28th May 2018
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Ms Rachel Reeve MP
Chair
Business, Energy and Industrial Strategy Committee
House of Commons
London
SW1A 0AA

Re: Executive Remuneration Progress Report

It gives me great pleasure to be able to write to you with an update to the evidence presented to the Committee in 2017 in respect of developments in corporate governance.

Since we last reported to your Committee, Manifest has been through a change of ownership and is now part of Minerva Analytics Ltd. Notwithstanding this change, the Manifest Total Remuneration Survey, and our commitment to independent and objective corporate governance research, remains undiminished. Now that most companies with December 31st year-ends have published their 2017 annual reports and associated remuneration details, we can provide you with an update on the numbers previously supplied and provide some background to the findings.

The 2018 survey is the 20th edition and, as with its predecessors, tries to tell the truth about pay and pay governance in an objective and unbiased way. We recognise that the truth is not always welcome, however we believe that there is a significant public interest in ensuring that the facts of governance are at the heart of any action by any stakeholders in the debate. Given the current low levels of societal trust in business and finance, the need for accurate, timely and independent data, rationally and logically analysed and explained has never been greater.

Headline numbers do not tell the whole story

The headline figure from the latest survey shows that the mean average remuneration of the CEOs of the UK's largest 100 companies, as defined by the Single Figure of Total Remuneration (SFTR), has increased by 18%.

In calendar 2017, we reported that there had been a 15% decrease in the 2016 financial year numbers. This year's 18% increase therefore restores SFTR back to 2015 levels.

However, due to the limitations of the SFTR, we do not think that these changes are giving the full picture. As we have previously indicated to your Committee, Dept BEIS, and other stakeholders, the better predictor of future executive remuneration is Total Remuneration Awarded or TRA, which saw a 4% increase of the mean in 2017.

While a single figure, because of its apparent simplicity, is very appealing, executive pay is complex both in context and construction. It is therefore best to look at the constituent components of pay to gain a full appreciation of changes and the impact (if any) that regulation may have had.

The Single Figure Effect

The median figure is telling a different story to the mean average in many cases. A more indicative figure of what is happening more generally is the median increase of the SFTR which is 6%. STFR is, however, a lagging indicator, whilst **TRA is a leading indicator** and suggests that pay, although flat since 2011, may be increasing again.

The Flexibility Effect

This year's data shows a radical **increase** in the **mean average salary** of the top 100 CEOs, **of 7%,** in addition to last year's even higher **increase of 10%.** We believe that these figures are truly indicative of change and reflects the Executive Remuneration Working Group Final Report (August 2016)[1] which included a stimulus for more flexibility in pay design. Recommendations included less performance related pay and less highly geared LITPs to be replaced by restricted share type schemes. The **median salary has not increased significantly** (only 2%), so what is happening is that a small number of companies have taken the opportunity to radically de-risk their CEO's remuneration package and significantly increase his (and it is mainly men) salary and other pay components. This is an example of how best practice or regulatory proposals can have unintended consequences, however well-intended the motives. Focus on structure alone without modelling possible scale effects should be avoided as much as possible.

The Outlier Effect

As usual, there is an outlier effect of a small number of extremely large packages which can affect the overall picture. Sir Martin Sorrell's STFR 2 years ago was £70m and this year is £13.9m. This, reduces the average pay half a million, but this has been made up for by increases for others.

