RESTORING RESPONSIBLE OWNERSHIP

ENDING THE OWNERLESS CORPORATION AND CONTROLLING EXECUTIVE PAY

BY CHRIS PHILP MP
WITH AN INTRODUCTION BY
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high pay centre

About the High Pay Centre

The High Pay Centre is an independent non-party think tank established to monitor pay at the top of the income distribution and set out a road map towards better business and economic success.

We aim to produce high quality research and develop a greater understanding of top rewards, company accountability and business performance. We will communicate evidence for change to policymakers, companies and other interested parties to build a consensus for business renewal.

The High Pay Centre is resolutely independent and strictly non-partisan. It is increasingly clear that there has been a policy and market failure in relation to pay at the top of companies and the structures of business over a period of years under all governments. It is now essential to persuade all parties that there is a better way.

The High Pay Centre was formed following the findings of the High Pay Commission. The High Pay Commission was an independent inquiry into high pay and boardroom pay across the public and private sectors in the UK, launched in 2009.

For more information about our work go to **highpaycentre.org**

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About the author

Chris Philp studied Physics at Oxford. He began his career at McKinsey before becoming an entrepreneur. He floated his first business on the stock market and has founded businesses in distribution, finance and real estate. Chris became the Conservative MP for Croydon South in 2015 and is a member of the Treasury Select Committee. Follow Chris on Twitter @ChrisPhilp_MP

Paul Marsland of the High Pay Centre contributed sections 3a and 3b

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- Fragmented shareholdings and short-term investor horizons mean that some shareholders are not exercising proper oversight of companies they own
- The market does not work if shareholders are not always responsible custodians of their capital
- Shareholder interests and the wider public interest are often not served by executives who over-compensate themselves, do not focus on the long-term or engage in unchallenged strategic initiatives, such as reckless acquisitions

The Rise of Excessive Executive Pay

- One symptom of the rise of the Ownerless Corporation is the rapid rise in total Executive pay
- FTSE100 CEO total pay in the UK now averages £6 million per year, or 150 times average worker income. This ratio has doubled in 10 years as worker pay has stagnated (see page 11)
- This level of inequality is socially divisive and public opinion is firmly against it (see page 12)
- There is clear evidence that high CEO pay is no longer strongly associated with performance, and two academic studies clearly show that in fact high CEO total pay negatively correlates with performance (see pages 14-15)

Proposal 1: Mandatory Publication of Pay Ratios

- Mandatory publication of total CEO remuneration to median worker total pay
- Creates transparency and downward pressure on unduly high ratios

Proposal 2: Annual Binding Shareholder Votes on Executive Pay

- Besides the binding pay policy vote each 3 years, annual binding vote on actual pay awards
- This will increase shareholder control of actual pay awards
- This is already done in Switzerland, Holland and Denmark

Proposal 3: Mandatory Shareholder Committee, with employee rep attending

- Establish a Shareholder Committee consisting of top 5 shareholders based on >12 month holdings. If a shareholder declines, move to next shareholder down
- Main Board Chairman and an employee (not union) representative should attend as non-voting but speaking members to give them a voice

- Shareholder Committee exercises 3 powers:
  - Replace the Nominations Committee in recommending the appointment and removal of Directors to the AGM. This will make Directors more directly accountable to shareholders
  - Ratify the pay policy and actual pay packages proposed by the Remuneration Committee before they go to a vote of all Shareholders at the AGM
  - Pose questions to the Board, including on corporate strategy and corporate performance, which the Board must respond to
- This will re-empower shareholders and makes boards more accountable. It will help end the Ownerless Corporation

"Chris Philp MP has produced a provocative agenda to rectify the weakness at the core of modern corporate ownership. His proposals are well thought through and carefully argued. Most importantly they are rooted in existing practices in other geographies."

Lord Myners, former Chairman of M&S and Land Securities and former City Minister

"I believe that the initiatives in this paper represent important steps towards cultivating a more appropriate and valuable form of corporate governance in the UK"

Neil Woodford CBE, Head of Investment, Woodford Investment Management

Introduction

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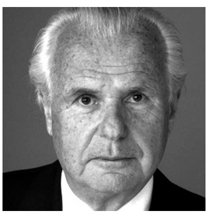
"A focus on corporate governance has always been a vital part of my investment process. I strongly believe that I should represent my investors' best interests in my discussions with management teams. This means doing everything I can to ensure that the executive and board of a company are aligned with shareholders and the course they set for a business will deliver long-term shareholder value.

Regrettably, this view and approach is not shared by many in the UK investment industry and I believe the problem is getting worse. Many fund managers do not behave or think like owners, because they are borrowing stock rather than investing in it. In many institutions, corporate governance duties have been separated from fund management responsibilities with the result that engagement is often not as effective as it should be. Short-termism, which is frustratingly rife in fund management, also hinders the UK's institutional investment industry's ability to hold executive management teams to account in an appropriate and effective way.

I believe that the initiatives in this paper represent important steps towards cultivating a more appropriate and valuable form of corporate governance in the UK. By adopting some of the best practices already in existence around Europe, we can help boards become more accountable for their long-term performance with, I believe, meaningful benefits flowing to shareholders and the border UK economy."



Lord Myners, former Chairman of M&S and Land Securities and former City Minister

"The ownership of our major corporations have become increasingly fragmented. This is as a result of the institutionalisation of ownership and increased pressure in fund management towards creating portfolios with investments in several hundred different companies.

The simple model of a group of people with a common interest in establishing a business with a pooling of capital and limitation of liability together with, in due course, a separation of day to day management from ownership worked well. Farmers might have done this to build a flour mill or share in the selling of produce. The owners lived near the mill. They kept a close and informed eye on the mill, including effectiveness of management, care for employees and the wider community.

