsibility, case by case, to a small sub-committee, which might include the chief executive officer.

V Disclosure

4.14 Section 12.43(x) of the Listing Rules implements most of the disclosure provisions in section B of the Greenbury code by requiring companies to include in their annual report:

(a) a report by the remuneration committee on behalf of the board, covering hoth the company's remuneration policy for executive director-s; and

(b) details of the remuneration packages of each director.

Consistent with our view of the status of the remuneration committee, we consider that reports to shareholders on remuneration should be made in the name of the board as a whole.

4.15 We have reviewed the value of a general statement of remuneration policy. A number of companies have met the letter of this requirement with anodyne references to the need to 'recruit, retain and motivate' or to pay 'market rates'. We consider that a policy statement is potentially helpful, to set the context for the more detailed information; we hope that companies will provide more informative statements, drawing attention to factors specific to the company.

4.16 Remuneration disclosures are often excessively detailed, to the point where the essential features of remuneration packages have been rendered obscure to al1 but the expert reader. We welcome the recent changes to the Companies Act disclosure provisions, designed to avoid duplicating the Listing Rules. We hopc that it will he possible for thc authoritirs concerned to explore the scope for further simplification and for listed companies themselves to present the required information in a form more accesible to the lay reader.

4.17 It was also put to us that the requirement to disclose details of individual directors' remuneration was more intrusive than regulations in force in most other countries; and that this was a disincentive to foreign nationals from accepting appointments to thr boards of UK companies. We acept that this may be so in some cases; but wc believe that shareholders havc an equal interest in disclosure of the remuneration of all directors, regardless of nationality or residence.

Pensions Disclosure

4.18 Greenbury recommended that 'also included in the report should be pension entitlements earned by each individual director during the year, calculated on a basis to be recommended by the Faculty of Actuaries and the Institute of Actuaries' (code, B.7). In their detailed discussion (report, 5.17-5.23) the Greenbury committee found that for defined contribution pension schemes the contribution paid by the company measured correctly both thr benefit to the individual and the cost to the company; but that was not true for defined benefit (final salary) schemes. In particular, pay increases shortly before retirement could greatly affect the value to the director and the long-term cost to thc company. This is not necessarily fully reflected in the level of the employer's contribution.

4.19 **The Faculty of Actuaries and Institute of Actuaries recommended in April 1996 that in the case of defined benefit schemes, the company should disclose :**

(a) the amount of the increase in the accrued pension to which each director became entitled during the year; and

(b) either the transfer value associated with that increase or sufficient, prescribed information to enable a reasonable assessment to be made of the value of the increase in accrued pension.

The London Stock Exchange has now issued an amendmcnt to the Listing Rules requiring disclosurc on these lines in company reports for periods ending on or after 30 June 1997. We support a requirement in these terms; and we suggcst that when making disclosures under (b), companies might spell out that thr transfer value represents a liability of the company but not a sum paid or due to the individual; and that it cannot meaningfully bc added to annual remuneration.

VI Shareholder Involvement in Remuneration

4.20 We agree with Greenbnry's recommendation that shareholders 'should be invited specifically to approve all new long term incentive plans.. which potentially commit shareholders' funds over more than one year, or dilute the equity' (code, B.12).

4.21 Greenbury recommended that the remuneration committee's report to shareholders should not be a standard itrm of agenda for AGMs; but that a view should he taken each year whether the AGM should be invited to approve tho remuneration policy. We agree that the decision whether to seek shareholder approval for the remuneration report should be one for the company. To require shareholder approval for a single aspect of company policy would, in our vicw, be inappropriate. A shareholder sufficiently unhappy with the remuneration report ultimately has the opportunity to vote against the whole of the report and accounts (see 5.20 below).