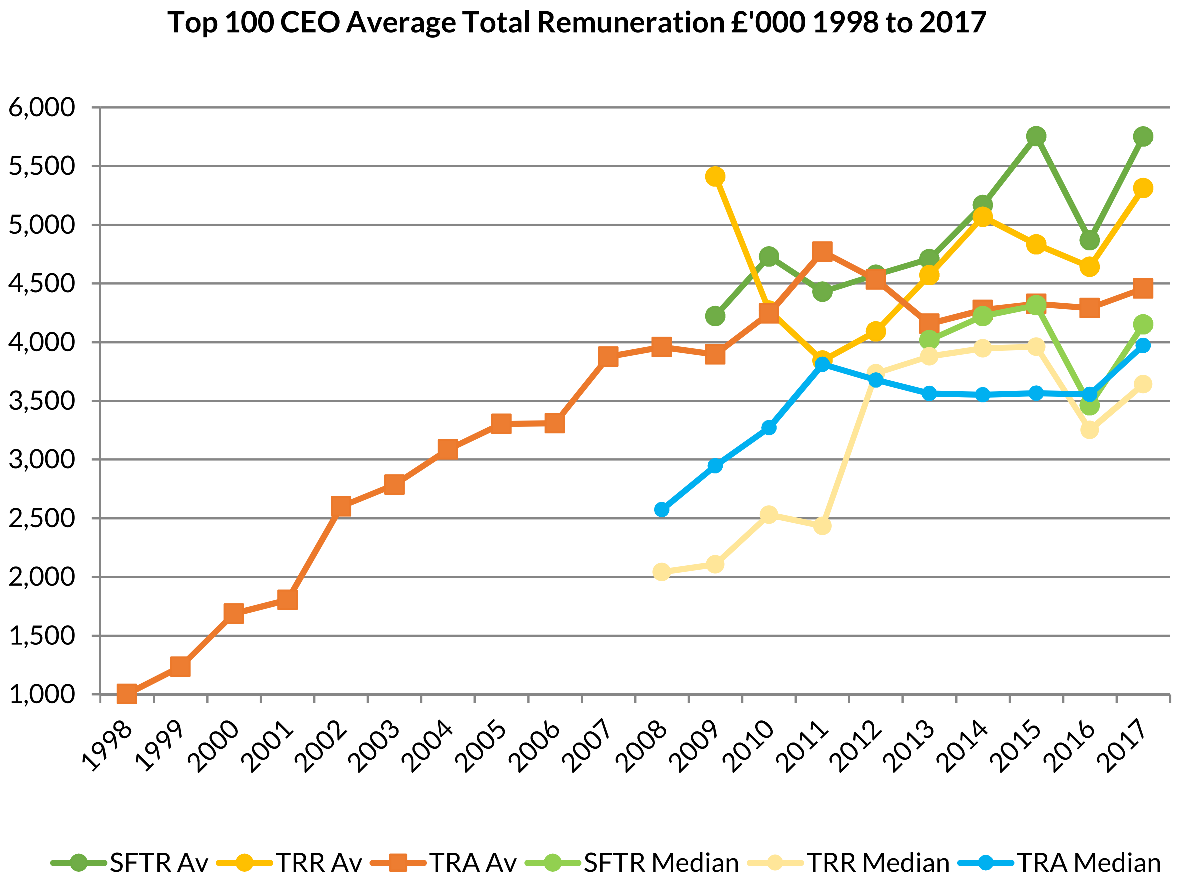
Remuneration Trends since 1998

The charts on the following pages shows the breakdown of the elements of remuneration awarded to the top 100 chief executives over time. Use of the mean average allows this breakdown to be shown since the mean for the elements of remuneration always add up statistically to the mean for the total (which is not true for medians).

