

cc Sir Adrian.

CAD-01093

PRONED

Promotion of Non-Executive Directors

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Nigel Peace Esq
The Committee on Financial Aspects of
Corporate Governance

PO Box 433
Moorgate Place
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Dear Mr Peace,

Following our conversation this morning I am sending to you a first draft of 'Some Guidelines for Remuneration Committees' and of our survey on Remuneration Committees. I must emphasise that the Guidelines is only a preliminary draft and will emerge in a very different state. I would, therefore, be grateful if you would regard it as confidential to you at this stage, although you are free to quote from it.

I am sending the Guidelines by fax and the Survey will follow by normal mail.

Please don't hesitate to contact me if you think I can be of further help.

Yours sincerely

Colin St Johnston

REMUNERATION COMMITTEES

Some guidelines suggested by PRO NED
and endorsed by its sponsors

proposed

PRO NED recommend that every PLC should have a remuneration committee constituted and run in accordance with the following guidelines.

THE FUNCTION OF THE COMMITTEE

The committee's basic task is to recommend to the board the remuneration of the chairman, chief executive and other executive directors including the managing directors of principal subsidiaries and divisions.

In addition ^{also} the committee may be asked to make ~~similar~~ recommendations for other senior staff.

In addition the committee may be asked to make recommendations about succession to top posts and development of senior staff.

In addition the board may wish the committee to assist it in the determination of remuneration policy and what some would describe as its underlying philosophy.

Occasionally the committee may also be asked to take on the functions of what in the USA is called the nomination committee, ie to suggest non-executive directors for the board.

*When should
be established
by the board*

PRO NED recommends that the board should set down formally what the committee's role is to be when it is established.

THE COMPOSITION OF THE COMMITTEE

In executing its function the committee has to take into account and to balance the interests of:

The company
Individuals
Shareholders

The levels of remuneration must not be so mean as to produce dissatisfaction or defection, nor so generous as to weaken the business or cause shareholders to believe, with justice, that they are extravagant. Remuneration means not just pay or benefits but the total package an individual receives - his or her total cost to the company. It includes the creation or amendment of any scheme for awarding options. An attempt to compensate the management inadequacy by buying loyalty may be both ineffective and expensive: on the other hand it is unreasonable to depress the remuneration of excellent long serving employees far below the cost of a replacement. The chief executive has a lonely task in reconciling all his conflicting considerations, and the cool counsels of a sympathetic but objective remuneration committee are of great value to him.

With these considerations in mind, it is clear that the committee must be comprised of people who combine disinterest with understanding, good judgment and strength of character.

~~PRO~~ NED therefore recommends that the committee should not include anyone whose remuneration it determines; if advice is needed - as it often is - from the chairman or chief executive or personnel director they should be invited to submit it in writing or attend the relevant meeting: other executives may be invited when the committee feels it would be helpful.

This means that a heavy burden will fall upon the non-executive directors. Regrettably within some big companies there may not any or they may be too few. If so the board should invite disinterested outsiders to join the committee. ^{limited}

The establishment of a remuneration committee may be ^{more} particular difficult for a smaller plc, which has few if any ^{non-} executive directors. Yet it is of great importance that there should be committee since the remuneration of the top executives is likely to be much higher in proportion to the company's profits than it is in a big company. It is therefore strongly recommended that committee be established and qualified outsiders brought in to it, even if they are not directors of the company. Their names and backgrounds ^c would be published in the report and accounts.

Selection of the committee is all important in every case. The experience suggests that although CEOs from other companies look ideal in principle, there is a danger of an interest in reciprocal benefaction developing, in other words high priced circularity. On the other hand, deliberately to pick people from a low paying industry to sit on the remuneration committee of a company in a higher paying industry is to court the opposite danger. Of course members of the committee are expected to review evidence impartially and no doubt they do, but people's views are inevitably coloured by personal experience and interest (even if indirect).

