Theresa May's Promising Message On Corporate Governance

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Since her appointment as Prime Minister on July 13, Theresa May has made multiple statements on corporate governance during her public speeches, whether at the G20 summit in Hangzhou in early September or, more recently, the annual Conservative Party conference. She had already announced her corporate governance reform commitments during a speech made for the launch of the leadership campaign on July 11. After several observations made on the current situation regarding companies' social responsibility in the UK, she emphasized the need to "*change the way businesses are run*" and submitted several proposals, notably on remuneration issues. The department for Business, Innovation and Skills (BIS) has rapidly addressed the issue by setting up a committee to study the proposals made by Theresa May and launching a public consultation mid-September.

Several recent controversies, in France or the UK, have indeed highlighted the inadequacy of mechanisms aimed at monitoring executive pay, underlined the apparent decorrelation between pay and performance, and questioned the fairness of executive pay. Shareholders must therefore pay more attention to the creation of long term value and ensure the integration of this aspect into compensation systems. Pay equity also deserves higher scrutiny from investors, for example through the elaboration of appropriate voting policy or a strong engagement strategy.

Caught in the midst of passionate debates, investors are therefore required to take position on these topics because of their fiduciary responsibility. What preliminary thoughts does Theresa May's speech propose? How were these proposals welcomed by the financial sphere? Answering these two questions will allow us to better understand strengths and limitations of existing speeches on executive compensation

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Introduction

A recurring debate more and more addressed

The debate over executive compensation is not new. In the 2000s, public accounting scandals in the United States highlighted the problematic remuneration practices at companies like Enron, WorldCom, Fannie Mae, and General Electric, launching discussions about the necessity of a remuneration-specific regulatory framework. The United Kingdom played a pioneering role in these issues by implementing an advisory shareholder vote on the remuneration report in 2003. In the United States, the Dodd Frank Act (2010) introduced the principle of a ratio of the CEO’s pay to the median compensation of other employees, which finally materialized under the leadership of the Securities and Exchange Commission (SEC) in August 2015. France is currently exploring the path of a binding vote on compensation with the Sapin 2 Law passed on second reading by the National Assembly in October. At the same time, public and investor expectations seem to have increased as shown by the high rates of dissent expressed at Annual General Meetings this year, both in France (Renault and Alstom) and elsewhere (BP in the U.K.).

Issues at stake in the debate over executive remuneration

The debate around remuneration revolves around two distinct concepts: the link between pay and performance, and what is deemed (rightly or not) to be an acceptable level of remuneration.