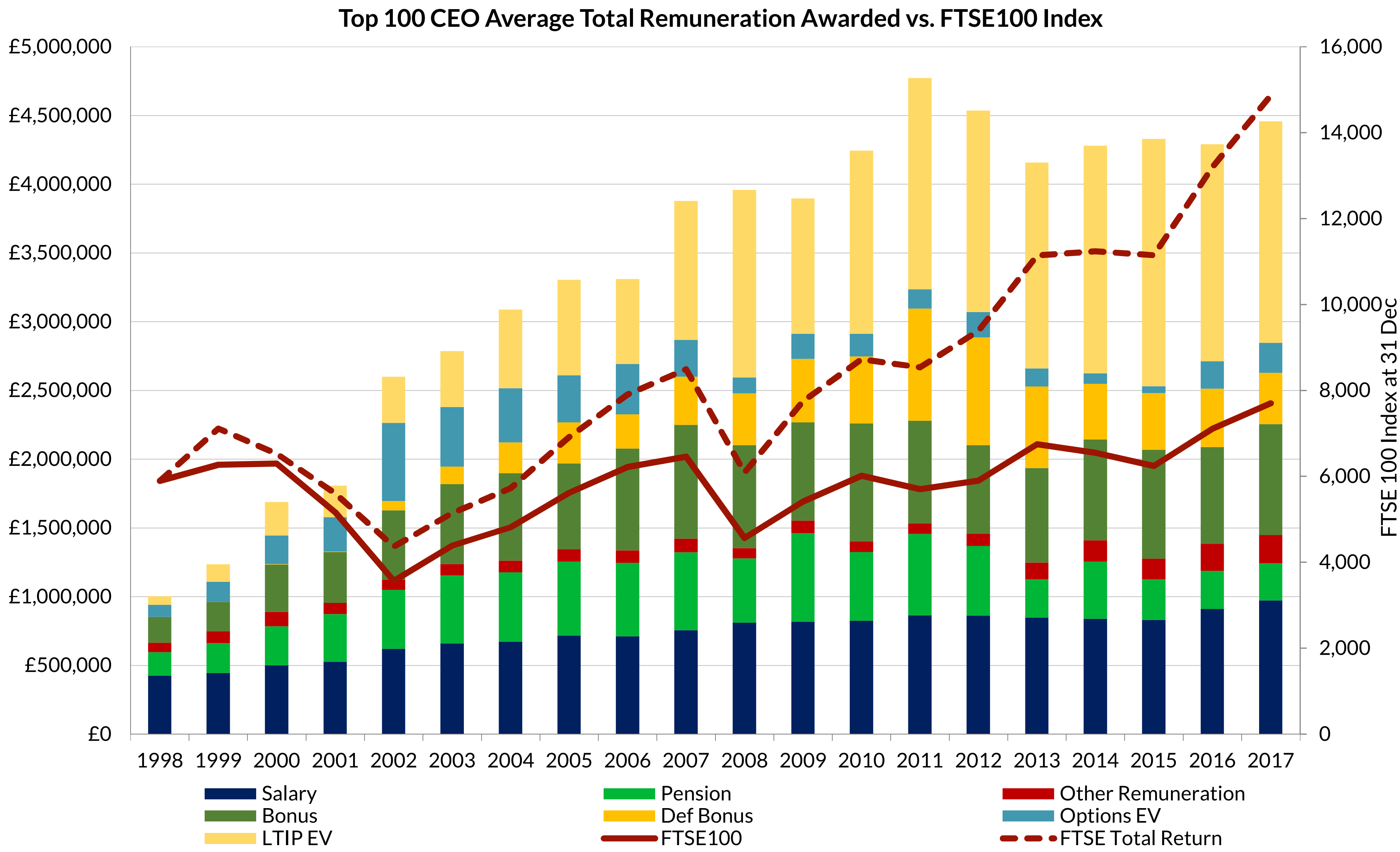
The second chart shows the development of the FTSE 100 share index and the total return index over the same period. The latter is more relevant since it shows how shareholders fared over the same period and so is a measure of **alignment**. The chart indicates that since the recovery from the dot-com bubble burst in 2000-2002, average remuneration awarded has been inflating at a rate equal to the shareholder return.

While Total Remuneration Awarded to the chief executives of the top 100 companies has shown major fluctuations from year to year, it **has been essentially been flat since 2013, with no real significant trends.**

[1] Source: https://www.theinvestmentassociation.org/assets/files/press/2016/ERWG%20Final%20Report%20July%202016.pdf



Source: Manifest



Source: Manifest

Did the 2013 Reforms Work?