Companies are increasingly international in terms of the markets they serve and the creation of their operations. It is therefore of growing importance that the remuneration committee should include non-executive directors with international experience of remunerations practices.

PRO NED therefore recommends that the greatest care is paid to the selection of the committee bearing in mind the background and skills of those it comprises.

INFORMATION

Getting the right information is at the heart of the matter. The person who after consultation is responsible for formulating what he considers necessary is the chairman of the remuneration committee. The company may well furnish him with executive views but if the committee is to have a real role it must satisfy itself that it has all the information it needs about:

- Internal relativities
- External comparisons

The committee needs to have a clearly designated source of supply within the company, preferably from a "neutral" quarter such as the secretary's offices which would be responsible for commissioning and collecting the data requested.

Internal relativities

It normally falls to the personnel department to provide information about the company's command, grading and pay structure. Vertical and horizontal relativities within an organisation are of great importance. It was noted many years ago by an astute observer of the corporate scene that it was often a sign of a company heading for trouble if the gap between the pay of the chief executive and the next tier were overly large.

External comparisons

Companies use various ways of getting their information - three of the main ones are consultants' surveys, consultants' advice ad hoc, and salary clubs. Salary clubs exist in many industries to provide pooled information often against agreed disciplines of benchmark posts. Members of the committee will also use their personal experience. There is nothing wrong with this (or any other source of information) provided the distinction between pa

by itself and the total remuneration package is always borne in mind. If comparisons are being made, they must be like with like

for
and
PRO NED recommends that the remuneration committee be given access to all the information it needs (in good time for its deliberations); and that responsibility be clearly allocated within the company for providing it. *Further, it is suggested that a line for the NED, possibly with committees that the company should appoint on this*

REMUNERATION PACKAGES

The committee will want to know what existing company policy is on the structure of remuneration packages, whether for instance share options or an ESOP is available, and what other benefits the company is willing to provide. One of the committee's functions, after considering the evidence, is to offer suggestions to the board about policy.

The committee must look ahead as well as at the present and it must deal in realities not pious hopes. There has been a tendency in some companies to introduce results-related bonuses which form a large part of a remuneration package. The question for any remuneration committee is whether in practice, if results deteriorate, the executive(s) concerned will tolerate the accompanying reduction in pay. Experience suggests they will often seek to consolidate their basic pay at a level which incorporates a substantial proportion of their bonus.

PRO NED recommends that committees do not fix the bonus element of any remuneration package at such a high proportion of the total that its reduction (if circumstances so dictate) becomes difficult

It is for committees to decide how bonuses should be structured but here practice seems to be to relate them to earnings per share not turnover. This promotes the greatest coincidence of interest between executive and shareholder and facilitates the consideration of the dividend free from taint of self-interest (such as might arise if the bonus were related to that instead).

ACCOUNTABILITY

There are divided views on whether the committee's recommendation should be binding on the board or not and in law it is doubtful whether they could be so binding. In any event, the board must have the last word because it cannot abrogate its responsibility for running the business and remuneration is a critical element. Even so, no Board should lightly put aside the recommendations of its remuneration committee since to do so is to weaken it and destroy its members confidence in themselves and in the company. If a committee persistently produces results the board finds intolerable there is no choice but to change the membership of this committee - And if the committee is manned solely by non-executive directors a major confrontation may (and indeed probably should, ensue), Such an eventuality is unlikely but it may happen if there is a wide gulf between the committee's assessment of remuneration and the executives opinions of themselves.

The committee's position will be strengthened if its composition is mentioned in the annual report and accounts and its chairman is open to question at the annual general meeting.

PRO NED recommends that

- Boards should normally treat the recommendations of the remuneration committee as binding
- The company should publish the names of the remuneration committee in its report and accounts (and state its terms of reference)
- The chairman of the remuneration committee should attend the annual general meeting of the company and should answer questions referred to him or her by the chairman of the meeting.