

## **SECRETARY OF STATE'S SPEECH, 19 JULY 1999: DIRECTORS' REMUNERATION**

I am delighted to see that the theme of today's seminar is UK competitiveness. The Government has a duty to do everything it can to promote the competitiveness of British based companies. But there is also an absolutely crucial role for institutional investors and fund managers to play in enhancing their performance.

### Institutional investor voting

One of the key roles of investors is their direct role as shareholders. There was, for many years, a tradition of institutional investors not using their voting powers in a particularly active way. Many institutions preferred to sell their holding if a company's performance deteriorated rather than to engage the company in positive dialogue. This is changing. Indeed we are seeing the beginning of the shareholder activism that exists in the USA.

There have been two recent developments in this area by institutional investors and fund managers, both of which I warmly welcome.

First, the independent Committee of Inquiry into UK vote execution set up by the National Association of Pension Funds published its report on 5 July. It looked at two key issues.

First, whether the low voting rate achieved by pension funds reflects the intentions of trustee boards;

and, second, the nature of the problems within the current system of voting.

The Inquiry concluded that the low voting figure partly reflects conscious decisions by some institutions and fund managers not to vote on routine items of corporate business, but that it also reflects a complex and antiquated system.

The Inquiry's key recommendations were that:

regular, considered voting should be regarded as a fiduciary responsibility of trustee boards;

trustee boards should record their policy position on voting in the Statement of Investment Principles;

the Association of British Insurers and the National Association of Pension Funds should continue to encourage and provide practical help to their members to adopt or review considered corporate governance and voting policies;

and, finally, that the UK's voting system should be modernised.

These are important conclusions with implications both for institutional investors and for the Government. We shall be acting on the points for which the Government has responsibility.

First, the Department of Social Security laid regulations under the Pensions Act before Parliament on 1 July that will require pension fund trustees to declare the policy they have adopted in directing the exercise of the voting rights attaching to their investments.

Second, with respect to making voting easier, and in response to the preliminary recommendations by the Company Law Review Steering Group, we intend to seek a general power under the Electronic Communications Bill to clarify the Companies Act 1985 to enable companies to transmit by electronic means any document which the Act requires that they send to members, provided that the individual member has agreed. This would include, for example, the report and accounts and notice of company meetings.

Companies could also place the document on a web-site and, again, with the shareholder's agreement, send only a notification that the document was there.

Companies would also be able to receive shareholder proxy and voting instructions electronically, cutting out time-consuming paper processing for both the company and the shareholder.

Finally, our proposals also include enabling companies to incorporate electronically, increasing the number of services Companies House is now able to offer on-line.

Companies have told us themselves that they would value these measures. We are aiming to help them to save money and time, two of their most valuable resources.

I mentioned that there had been two important developments. The second development is, of course, the one you have heard about earlier at this seminar, namely the joint statement by the Association of British Insurers and the National Association of Pension Funds on responsible voting.

I very much agree that responsible voting involves the application of informed decisions reached within the framework of a considered corporate governance policy. High voting levels are important; but it is essential that voting is considered rather than just simple "box-ticking" if it is to benefit British companies.

### Directors' remuneration

The key area about which I would like to speak today is that of directors' remuneration.

I believe that it is essential that we consider this area in a responsible and reasonable way.

It is crucial for you, as the shareholders, that the companies you invest in attract, retain and motivate people of the right calibre and experience to make their businesses successful.

It is important for the prosperity of our nation that you do so.

We need to recognise that in a global economy world class performance must be rewarded with world class pay.

We accept such an approach in relation to sports stars so why don't we adopt the same attitude for directors. To attract world class players, we need to pay at world class levels.

It is not for the Government to determine or dictate levels of pay for company directors. But it is for government to ensure that a framework is in place which allows shareholders to exercise their influence effectively on companies' remuneration policies.

The key principle must be the effective link of rewards to performance. I believe that this is a principle that everyone should sign up to.

It does none of us any good to design contracts for any member of an organisation which fail to encourage good performance.

In the case of company directors, it is particularly important to get that link right.

Get it wrong, and the company will be taken in a direction that does not enhance long term value, to the detriment of shareholders and of the nation.

This is, of course, where shareholders - and, in particular, institutional investors and fund managers - have a crucial role to play.

Linkage to performance is, of course, in the first place a matter for the members of the remuneration committee. They are the ones responsible for ensuring that - to quote from the Greenbury Report - remuneration packages link rewards to performance, by both company and individual, and align the interests of directors and shareholders in promoting the company's progress.

But the long-term performance of a company must also be a matter of the very greatest concern to shareholders.

I know this is an area where many fund managers, as well as organisations such as the Association of British Insurers and the National Association of Pension Funds, are already active.

Many of our best firms engage in a constructive dialogue with them and the result is good all round.

In particular, I am encouraged by the way in which the Association of British Insurers' statement on the principles of executive incentive arrangements encourages companies to set challenging performance conditions and to measure such conditions relative to an appropriate defined peer group or other relevant benchmark.

This is, I am sure, the direction in which best practice will continue to develop, and I am pleased that, once again, the UK is leading the way in developing the highest standards of corporate governance.

I have no doubt that we can do even better in this area; because the performance of British companies would clearly be enhanced if directors' remuneration was more

closely linked to performance. The question is then whether we have the structures, the accountability and transparency to achieve this.

You will be aware of the valuable work that has already been done in the whole area, most notably by the Study Group chaired by Sir Richard Greenbury in 1995.