The 2013 remuneration reforms, which were a reaction to post financial crisis concerns, introduced **new remuneration disclosures** and a **binding pay policy vote**. One of the major questions for everyone with an interest in better governance is "Did the reforms work?" Based on the data in our report we can say yes, they have had an effect. Firstly, there has been a moderation in the rate of increase in executive pay overall. Secondly, as the second chart shows, remuneration has been more closely aligned with shareholders' interests than in the immediate pre-reforms period. There were many additional factors surrounding the reforms which may have also encouraged change: increased public awareness; media coverage; political debate and underlying client pressure on asset managers, all of which may all have had an impact. We should therefore look at the reforms as an overall package rather than attributing the changes to one specific reform.

Similar observations have also been made by research by academics from the Universities of Sheffield, Glasgow and Nottingham Business School. A working paper (Rodion Skovoroda, Alistair Bruce, Trevor Buck, 2018) was recently presented to a Royal Economic Society's conference in March and subsequently reported in the Financial Times in April.[2] Skovoroda et al are proposing that binding votes on pay have substantially improved the alignment of the interests of CEOs and shareholders, particularly when looking at the LTIP component of TRA rather than the SFTR.

In respect of shareholders' response to binding or advisory votes, prior to the 2003 Companies Act amendments which introduced the advisory vote on pay policy, shareholders were able to use binding votes on share options and LTIPS, the component of the executive pay mix with the most inflationary and dilutive potential. However, dissent on either the binding or advisory pay votes was extremely rare. It had been proposed by some industry observers that, while binding votes can have a disciplining effect on management pay-setting, shareholders have been reluctant to use binding votes because of the potential to damage share prices. The work of Skovoroda et al suggests otherwise and that binding votes have created a strong alignment between management and shareholder interests.

As a historical aside, the 2013 reforms returned shareholders to the same position of control over directors pay as the 1862 Companies Act. This contained a default rule that the remuneration of directors was to be set, on a binding basis, by the company's general meeting, under Table A, article 54.

There are many complex and inter-locking reasons for the apparent lack of action on the part of some shareholders. Since the 1990s there has been a sharp fall in domestic ownership of UK-listed companies together with a significant rise in US ownership. At the same time, despite the increase of retail shareholders, these owners are essentially voiceless having been disenfranchised by the pooled nominee ownership system.

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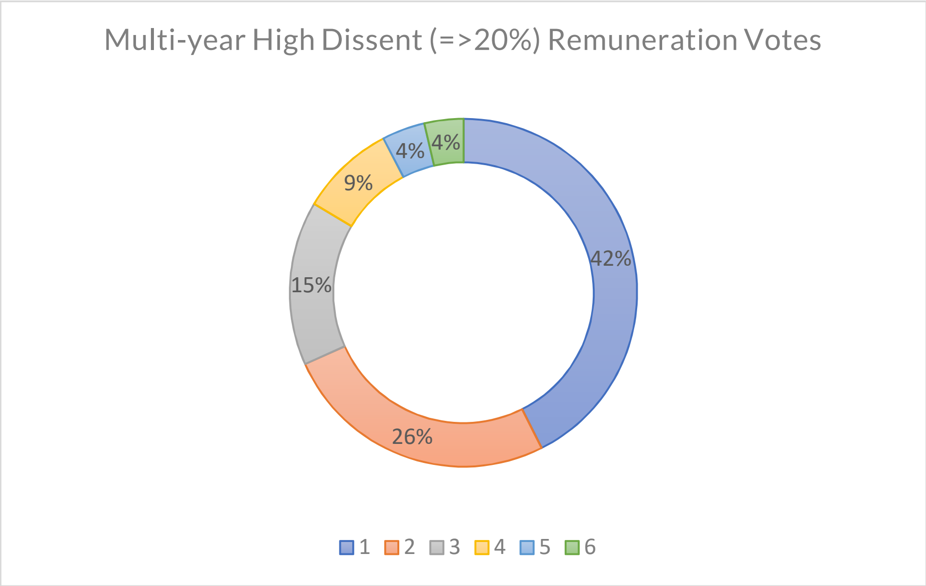
[2] Rodion Skovoroda, Alistair Bruce, Trevor Buck, Ian Gregory-Smith (2018). *'Say-on-Pay', Binding Votes and the Vesting Ratios of Performance Equity*
https://www.ft.com/content/30abb36c-3805-11e8-8b98-2f31af407cc8