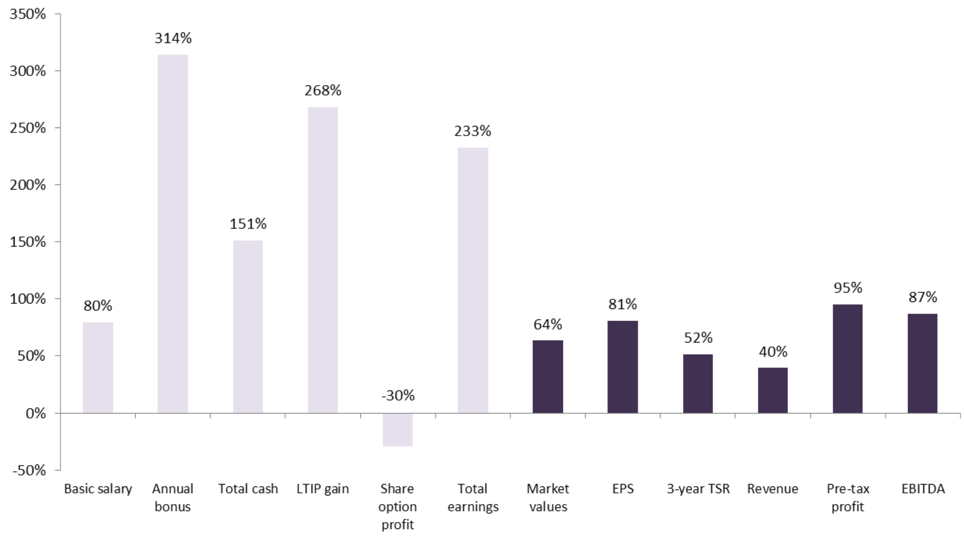
Pay for performance

Recent scandals have highlighted the lack of a clear link between remuneration paid and performance achieved. At BP, for instance, the salary of the CEO, Bob Dudley, increased by 20 percent between 2014 and 2015 while the company recorded a historic loss of $6.5 billion. Using a more general approach based on historic data, Lucian Bebchuk and Jesse Fried1 also emphasized the disconnection (if not decorrelation) between pay and performance, particularly citing the failure of long-term remuneration instruments based on stock or option awards. These analyses were further confirmed by recent studies originating from the private sector and think tanks, such as a 2014 publication by the High Pay Centre2, a nonpartisan British think tank dedicated to compensation topics. This report indicated that most executive compensation elements of FTSE 350 companies have increased at a rate far surpassing the evolution of their key financial indicators.

[1] Bebchuk, L. A. and J. M. Fried (2004), *Pay Without Performance: The Unfulfilled Promise of Executive Compensation,* Cambridge, MA, Havard University Press
[2] High Pay Centre (October 2014), *Executive remuneration in the FTSE 350 – a focus on performance-related pay*

Graph 1

Percentage change in median remuneration of FTSE 360 executives and selected corporate indicators (2000-2013)



Source: Mirova/High Pay Centre.

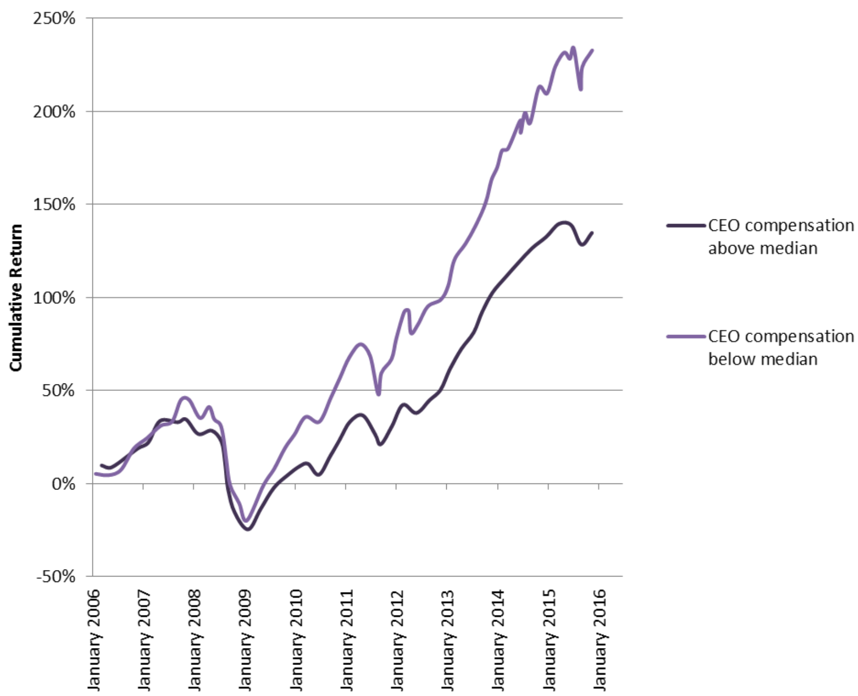
MSCI recently published a study[3] on the evolution of remuneration issues in the United States which came to similar conclusions. After analyzing 429 large US capitalizations during the period from 2006-2015, the companies with the highest cumulative remuneration for their CEOs were those who delivered the lowest yields.

Today, some academics[4] believe that this decorrelation results from frequent use of benchmarking with sector peers when defining the remuneration policy, which makes the pay level depending on the size of the company rather than its specific key indicators.