The rapid growth of institutional investment over the second half of the last century broke these links. Institutions became professional managers of other people's money. The owner was pushed one remove away and now, in many cases, even further away via the insertion of trustees, consultants and fund of fund managers. At the same time academia began to promote the use of performance benchmarks and the case for diversification to reduce stock specific risk.

Shares became evidence of an ownership claim rather than acknowledgement of ownership responsibilities and obligations. The mentality of share investors switched from that of a car owner to a car renter. The owner services his car, maintains it in good condition, drives it carefully and relies on it. The renter does none of these things. Institutional investors are the equivalent of renters. They are driven by the short term with qualified interest in the long term, largely as a result of client focus on short term performance versus a diversified index or benchmark.

In this environment little remains of the mill owning model.

We have tried to address this, primarily through the creation and elevation of the role of the non-executive director. This has helped, but most NEDs remain detached from shareholders. It is striking that NEDs rarely meet with shareholders until something bad has happened. They are elected with North Korean-like majorities by uninterested shareholders, selected through a process led by the chairman which would also be familiar to those in Pyongyang.

Chris Philp MP has produced a provocative agenda to rectify the weakness at the core of modern corporate ownership. His proposals are well thought through and carefully argued. Most importantly they are rooted in existing practices in other geographies. They will not be universally welcomed by either company directors or fund managers because they challenge the existing order that has suited these two communities so well. But implementation of his programme would represent a transformational change in the democratisation and accountability of ownership. He should be congratulated for his initiative.” ■

The rise of the ownerless corporation

Large listed companies have become what Lord Myners refers to as “Ownerless Corporations”. Shareholdings have become highly fragmented and fund managers are often focused on the short term, which means shareholders often fail to exercise proper oversight of the companies they own.

For capitalism to work, the owners of capital (i.e. shareholders) need to exercise a measure of control and oversight over the companies they own. Absent this, executive and non-executive management may simply run corporations in their own interests, and not that of shareholders and other stakeholders. Symptoms of this are escalating executive pay (page 12) and over-ambitious expansion and takeover plans. This can lead to adverse outcomes for the shareholders and for society as a whole.

The proper ownership function of shareholders tends to be exercised in only the most abject governance situations, such as the most egregious compensation or the most obviously detrimental M&A activity. Most fund managers

Large public companies have become “Ownerless Corporations” where shareholders have very limited influence

The problem that I see today is that most fund management groups do not behave like owners; they do not think like owners. If something goes wrong at a business, they emphasis sale over voice. You have got to have a long-term perspective to emphasise voice over sale.

Neil Woodford, one of the UK’s most respected Fund Managers

Shareholders tell themselves that stewardship in private is effective... it is not... there has been a lack of collective action due to inertia and reluctance to stand out from the crown.

Stefan Stern, High Pay Centre

Public companies, owned by investment funds, are effectively ownerless corporations. The fiduciary owner has interests in so many companies it can’t possibly act as a proper fiduciary. These investors don’t think of themselves as owners. Consequently, they are not equipped or rewarded for performing the duties of ownership

Lord Myners, former City minister & FTSE 100 Chairman

Source: Neil Woodford 24th July 2013, Business, Innovation & Skills Committee, Minutes of Evidence HC603; Stefan Stern, May 8th 2016, ‘Biggest backers of executive pay revealed’; Lord Myners, Listed Magazine, May 13th 2015 are not set up or resourced to be properly engaged owners. Most shareholder engagement is conducted one-to-one and so it is hard for shareholders to exercise collective pressure. The Investor Forum, set up to facilitate collective discussion with shareholders on a voluntary basis, worked with only 9 firms in the whole of 2015 and is not a panacea.

This contrasts with family-owned or private equity owned businesses, where shareholdings are more concentrated and shareholders more active. This is why family-owned and privately owned businesses often perform better than publicly owned companies over the medium and long term. Frequently, if public company shareholders are unhappy with a company they simply sell the stock rather than engage with the company to improve it. Long-term and engaged investors, such as Warren Buffet's Berkshire Hathaway, are rare exceptions but are often highly successful.

This thesis was confirmed by a McKinsey study which found that the boards of private equity owned businesses (where the board is generally directly appointed by shareholders) were rated by directors who had sat on both types of board as being more effective than the boards of public companies.[1]

Typically, the Chairman of a public company (acting via the Nominations Committee) is instrumental in choosing the board and shareholders simply rubber-stamp the recommendation (it is virtually unheard of for shareholders to vote down the Nomination Committee recommendation of company-nominated director candidates). It is hard to argue typical shareholders are hands-on owners of their capital. When a new director is chosen by a Chairman, the individual is unlikely to be a figure that challenges the consensus. A board-level recruiter typically obtains references from other Chairmen the executive has worked under, so directors looking to expand their portfolio of roles may tend to toe the line. Research shows directors who implement corporate governance reforms can experience "social distancing".[2] It is clear that "norms of deference" in public company boardrooms are a major barrier to executive oversight, as recently argued in a paper *Are Boards Designed to Fail? The Implausibility of Effective Board Monitoring*.[3]

Shareholder impotence in the face of board recommendations is illustrated by shareholder advisory votes on pay. These currently have no effect on actual pay, despite frequent expressions of shareholder dissatisfaction as the table overleaf for 2016 AGMs shows.

This is also seen in the large number of cases where shareholders have voted for a theoretical maximum CEO pay package, which then gets surpassed due to the complex and unpredictable structure of the remuneration package. The chart overleaf illustrates some examples.