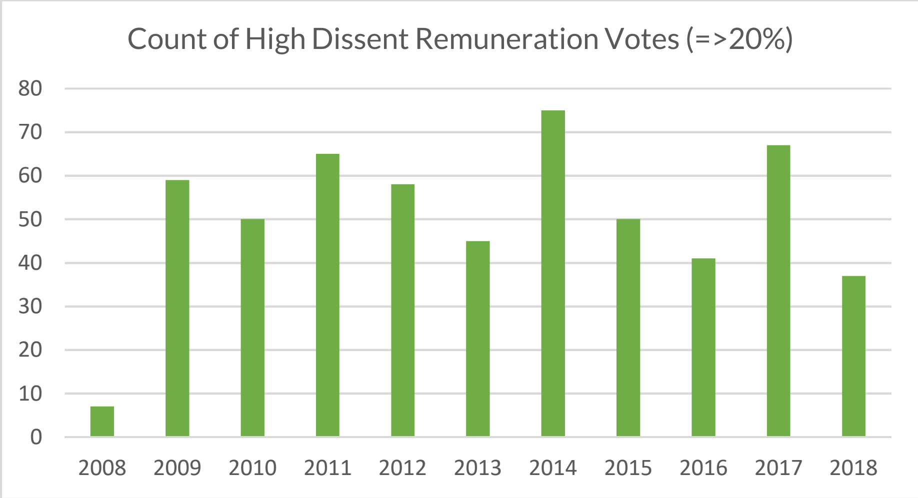
As the previously accepted cultural norms that were once shared within a concentrated group became less powerful due to this changing ownership structure, companies may have received mixed messages about the best way to proceed with shareholder relations. US remuneration operates under very different securities law and taxation influences and these practices, when translated into different markets may well have had significant unintended consequences.

Shareholders ignored?

This is not to say that all shareholders have been quiet about raising their concerns about the disconnect between pay and performance. A number have been extremely forthright in their criticism of pay for failure, mediocre performance or just plain luck. However, despite these efforts, we would argue that the quality of discourse surrounding governance and stewardship could be significantly better. This is an issue that the FRC's review of the Stewardship Code aims to address.

By way of evidence, the charts below show, for the constituents of the FTSE350, the number of remuneration-related resolutions which received greater than 20% dissent over the past 10 years (554) and the proportion of resolutions with multi-year dissent. Surprisingly 59% of companies in this group experienced two or more high dissenting votes.





2018 figures as at 25 May 2018

This data would seem to suggest a breakdown in communication: either companies aren't listening to feedback, or shareholders are not explaining effectively, or possibly a mixture of both. We would therefore propose that any regulatory interventions should address human and cultural factors of stewardship rather than focussing primarily on the mechanical elements of governance.

In respect of companies, we have observed a tendency on the part of some to assume that investors have voted on a rote or box ticking basis. At the worst extremes, some companies and their advisors have attempted to shift the blame for poor voting outcomes to shareholder voting research services. This can mean that remuneration committees spend undue time focussing on what X, Y or Z voting service thinks rather than talking to shareholders. For those asset owners and managers who do engage very positively on a range of ESG issues, including pay, this is extremely unhelpful and discounts their pivotal stewardship role.

The "tin ear" problem of ignoring votes is the reason Manifest talks about shareholder dissent (being the sum of Against and votes Withheld) rather than only looking at votes against management. Why? Given that the majority of votes get majority support, most of the time, setting a threshold of concern at 20% against is too high. Even 10% dissent should be disturbing to shareholders and boards as it shows there are unresolved differences of opinion between management and shareholders which would be better addressed rather than being dragged out in public over multiple AGMs.