[3] Ric Marshall, Linda-Eling Lee (July 2016), *Are CEOs paid for performance? Evaluating the Effectiveness of Equity Incentives*
[4] Gabaix, X. and A. Landier (2008), *Why Has CEO Pay Increased So Much?,* Quarterly Journal of Economics 123: 49-100

Graph 2

10-year TSRs comparing above vs below peer summary pay medians



Source: Mirova/2016 MSCI ESG Research Inc. Reproduced by permission

Pay equity

Other controversies have focused on pay level. WPP's CEO, Martin Sorell, received a total package equal to 70.4 million pounds as the company outperformed competitors like Publicis and Omnicom in recent years. Boris Johnson, the current U.K. Secretary of State for Foreign Affairs, raised this issue last year at a Conservative Party conference, drawing attention to the fact that FTSE 100 chief executives were paid 25 times as much as their average employee in 1980, and 130 times as much today. These figures were further confirmed by a Manifest study[5] in 2012. This year, a similar debate erupted at Renault when Carlos Ghosn appeared to receive 7 million euros in total remuneration for his position as the company's CEO. This amount doubled when the compensation he received from his executive position at Nissan was considered, leading the High Committee of Corporate Governance (HCGE) to assert that "*executive compensation [...] must be measured, balanced, equitable [...]*."

The figures speak for themselves in regard to wage trends since the 1990s: the median remuneration of the S&P500's CEOs stood at $2.3 million in 1992 versus a total amount of $7.2 million in 2001 (the amount has stabilized at this level since[6]). While some, like Thomas Piketty, argue for higher taxation of high incomes in order to meet the challenge of increased income inequality, other organizations, such as the SEC, choose instead to

[5] *Manifest/MM&K Director's Remuneration Survey,* 2012
[6] Carola Frudman & Dirk Jenter (2010), *CEO Compensation,* NBER Working Paper No. 16585

explore a compensation ratio intended to prevent abuses and scandals like those in 2008-2009 from happening again. However, few academic studies have been produced thus far which assess the impact of such measures, likely due to the limited time scale.

Theresa May's program

The program announced by Theresa May regarding governance issues has the potential to directly echo the abovementioned concerns.

Observations

Theresa May's strong proposals address both issues of performance and equity

In her speech made for the launch of the leadership campaign, Theresa May does not hesitate to emphasize the importance of corporate governance, accurately targeting the two previously mentioned issues and acknowledging the decorrelation between performance and remuneration. "*The FTSE, for example, is trading at about the same level as it was eighteen years ago*" she said, indicating that "*in the same time period executive pay has more than tripled*." She concludes that "*there is an irrational, unhealthy and growing gap between what these companies pay their workers and what they pay their bosses*".

More unexpectedly, Theresa May enlarge the reflection on remuneration to the more technical issue of board composition, promising that employees will enter boards as directors. Indeed, the responsibility for establishing a compensation policy lies in boards' hands. By encouraging the representation of companies' various stakeholders at the board level, one may expect that the issue of equity would be better handled. Though the 1977 Bullock Report strongly encouraged such a presence of employee representatives on boards in the UK, the practice never materialized while employees' participation in governance bodies is a widespread practice in Europe, including Nordic countries, France, and Germany. Such discourse serves to open the debate around the very shareholder-focused existing global governance model and suggests that the current model may have reached its limits. Furthermore, it calls for re-evaluation and revalorization of employees' expectations and, more generally, of civil society as a whole.

Propositions

Theresa May proposes several actions which foster these evolutions:

- Reinforce shareholder rights on remuneration topics, through a binding vote on the remuneration report;
- Require a more comprehensive disclosure, especially through the publication of a pay ratio like the one implemented in the US;
- Simplify remuneration structures, specifically those pertaining to bonuses, in order to better align executives' remuneration with long-term company performance;
- Establish employee representation at board level.