The Greenbury Group set down three fundamental principles in this area: accountability, transparency, and linkage to performance.

As I have made clear, I agree that these are the right principles; my concern and that of the Government is that they should not just be abstract principles but the basis of a practical and effective framework.

It is now four years since the Greenbury Group made its recommendations.

Some of its recommendations - particularly in relation to the disclosure of individual directors' remuneration - have been implemented as formal requirements in the Stock Exchange's Listing Rules.

For the most part, however, they have been implemented as best practice provisions, first as the Greenbury Code of Best Practice and more recently, following publication of the Hampel Report in January 1998, as part of the Combined Code.

Both the Greenbury Group and the Hampel Committee recommended that statutory controls should be unnecessary in this area. The Government has made it clear several times in the last two years that it agrees that prescription in this area should be unnecessary, but that it wants to see more evidence that companies are complying with the spirit of the best practice framework.

In May this year, my Department appointed PricewaterhouseCoopers to monitor compliance with the current best practice framework by quoted companies with a financial year end between 26 December 1998 and 31 March 1999. A summary of the results of their survey are available this morning. The results of their monitoring are significant.

## *Transparency*

Greenbury said that it is important that companies and their remuneration committees adopt a philosophy of full transparency such that shareholders have access to all the information they may reasonably require to enable them to assess the company's general policy on executive remuneration.

I agree entirely with this. It is not just a case, of course, of putting a spotlight on companies which are not doing a good job of linking pay to performance; it is also important that companies which are achieving an effective link are seen to be doing so.

The monitoring by PricewaterhouseCoopers suggests that there is still considerable room for improvement in the way that many companies report on major issues such as how performance measures relate to longer-term company objectives and how the company has performed over time relative to comparator companies. This is an area that the Government will wish to consider further to see how standards of disclosure might be improved.

## Accountability

Greenbury was also concerned with accountability. Both the Greenbury and Hampel Reports recognised that directors' remuneration is of legitimate concern to shareholders.

They did lay down that shareholders should be invited specifically to approve all new long-term incentive schemes on the basis that they relate to performance over a run of years and potentially commit shareholders' funds for more than one year ahead, or dilute the equity. There has been a requirement to this effect under the London Stock Exchange's Listing Rules since 1996.

The Greenbury Report further recommended that boards of directors and remuneration committees should consider each year whether the circumstances are such that it would be appropriate to seek shareholder endorsement of the company's remuneration policy.

It suggested that a company might wish to consider doing so in circumstances where, for example, a company wished to change radically its remuneration policies, or if its policies in this area had attracted controversy.

The survey by PricewaterhouseCoopers showed that, in the period under review, only seven of the 270 companies monitored chose to put forward the remuneration report for endorsement by shareholders at the annual general meeting.

The PricewaterhouseCoopers study suggests that many companies may not yet be achieving a close link between pay and performance; only five per cent of companies, for example, disclosed even in broad terms how performance measures relate to long-term company objectives.

The consultation document which I shall publish shortly will float the idea of strengthening the disclosure requirements in this area.

The key issue is whether the institutional investors and fund managers need increased leverage to promote dialogue with companies that will ensure that the link is a good one.

For accountability can only work properly if there is a framework in place which allows shareholders to exercise their influence effectively over remuneration policy.

Best practice has an important part to play here. In the first place, investors should, of course, seek meetings with directors to express their concerns over remuneration policies.

Indeed, I know that many listed companies ask major investors to review new share incentive schemes before they are published. This type of dialogue is bound to be helpful in ensuring that the interests of directors and shareholders are aligned.

Secondly, the best practice framework should encourage boards to choose to put the remuneration report to a shareholder vote. I find it encouraging that some companies - including some of our larger listed companies - are already choosing to do so.

The best practice framework of dialogue between directors and shareholders and companies choosing to put forward their remuneration report may, however, need to be underpinned by new mechanisms to give shareholders greater influence over remuneration policy. The two main options open to shareholder at the moment if they have concerns about an aspect of directors' remuneration - and the company has not chosen to put its remuneration report to a shareholder vote - are either to vote against the company's report and accounts or to oppose the re-election of a non-executive director who is a member of the remuneration committee.

Both of these options have serious drawbacks. A vote against a company's report and accounts is a major step, and many investors are understandably reluctant to do so.

Equally, investors may be unwilling to vote against a non-executive director whom they regard, in general terms, as a strong member of the board. It's not surprising therefore that there have been a number of other suggestions for creating an effective and more focused way in which shareholders could influence directors' pay.

These will be included in the Department's consultation document which will be published before the end of the month. We have identified five options on which we intend to consult:

- special procedures to allow shareholders to table resolutions on remuneration at a company's annual general meeting;
- a requirement for quoted companies to have an annual vote by shareholders on the board's remuneration report;
- a requirement for quoted companies to have a remuneration policy and to seek shareholders' agreement to that policy annually;
- a requirement for directors of quoted companies to stand for election every year;
- a requirement for the chairman of the remuneration committee to be elected every year.

At the moment, I am most attracted by the first two of these options, but I will consider this further in the light of the responses to my Department's consultation paper.

### Conclusion

Let me remind you in conclusion why I see both these areas - institutional investor voting and greater linkage between pay and performance - as important.

It is in the interests of all of us that British companies are able to compete with the very best in the world. And improved competitiveness demands a constructive

relationship between investors and companies in all of these areas. I look forward to seeing that relationship continuing to develop over the months ahead.