[1] http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-voice-of-experience-public-versus-private-equity
[2] J. Westphal, P. Khanna, 'Keeping Directors in Line: Social Distancing as a Control Mechanism in the Corporate Elite' (2003).
[3] Boivie. S, Bednar. M, Aguilera. R, Andrus, J, (2016).

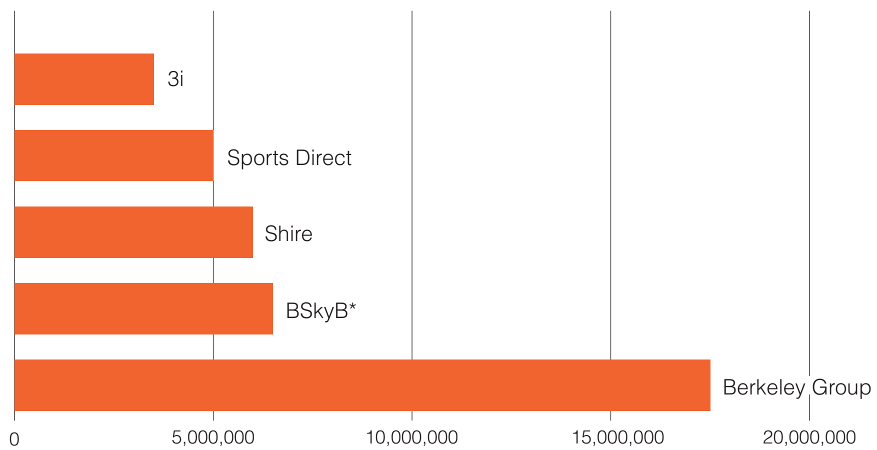
table 01 **Votes against high executive pay packages have often been ignored by boards this year, showing the limits of shareholder power**

	Vote against pay report, %	CEO pay award £m	Date
Weir	72	Policy*	28.04.16
BP	59	14.0	14.04.16
Smith & Nephew	53	2.1**	14.04.16
Shire (Ireland)	49	14.8	28.04.16
CRH (Ireland)	41	7.5	28.04.16
WPP	33	70.4	08.06.16

* Policy in relation to senior executive pay ** Sum awarded to a group of executives

figure 01 **Even where theoretical maximum FTSE100 CEO remuneration is agreed by shareholders, it often get surpassed**

Total CEO pay exceeding shareholder agreed maxima, £



Source: Paul Marsland, High Pay Centre analysis of 76 FTSE 100 companies annual reports

* The data for Sky shows a one year figure within a scheme that pays out biannually, meaning one year 'spikes' and the next year reduces significantly. Therefore, over Sky's two year payment system, Sky would not appear in this grid and would fall below the theoretical maxima.

"If boards don't take ownership and work with investors to tackle the issue head-on, regulators and politicians will"

Nigel Wilson CEO, L&G[4]

[4] Source: FT, May 8th, 2016, "Is a pay revolution nigh? And if not, should it be."

The rise of excessive executive pay

The increase in the share of wealth of the top 1% is a major policy challenge for this century and one that capitalism must carefully address. High CEO pay is increasingly a fulcrum for discontent over widening income distribution; it is seen as insufficiently connected to performance. It threatens the implicit social contract under which society functions, which assumes that the system we work within is inherently fair.

"In the public mind, there is now a gap between FTSE CEOs and the public as wide as that between Crassus and the Roman plebs"

Simon Walker, Head of the IoD[5]

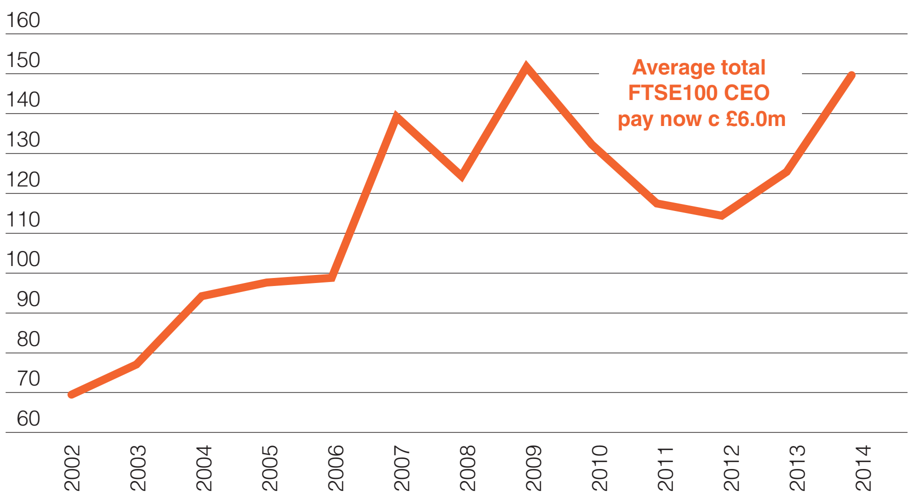
The table below shows that total CEO pay in the UK has rocketed, and now stands at around £5 million per year on average, or 150 times average worker income.

The doubling of the ratio of CEO pay to employee earnings in the last 12 years is best explained as a failure of governance. Excessive pay is a symptom of a weak board and poor shareholder engagement. Public opinion, as figure 03 shows, is very firmly of the view that CEO is excessive, poorly linked to performance, and counter-productive to staff motivation.