Groupthink effects

The extreme concentration of the governance research market has no doubt played a part in companies' and advisors' thinking about voting behaviours. With two US-domiciled services accounting for circa 75% of global market share, parallels have been drawn between the proxy advisory industry and the role of Credit Ratings Agencies in the run up to the financial crisis. If most shareholders are looking at the same data, using the same evaluation models and applying the same recommendations, it is not surprising that assumptions are made about who is responsible for votes, which makes it easier for companies to dismiss legitimate concerns.

Now that the effects of Groupthink are being more closely analysed through the work of, for example, the Behavioural Insights Team and the Cabinet Office, we are all better able to appreciate the importance of diverse thinking and its role in providing essential safeguards against excessive conformity and its unintended consequences.

We hope that the forthcoming regulations from BEIS and DWP together with the transposition of the Shareholders Rights Directive in 2019 will help by improve market demand for better stewardship. Certainly, the Pensions Regulator's recent guidance to trustees on ESG and voting provide very important nudges for all parties.

Conclusions

In summary, what would our recommendations be for the Committee to consider?

- Good governance and stewardship are essential to rebuilding trust in business and finance. All involved parties should therefore strive to improve mutual understanding and provide better explanations for decisions and actions.
- Remuneration is complex and cannot be reduced to a simple single figure.
- Companies should provide 3 figures: Total Remuneration Awarded, Total Remuneration Realisable and Total Remuneration Realised.
- Some pre-reform disclosures should to be restored.
- Binding votes have been more effective than advisory votes and have not suffered from the drawbacks that were initially proposed. Whether all remuneration votes should be made binding is therefore an important question.
- Remuneration committees and shareholder engagement needs a re-think, changes to the Governance and Stewardship codes will be important to achieve this.
- The role of retail shareholders and their lack of voting influence is an important and urgent issue which should be addressed at the earliest opportunity.
- Companies and shareholders should be encouraged to think more diversely about pay and consider new approaches which are more consistent with the latest thinking on, for example, behavioural economics and work on incentives.

If we can be of further assistance to your Committee in its deliberations, please let me know.

Yours sincerely

Sarah Wilson
Chief Executive

Appendix A: Definitions of Total Remuneration

To cope with the complexity of pay, the Manifest Total Remuneration Survey shows long-term incentive and deferred bonus figures prepared under three different conventions. None is inherently 'correct'. The choice of which to use depends on the purpose to which the pay information is being applied:

Total Remuneration Awarded:

Using Total Remuneration Awarded or 'TRA', the LTI is measured as an 'Expected Value' or 'Fair Value' of the grant and is included in the year in which the grant is made. The deferred element of the bonus is included in the year the bonus is earned but at its Expected Value.

This is the most useful measure for comparing executive pay, and also for tracking the trend in decisions being made by remuneration committees. The US Securities & Exchange Commission pay disclosure rules follow this approach, except in respect of pension.

Total Remuneration Realised:

Using Total Remuneration Realised or 'TRR', the LTI is measured at the time it is receivable by the executive, i.e. when and to the extent that performance vesting conditions have been met. Performance shares are valued at the market price at the time of vesting. Share options (including nil or nominal cost options) are included in the year they are exercised, at the intrinsic (in-the-money) value at the time of exercise. The deferred element of the bonus earned in the relevant year is excluded, but the value of previously deferred bonus amounts which vest in the year are included. The UK tax authority, HMRC, broadly follows this approach, except for pension for which there are special rules.

As this figure represents the remuneration actually received by the director, it is the figure that should be used by shareholders and other stakeholders who wish to see if the amount received has been justified by company performance. It is less useful in comparing the competitiveness of remuneration because of the necessity of factoring-out share price performance; neither is it a good indicator of the trend in remuneration committee decisions, since the decisions affecting long-term incentives were made some years earlier.

Single Total Figure of Remuneration:

The Single Total Figure of Remuneration 'STFR' is the figure required by the UK remuneration disclosure regulations. In introducing its new regulations in 2013, the Government sought to define a single figure (and its elements) that would suit all purposes. Clearly no single figure can do so, and the flaws in the methodology are described below.

