

Abstract

This study looks at the inner workings of the remuneration committee of a company's board (RemCo). The functions of the RemCo and its interaction with other actors who exercise influence in designing executive compensation programs were considered under an ethnographical approach. The aim is to identify, understand and propose ways on how to improve the work of the RemCo. The study used interviews with RemCo members and company disclosures as its main source of data. The interview respondents are either former and current serving members of RemCo of companies from the US, the UK and Hong Kong. This helps to gain insight from a wider range of respondent perspectives. The findings were validated by reports of executive compensation consultants.

The findings identified three critical issues that affect the work of the RemCo. These issues are 1) independence of RemCo from management, 2) over-reliance of the RemCo on the executive compensation consultants, and 3) the competence of the RemCo itself. The study proposes a number of actionable items that both management and the RemCo could adopt. RemCos could improve the design of executive compensation by aligning it with the Company's market stage. Compensation plans could be designed such that all employees not just the executives benefit from the plan. Independence could be enhanced by choosing a more proactive chairman of the RemCo.

This study contributes to existing literature on corporate governance, particularly in the areas of executive compensation and director independence. The study also identifies opportunities for further research.

Research Proposal

Proposed title

Remuneration Committee : Understanding Persistent Issues in Executive Remuneration

Introduction

Executive compensation is one subject that never escapes the scrutiny of any activist shareholder. And the media likes to sensationalize it by linking it to corporate performance, calling it “excessive” if it is perceived to be not commensurate to or disconnected with performance. Observers also criticise the disproportion of a CEO’s pay with the salary of an average employee of the company. For example International Shareholder Services (ISS) highlighted in its report that Apple’s Tim Cook’s pay in 2021 was 1,447 times more than the salary of an average Apple employee (source: various media reports). In the same vein, regulators have not been remiss with their role as they continue to propose new legislation or formulate new rules to appease public concern about perceived executive pay excesses. Disapprovals are not only directed to the executives. The individuals who design and propose the compensation of executives have also been the subject of criticisms. These individuals make up the remuneration committee (RemCo). This study is about the role that RemCos play in this controversial area of corporate governance.

Research on executive compensation have been driven by attempts to explain relationships between business performance, organization size and executive pay. Perkins and Hendry noted several of these studies and observed that the relationships among these variables have not been robustly demonstrated. Other studies found a complex relationship between executive pay and corporate governance (Perkins & Hendry, 2005). The role of independent directors in RemCos and their efforts in addressing concerns about executive compensation have also attracted criticisms from a number of studies (Bainbridge, 2002). Some evidence suggests that there is close alignment between RemCo and the composition of the board (Conyon & Peck, 1998) which is consistent with findings that independent directors affect the quality of disclosures made by public companies (Perkins & Hendry, 2005).

This study will investigate RemCos of companies in select jurisdictions, notably the United States, the United Kingdom and Hong Kong. Indeed, it is intellectually appealing to compare

and contrast the experiences of RemCos and independent directors across other jurisdictions and even among family controlled companies but these are beyond the scope of this study.

This study hopes to highlight the shortcomings of RemCos and to propose pathways to improve their work thereby enhancing their role in corporate governance. The study will focus on director independence and how independence could be utilised in crafting executive compensation packages that address the concerns of critiques.

Literature review

The past twenty years saw a proliferation of studies on corporate governance (Pandey, et al., 2022). This was in the aftermath of a series of corporate scandals punctuated by Enron. Legislation and regulations like Sarbanes-Oxley and similar regulatory mechanisms in other jurisdictions promptly followed the scandals and have likewise attracted much research and commentaries from the academe, the professions and the media at large.

Executive compensation, RemCos, director independence and related regulations usually form a research cluster. This research field intersects with several research areas such as management, law, finance, economics, accounting and even psychology and politics. Ellig constructed a timeline of events that tracked the introduction of corporate governance regulations and taxation rules that affected executive compensation (Ellig, 2022).

Pandey, et al., who mapped the corporate governance literature of the past twenty years identified six prevalent themes of research and each of these relate to the focus of this study.

Regulations have been criticised as they are based on unsubstantiated evidence and that they suffer from the flawed “one size fits all” assumption (Bainbridge, 2002). The engagement of remuneration consultants and references to salary surveys have also received commentaries as these were viewed as not the “best way of getting information” in designing and benchmarking executive compensation packages (Perkins & Hendry, 2005). Linking corporate performance with executive pay has also been viewed as a biased research approach as no robust relationship between these variables have been established. That being the case, it is not surprising that research have redirected its focus on the social dimensions of executive compensation (Conyon & Peck, 1998). A qualitative research approach is, therefore, appropriate.

Research aim and research questions

This study will investigate the role of the principal actors in the design of executive compensation packages such as the RemCo, the executives themselves and the remuneration consultants. It will attempt to articulate the various elements that influence the RemCo and identify the challenges that the RemCo faces each time it makes pay recommendations. These aims lead to the following research questions:

First, how does the RemCo see itself as being influenced by the perception of a market for executive pay?

Second, how does the Remco interact with remuneration consultants and what influence does the remuneration consultant bear on pay recommendations of the RemCo?

Third, how much influence does the executives' perception of their own talents and performance bear on the RemCo?