Mechanisms for controlling CEO compensation have vexed governance and policy experts for some time, and the results

figure 02 **FTSE 100 CEO total remuneration relative to average worker income has grown hugely in the last 15 years and is now a staggering 150x**

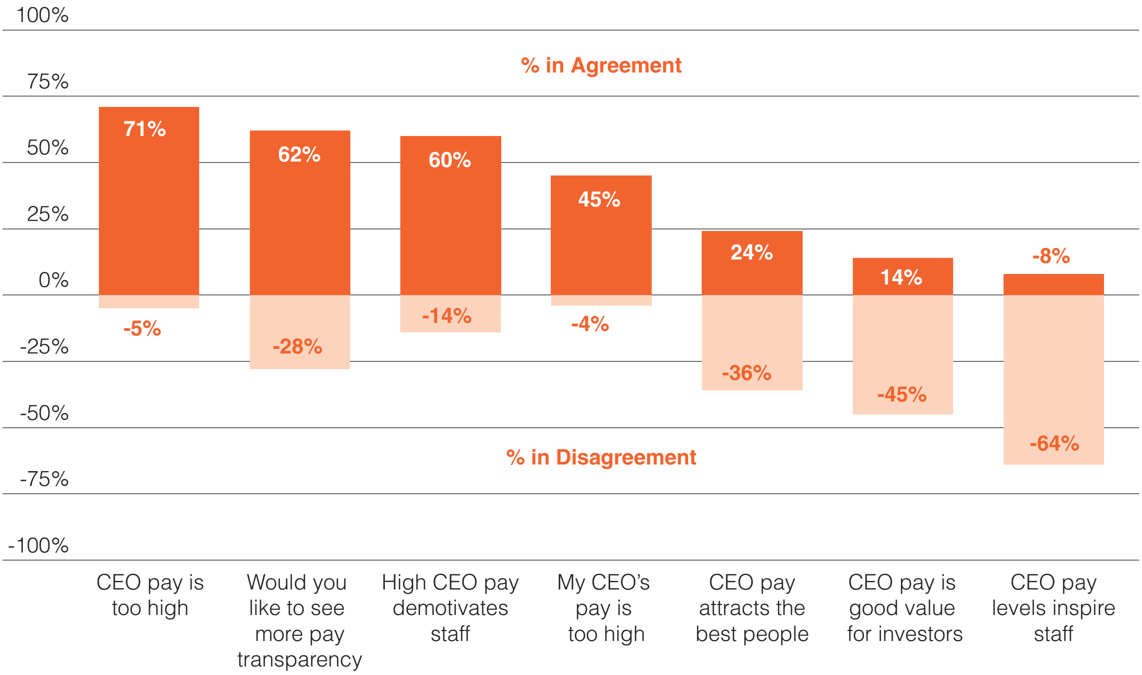
Total CEO Total remuneration / average employee total remuneration



Source: Manifest

[5] Source: FT, May 8th, 2016, "Is a pay revolution nigh? And if not, should it be."

figure 03 **There is a widespread public view that CEO pay is too high, is poor value for money and demotivates staff**



Source: You Gov survey of 1,030 people, September 2015 commissioned by CIPD

of different initiatives have been indifferent. The Cadbury, Greenbury and Higgs reports sought to address disclosure, voting, remuneration and the independence of boards. The coalition Government made progress via a triannual binding shareholder vote on remuneration policy among various changes in 2013. Nevertheless, such efforts have done little to dampen the increases in executive pay set against declining real average employee pay. Pay is ratcheting higher.

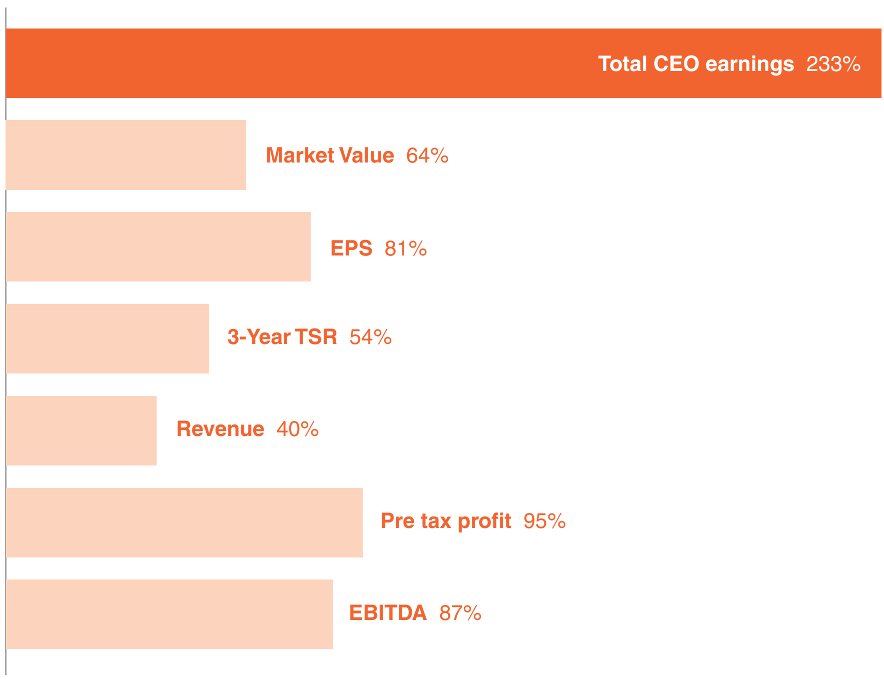
Shareholders do not seem to have the right tools to be good stewards of their capital, given the well-established trends in executive pay. Shareholders seem to be passive onlookers to pay trends, given their short term holding periods and the relative immateriality of board pay to the overall financial accounts of the company. The Kay review – *'Building a culture of long term equity investment'* – highlighted the challenges to stewardship amidst high turnover and ephemeral shareholder lists. Initiatives like the Investor Forum which only engaged with 9 companies in 2015, are still some distance from addressing the issues highlighted in that review.