The method largely follows the definition of TRR, with some important differences:

- Share options are valued at the intrinsic value at the time they become exercisable (i.e. 'vest'), not when the option is exercised.
- The deferred element of bonuses is included in the year it is earned rather than received (future changes in the share price prior to vesting are not considered); and
- Defined benefit pensions are valued on a standardised multiple of the increase in the year in retirement benefit accrued.

The Single Total Figure of Remuneration does not show the true value of the benefit received by the director nor the correct timing of its receipt.

Both Total Remuneration Realised and the Single Total Figure of Remuneration depend on how much long-term incentive schemes eventually pay out, which in turn depends on the size of the award; the percentage vesting; and the share price change between award date and vesting.

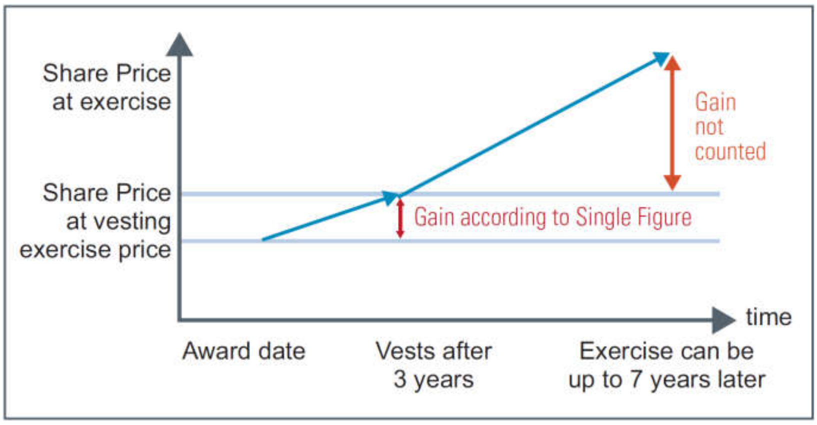
The Problems of Single Total Figure of Remuneration

As part of its introduction of the new directors' remuneration reporting regime from 30 Sep 2013, the UK Government was challenged to create a more straightforward way to be able to understand pay through the provision of a 'single figure'. The Financial Reporting Council convened an independent advisory group and prepared a range of proposals based on stakeholder feedback. This became the statutory 'Single Total Figure of Remuneration' which is required to be reported along with its component elements, for each director.

Unfortunately, the resulting metric was not helpful and, in some respects, **disclosure has become more complicated** rather than less. More importantly, there is an **overstatement** of reward in the short term and a **serious understatement** in the longer term.

The current officially mandated method:

- Includes deferred bonuses in the year they are awarded.
    - × This ignores the share price increase on vesting and has the effect of boosting the reported total remuneration received in the short term but reducing it in the longer term; and
    - × it can understate or overstate the amount the executive actually receives and pays tax on.
- Takes the 'in the money' value of share options at the date they become exercisable
    - × This ignores the very considerable 'future value' of the option which arises from the upside bet over the next seven years (see below)



Because of these distortions, for example, the Single Total Figure of Remuneration for top 100 CEOs showed an increase in remuneration of only 3% in 2012 and 2013, compared with an increase of 6% and 12% when using Manifest's method of Total Remuneration Realised.

For this reason, when the SFTR was introduce we believed it was essential for Manifest to continue to analyse remuneration across the range of methodologies to accurately assess the impact of the regulation changes.

Given this inconsistent treatment of executive pay, Manifest believes that **the Single Total Figure of Remuneration is not a true and fair view of pay** and should be revised at the earliest opportunity. Although BEIS consulted on the STFR definition through the Financial Reporting Lab, Manifest believes that findings were unduly influenced by the International Accounting Standards Board views of how to measure compensation and remuneration costs, rather than looking at information from the shareholders' point of view.

We are therefore Dept BEIS to revisit and revise the Single Total Figure definition and:

- Include deferred bonus when it vests;
- Include option gains when the option is exercised; and
- Restore pensions-related disclosures