It is worth noting that the latter two recommendations echo those made by the Investment Association, a professional organization comprised of U.K. players in asset management. Remarking that executive compensation has become "*too complex*" and "*does not fulfill its role*," the association launched a working group dedicated to remuneration topics in autumn 2015 and published its findings in a report on July 27th, 2016[7]. Similarly, these subjects have been highlighted by the Corporate Governance Code issued by the AFEP-MEDEF in France.

Conclusion

Mirova can only welcome these proposals as do some representatives of the political or financial world who have joined their voices to Theresa May's one.

Fidelity, one of the largest asset managers in the U.K., has already expressed support for certain proposals concerning compensation. Dominic Rossi (Global Investment Director) underlined that such changes would "*add significant momentum to [their] efforts to better align executive pay rewards with shareholder interests*." In the same way, the recommendations published by the Investment Association insist on the need for simplification of compensation structures and "*better alignment of interests between shareholders, executives and the company*" according to Nigel Wilson, Chair of the Working Group. Without any doubt, continued vigilance and monitoring must exist at shareholders' level as measures implemented so far to establish a clear link between pay an performance have failed (e.g., non-binding vote on remuneration reports). Having no direct control over the design of remuneration policies, shareholders can legitimately claim to greater expectations on these subjects. As such, Mirova pays special attention to the quality and level of disclosure of information.

Our role as investors is to incite companies to take ownership of this theme of value creation and distribution

Behind the seemingly unanimous support for Theresa May's proposals, it should be recognized that the positions expressed generally do not address the issue of pay equity but rather focus on the link between pay and performance. We think that both the pay-performance gap and pay equity need to be addressed with equal attention as the existence of inequalities is becoming a growing concern but also as we believe that equity, by fostering cohesion within the company, is also a factor of long-term performance. As investors, what can be our contribution? If our role is not to substitute for the legislator, we can incite companies, through our voting & engagement policy, to take owership of this theme of pay equity and more broadly, that of value's creation and distribution. We encourage companies to take measures by adopting a remuneration policy addressing explicitly this issue that would be established by the board and (ideally) approved by its shareholders and its employees (via, for example, a better representation on boards).

Mirova therefore welcomes the positions of Theresa May and sees a positive signal to continue the dialogue it has established with companies on the touchy issue of executive compensation that is at the heart of the debate on corporate governance.

[7] Report from Investment Association (2016)

Summary of Mirova’s engagement initiatives on remuneration topics

Voting policy			Engagement principles		
	Guidelines	Exercise of voting rights		Theme	Initiatives
Pay for performance	**Mirova**[8] votes against remuneration elements submitted to shareholders’ if the level of disclosure is insufficient and/or if there is no alignment with the long-term performance of the company **Mirova** also votes against remuneration elements submitted to the vote if the executives’ remuneration does not include environmental and social criteria	Dissent level on remunerations proposals equal to 57% in 2015 Dissent level on say-on-pay proposals equal to 44% in 2015 Dissent level on long-term incentive plans equal to 70% in 2015	**Pay for performance**	Promoting integration of E&S issues into compensation and challenging the choice of extra-financial criteria compared to the company’s sector and its ESG strategy Promoting the alignment of stakeholders’ compensation with the creation of value, especially in light of objectives announced under the strategic plan	119 one-to-one engagement initiatives with companies on the integration of CSR issues into governance structures
Pay equity	**Mirova** has decided since 2016 to vote against remuneration components if the company does not provide sufficient information to assess how the principle of equality into the remuneration has been taken into account and/or if there are no mechanisms allowing employees to share in the company’s profits	Dissent level on say-on-pay proposals equal to 62% over the first half of 2016	**Pay equity**	Discussing how other stakeholders’ interests are taken into account in setting executives’ remuneration policy and encouraging the integration of the principle of equity when designing executive remuneration structure and setting amounts Promoting the integration of employees representatives at the board and committees level and questioning their position on the remuneration policy	72 one-to-one engagement initiatives with companies on the distribution of value amongst stakeholders

[8] Mirova’s voting policy

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