The relationship between pay and performance is weak. Figure 04 below shows that between 2000 and 2013 total CEO remuneration grew 233%, but most measures of corporate performance only grew by between 50% and 90% over the same period. At the same time, workers' wages stagnated.

The two charts on the following page show that LTIP rewards and 3-Year Total Shareholder Returns have decoupled over the last six years, and that academic studies show high executive pay actually leading to relative under-performance. High CEO rewards seems to follow even indifferent or poor performance. Even when share prices go down, new option packages are granted with low strike prices reflecting the low share price. A slight subsequent improvement (often still well below the peak) then results in large pay outs.

figure 04 **FTSE CEO remuneration growth has far exceeded any measure of corporate performance**

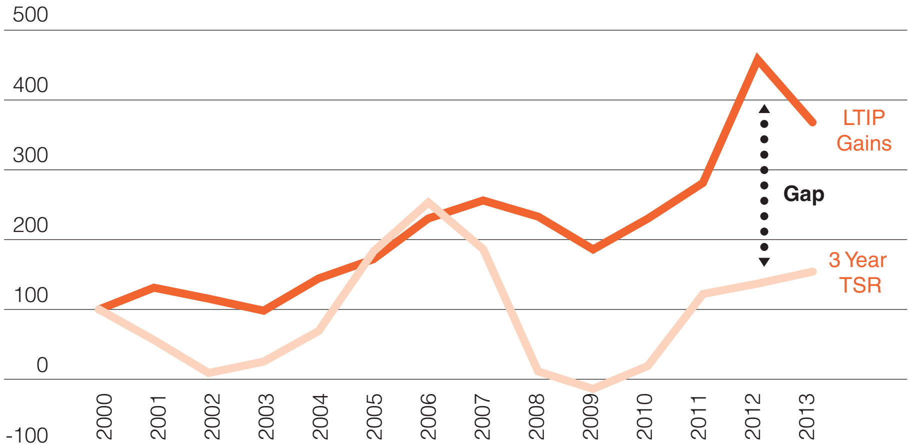
FTSE350 2000-2013: Total CEO Remuneration Growth vs Performance Growth



Source: Analysis by Income Data Services for the High Pay Centre, 2014

figure 05 **FTSE 350 LTIP payouts have detached from 3-Year Total Shareholder Returns, suggesting over payment relative to actual performance**

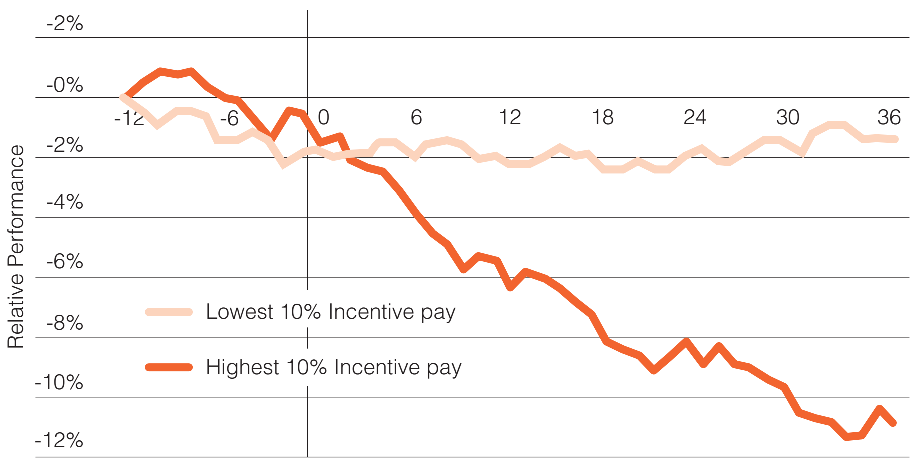
FTSE 250 LTIP payouts have detached from 3-Year Total Shareholder Returns, suggesting over-payment relative to actual performance



Source: Analysis by Income Data Services for the High Pay Centre, 2014

figure 06 **Academic research has uncovered a negative correlation between top decile CEO pay and 3 year forward performance**

"We find evidence that CEO pay is negatively related to future stock returns for periods up to three years after sorting on pay. Firms that pay their CEOs in the top 10% earn negative abnormal returns over the next three years of approximately -8%. The effect is stronger for CEOs who receive higher incentive pay relative to their peers and stronger for CEOs with greater tenure. Our results appear to be driven by high pay related CEO overconfidence that leads to shareholder wealth losses from activities such as overinvestment and value -destroying mergers and acquisitions."



Source: Performance for pay? The relation between CEO incentive compensation and future stick price performance' Michael J Cooper, University of Utah, Huseyin Gulen, Purdue University, P. Raghavendra Rau, University of Cambridge., October 2014

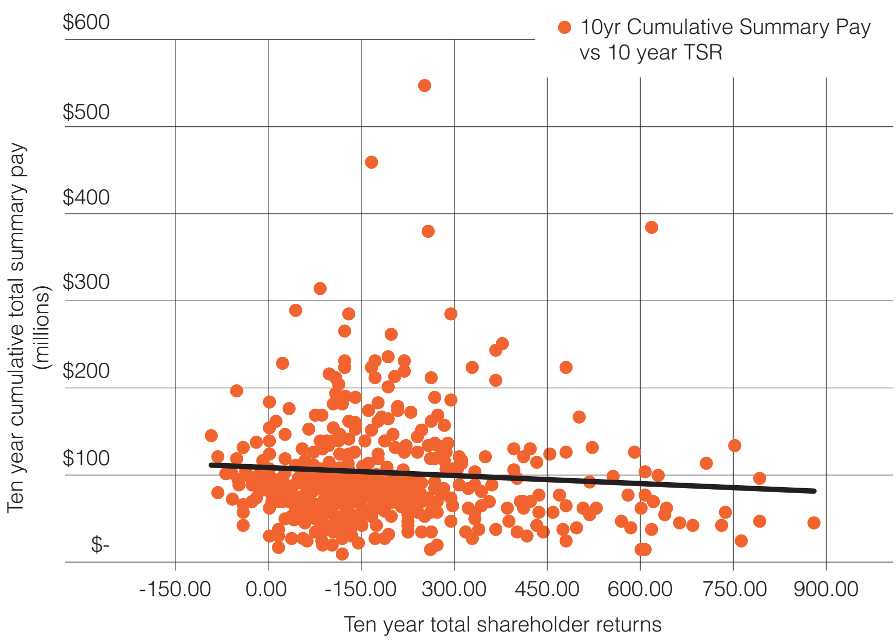
A study published in July 2016 by MSCI also found a negative correlation between executive pay levels and performance.[6] Their summary states:

> *"Has CEO pay reflected long-term stock performance? In a word, "no." Companies that awarded their Chief Executive Officers (CEOs) higher equity incentives had below-median returns based on a sample of 429 large-cap U.S. companies observed from 2006 to 2015. On a 10-year cumulative basis, total shareholder returns of those companies whose total summary pay (the level that must be disclosed in the summary tables of proxy statements) was below their sector median outperformed those companies where pay exceeded the sector median by as much as 39%."*

The results of the MSCI study are shown in figures 07 and 08.

Measures to address the apparently inexorable rise in CEO pay have thus far proved ineffective and in some instances wholly counter-productive. At the time, the mandatory disclosure of board level pay seemed like

figure 07 **MSCI Research published in July 2016 found a negative correlation between total 10-year CEO pay and 10 year Total Shareholder Return**

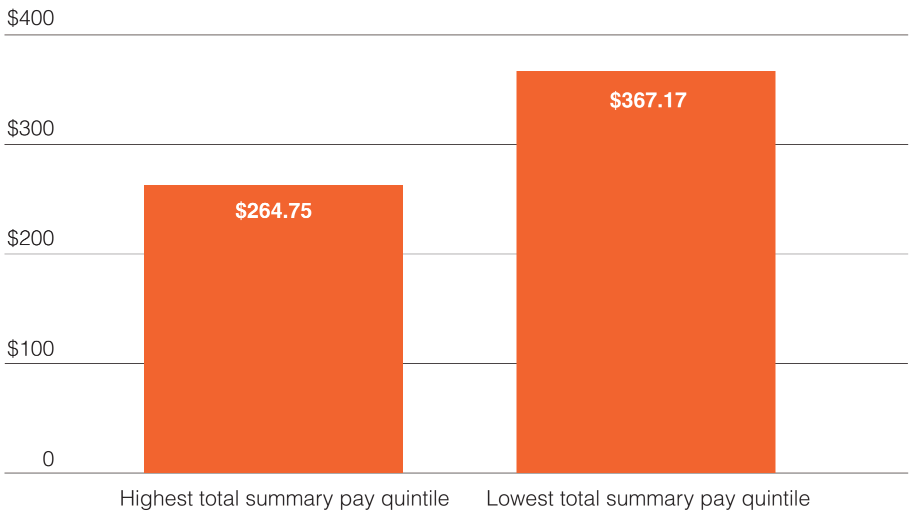


Source: MSCI, July 2016

[6] MSCI, Ric Marshall and Linda-Eling Lee "Are CEOs Paid for Performance?", July 2016

figure 08 **MSCI further found that the lowest paid quintile of CEOs in equivalent companies delivered 39% higher total shareholder returns over 10 years than the quintile of companies paying the most**

Total 10 year return on $100 invested in the stock



Source: MSCI, July 2016

a noble drive for transparency; excessive and unjustified compensation would meet with public opprobrium and shareholder dissent. The consequences have instead been a rise in executive compensation, widening pay ratios and more widespread employee dissatisfaction. There is substantial empirical evidence that the disclosure rules have led to CEO pay ratcheting upwards as companies increasingly benchmark pay via compensation consultants, who advise remuneration committees to pay more than the average to attract the best. The average then keeps on moving up in an endlessly increasing cycle.[7] Understandably, the current orthodoxy is being criticised as a closed, self-serving corporate elite.

Remuneration Committees and shareholders are able to relinquish some of their direct responsibility by benchmarking, using this to justify pay settlements. "Attracting and retaining" talent in this era can be equated to the wage spiral seen in premier league football. Paying above the average as a target in a closed pool of talent has rapid consequences for CEO pay.

[7] Bachelder. C (2007); Bizjak. J, Lemmon. M, Naveen. L, 'Does the use of peer groups contribute to higher pay and less efficient compensation?'(2008); Faulkender. M, Yang. J, 'Is Disclosure an Effective Cleansing Mechanism? The Dynamics of Compensation Peer Benchmarking' (2013); Lublin. J, Thurm. S 'Behind Soaring Executive Pay, Decades of Failed Restraints' (2006); Conyon, M., Peck, S., and Sadler, G. 'Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom' (2009); Goh. L, Gupta. A, 'Executive Compensation, Compensation Consultants, and Shopping for Opinion: Evidence from the United Kingdom' (2010).

The link between higher than sector pay and performance in listed companies has been convincingly questioned empirically.[8] Indeed there is significant recent evidence that the most highly paid, overconfident managers with the longest tenure have the most negative impact on returns – a finding consistent with the notion that weak board oversight is at the core of the compensation predicament.[9] Where the board is strong vs the CEO, compensation tends to be more related to performance.[10] Shareholder dissent does not currently appear to be effective in reducing pay awards.[11] ■

[8] Balafas. N, Florackis. C, 'CEO compensation and future shareholder returns: Evidence from the London Stock Exchange' (2014); HPC - Bruce, A Skovorodova R (2015).
[9] Cooper. M, Gulen. H, Ragha Vendra Rau. P, 'Performance for pay? The Relation between CEO incentive compensation and future stock price performance' (2014).
[10] Van Essen. M, Otten. J, Carberry. E, 'Assessing Managerial Power Theory: A Meta-Analytic Approach to Understanding the Determinants of CEO Compensation' (2014).
[11] Gregory Smith. I, Main. B.G.M, 'Heads I win, tails you lose? A career analysis of executive pay and corporate performance' (2014).

Proposals for reform

a) Mandatory Publication of Pay Ratios

Executive pay is no longer dictated by normal market forces and has broken free of any mechanism which ties it to the real economy.

There should be mandatory disclosure of the ratio of the CEO total single-figure remuneration and the median employee total pay. This would be disclosed for the financial year under review and for the prior financial year

Those at the top of UK business need rewards which reflect the responsibility they shoulder. The buck has to stop somewhere when performance is poor and the rewards should be generous for those whose efforts contributed most to truly great performance.

However, this basic logic has been lost in the complex and ever increasing pay packages at the top of UK business. Extreme pay gaps inhibit productivity. The government has made productivity a priority and has already recognised the need to share the benefits of growth by the introduction of a mandatory minimum living wage. A CEO to employee ratio emphasises the idea that a profitable company sustains all those who worked towards that profit.

Small businesses understand this. The kind of gaps tolerated by our largest public companies are just as alien to small business leaders as they are to the general public. A joint survey of IoD members by the High Pay centre and the IOD in late 2014 revealed that excessive executive pay was perceived by the business community to be threatening public trust in business.

The doubling of the ratio of CEO to employee pay has gone unobserved within corporate reporting. One reason for this is the complexity which surrounds executive pay outcomes due to payment being stretched over different periods and being mixed in shares and cash. The introduction of a single remuneration figure for the CEO is only part of the story. Publishing the ratio will make a statement about how the accepted measure of pay at the top compares with pay throughout the rest of the organisation.

b) Binding Annual Votes on Pay

At present, shareholders in UK listed companies have a binding vote on remuneration policy once every three years. However, the actual amount paid to Directors each year is only subject to an advisory vote. Due to the complex nature of performance based pay, it is often the case that the packages actually paid are in excess of the previously stated maximum, or exceed what shareholders think is reasonable bearing in mind performance. Advisory votes against remuneration are often ignored by Boards.

The annual vote on the remuneration report should be made binding. This would require a change to the Companies Act 2006 439(5) such that entitlement to the remuneration reported for the financial year becomes conditional on shareholder approval of the remuneration report.

Investors have legitimate concerns over the resources they must now expend in order to understand quoted company remuneration policy. The working group set up by the Investment Association to look into problems associated with remuneration says in its April 2016 interim report:

> *"The Working Group also understands that a growing and disproportionate amount of shareholder-company engagement is spent discussing executive remuneration, to the detriment of other potentially more significant issues."*

A binding retrospective vote relieves this pressure. An annual binding retrospective vote makes companies accountable for the outcome of their policy. The retrospective nature of the vote means shareholders can at last take an informed and impactful decision based on the known performance of their investment and the known quantum of executive pay.

International precedent exists for binding annual votes on pay. Shareholder resolutions on remuneration policies are binding in the Netherlands (2004), Denmark (2007) and Switzerland (2014). There is also a binding vote on the compensation report for all Italian banks and Insurers.

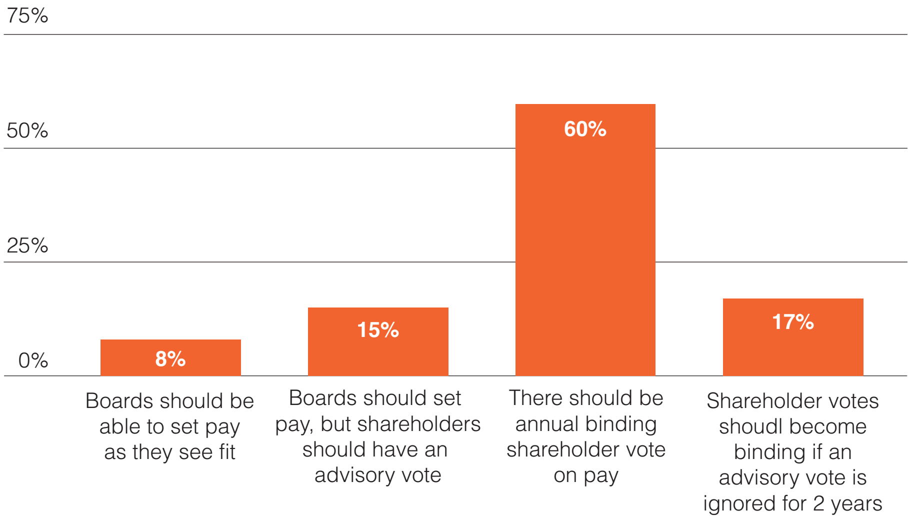
c) Mandatory Shareholders Committee

Boards have become too detached from their shareholders and other stakeholders. We propose to reform corporate governance by adapting the Swedish concept of a shareholder nomination committee. This reform is designed to give shareholders greater influence over the board composition and executive pay, and provide a formal mechanism to question the board. It is designed to end the problem of the Ownerless Corporation.

The formation of a Shareholder Committee (henceforth "SC") should be mandatory for all UK main-market public companies, comprising the largest five shareholders. If a shareholder declined the option of taking their seat, it would pass to the next largest shareholder on the list. The definition of "largest shareholders" would the largest shareholders who have held the stock for more than 12 months to avoid short-term traders being included. A list of shareholders declining to take their seat on the SC would be published, so that their own investors or clients could seek an explanation as to why the opportunity had been declined. A short resumé of the individual nominated by each of the five shareholders to serve would be published to ensure that suitable individuals were nominated by shareholders to represent them.

figure 09 **Public opinion is very firmly in favour of shareholders, not boards, setting executive pay**

Agreement with different arrangements for setting executive pay



Source: Populus survey of 2,058 adults, May 2012

The SC would be chaired by the largest Shareholder. Like in Sweden, the main Board Chairman would attend the SC and could speak, but would not vote. In order to allow shareholders to hear other stakeholder views, an elected employee representative (not a trade union representative) could also attend and speak at the SC, but not vote.

The SC would exercise the following three powers:

1. Replace the Nomination Committee and assume responsibility for recommending the appointment and removal of Directors for a vote of all shareholders at the AGM. This will make Directors feel more accountable to Shareholders and not to the board Chairman

2. Approve the pay policy and specific pay packages proposed by the Remuneration Committee before they are put to a binding vote of all Shareholders at the AGM. This allows for proper pre-scrutiny by shareholders before the AGM vote takes place and avoids binary confrontations at the AGM

3. Pose questions requiring a response by the main Board, including on corporate strategy and corporate performance. This formally empowers shareholders to raise issues with the board, while still firmly leaving the board ultimately responsible for strategy and performance

The board would of course remain legally responsible for the wider interests of the whole company (and stakeholders in the broadest sense) besides just shareholders.

Figure 09 shows that public opinion is very firmly in favour of shareholders and not boards setting executive pay.

Shareholder Committee Case Study: The Swedish Approach

The Cadbury report of 1992 was key in prompting the evolution in Swedish corporate governance that created a system admired for its strong shareholder engagement.[12] The model has received some favourable appraisals in recent years.[13 14]

In the UK system, a Nomination Committee sits under the board. That NC is made up exclusively of board members and chaired by the board Chairman. In Sweden the Nomination Committee is made up of the largest shareholders and the Chairman (sometimes the Chairman is a full member, and sometimes attends as a co-opted non-member). Shareholders are typically offered the position based on the August shareholder list, in preference order of size. The SC typically meets around 3 times per year to make nominations to the board. This is presented at the AGM for shareholder vote amongst all shareholders (irrespective of size of shareholding or holding period).

The Swedish SC has structurally increased shareholder engagement and produced greater collaboration and focus on shareholder value. Research in Sweden shows Board members feel they are have shareholder support and are there to act for shareholders. It also represents an opportunity for investment managers to show their end investors they are engaged in active stewardship.

Likely objections and rebuttals to a Shareholder Committee ("SC")

1. Insider status: Being a member of the SC will make shareholders insiders, so they will be unable to trade the shares for an extended period.

   The three powers to be exercised by the SC will not require market sensitive information. If an Insider conflict arises, it can be mitigated by ensuring that only the individual shareholder representative is made an Insider, creating a Chinese wall between them and the fund managers

2. Cabal effect: Is there a risk that the largest investment management institutions will collectively exert control over the listed sector?

   It is important to note the SC will only make proposals to the AGM on nominations and pay. Equal voting rights per share are provided at the AGM vote. The AGM remains the ultimate arbiter

[12] Tomorrow's Company, 'Tomorrow's Corporate Governance: Bridging the gap through Swedish-style nomination committees' (2010).
[13] Department for Business Innovation and Skills. 'Executive Remuneration: discussion paper' (2011)
[14] Association of British Insurers 'Improving Corporate Governance and Shareholder engagement' (2013)

3 Workload: Very large institutions will be overwhelmed as they will sit on dozens of SCs.

Shareholders are not obliged to take up all positions offered and it would be expected that they serve at the companies they are most actively interested in. There would be a certain amount of "spreading the load" among the larger institutional investors.

4 Cost to members of SC: There will be a sizeable additional cost to sending representatives to the SC.

In general, shareholders are already expected to engage with the Chairman. The SC consolidates that activity in a group setting. Fund Managers charge investors large fees and should be able to resource this obligation.

5 Will institutions send appropriately skilled and senior representatives?

The name and bio of the individual nominated will be published. A cadre of experienced people will likely be developed over time to fill these roles.

6 International take-up: Will large shareholders from abroad make the journey?

It is unusual for large asset managers not to have offices in the UK. Currently firms such as Baillie Gifford serve on Shareholder Committees in Sweden, by way of example. Most major international investors (e.g. Blackrock) have UK offices

7 Risk of Activists: Can activist hedge funds and "asset strippers" attempt to subvert the strategic course of a company for short term gain.

With a committee of five shareholders, this would require three such funds to build very large positions and hold them for over 12 months to dominate the nominations. Nominations and pay resolutions would still be subject to a vote of all shareholders at the AGM. Questions on corporate strategy and performance would be non-binding on the board.

8 Institutions will decline to take up the role on the SC.

The decline list will be made public. A "comply or explain" approach could be adopted. Fund Managers not taking up positions on the SC to which they are entitled would have to explain themselves to their own clients or investors

9 FTSE 100 Shareholdings are now so fragmented that the top five shareholders probably each have holdings in the 3-10% range, so will collectively probably only own 15-30% of the company. This is not very representative.

This will still dramatically improve the influence of shareholders on *nominations and executive pay, even if less than half of all shareholders by value are on the SC.*

10 We already have the Investor Forum so don't need a new Shareholder Committee

This is ad hoc, voluntary and limited in scope. The Forum only led nine company engagements in 2015. ■

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