Understandably, other questions or issues relating to the various influences and challenges faced by the RemCo may emerge in the course of this research.

Methodology

The research will be based initially on the analyses of Company disclosure reports that are publicly available. In the US, one such report is known as Compensation Discussion and Analysis (CD&A). The CD&A is a component of the proxy statement that publicly traded companies are required to file with the US Securities and Exchange Commission (SEC). The CD&A gives a summary of the policies and decisions of the company that relate to executive compensation. It is important to note that the CD&A is not a report of the RemCo.

The CD&A must communicate in layman's terms the elements of executive compensation, the reasons for paying such elements, the bases or formula of the amounts to be paid, and how the structure of the compensation package dovetails with the company's general compensation objectives and compensation program.

In addition to the CD&A, a company is also required to provide a Summary Compensation Table. This is the primary disclosure instrument with respect to the compensation of the *named executive officers*. These include the CEO, the CFO and the three highest paid executives. The

Summary Compensation Table shows the salary, bonus, stock awards, option awards, incentives, perquisites, other personal benefits and all other forms of compensation that is paid or awarded to the named executive officers.

In the UK, the equivalent report that publicly-traded companies are required to provide in the annual report is called the Directors' Remuneration Report. Its components and objectives are similar to its US counterpart.

Using the researcher's personal network, interviews will be organised with select independent non-executive directors who served or are still serving as members of RemCo in the US, UK and Hong Kong by employing a set of interview guides and questions. The goal is to interview at least 3 RemCo members from each of the US, the UK and Hong Kong.

The interview questions will be framed in a manner that respondents will be encouraged to talk around the topics and develop issues that are important from their perspective. The proposed interview topics would include: a) the respondent's perception of his or her role as an independent director, b) the factors that influence his or her decisions regarding the amount and elements of executive compensation, c) his or her perception about the awareness of the executives of their market value, and d) the influence of salary surveys and executive compensation consultants on his or her role as a member of the RemCo.

If opportunity should arise, interviews could also be organised with executive compensation consultants. The interview topics would track those of the RemCo members but from the consultant's perspective. Additional topics for consultants would be about their perceptions of trends affecting executive hiring and firing and about sectors that are experiencing unusual executive turnover.

In the event that interviews with consultants could not be organised, the research will access published reports of compensation consultants and professional bodies. An example of such report is the one commissioned by ICAEW that investigated the factors that influenced executive compensation consultants' advice to clients (Bender & Franco-Santos, 2017).

Research Approach

There are possible alternative approaches in executive compensation research and this will be explained in turn.

Executive pay negotiation is a process that is influenced by the executive's perception of his or her talents and of his or her potential to contribute to the company. The level of compensation is perceived as a feedback on his or her performance. This is a phenomenon that requires a phenomenological approach where several individuals who have shared the same experience are studied.

Since the research will study the interaction of the principal actors and influencers in the field of executive compensation, a grounded theory approach would also be possible. Extensive interviews with RemCos and executive compensation consultants could be the bases of theory development.

Finally, the RemCo could be validly characterised as a culture-sharing group. There are patterns in the conduct of RemCo's activities and terms of reference that this study will focus on such as the exercise of their independence and accountabilities. The independence of the RemCo has been the focus of criticisms of observers who clamour to intensify efforts to minimise the influence of top management on the RemCo. This study will adapt an ethnographical approach. The objective is to generate a holistic understanding of the RemCo and its interaction with the other actors and influencers to establish patterns that would emerge during the course of the interviews and the analysis of the disclosure documents.

Expected outcomes and contributions

RemCos have long been criticised as being “...too eager to please management, too unwilling to challenge the assumptions underlying compensation plans ...” (Reda, et al., 2014). Indeed, one of the difficulties that RemCos face is that there are very few pathways to choose from in deciding what is the right compensation to attract, retain and motivate executive talent and avoid triggering complains from corporate governance observers. Executive pay levels and practices continue to attract public attention.

This study expects to find that RemCos could disagree with management on some components of compensation plan and at the same time remain supportive of the executives. This could be done, for example, by restructuring compensation package by taking into account the market stage of the company. On one hand, companies in growth market should pay a moderate proportion of the total compensation package in salaries and a high proportion in long-term incentives. If the long-term prospects of a company in a growth market are promising, long-term incentives are fair and reasonable way of compensating executives. On the other hand, companies in a mature market could pay a high proportion in salaries and a moderate proportion

in long-term incentives. This must be so because the company at this stage is stable with a steady income flow and therefore able to pay its executive in liquid funds.

The study also hopes to find that RemCos would be willing to place more emphasis on non-financial goals than on financial metrics. This would include addressing concerns of a wider range of stakeholders.

RemCos should be able to formulate a compensation plan that would benefit all employees, not just the executives, thereby incenting and rewarding every employee who contributes to the company's performance.

The role of compensation consultants could be made more meaningful by not limiting them to legitimising compensation packages. Consultants should be tasked to interpret salary survey data by investigating its usefulness in value creation, establishing the criteria used and explaining how, for example, bonus are calculated and if account is taken of different jobs and positions in the company. In this regard, both RemCo and consultants should review the benchmarking approach employed. For instance, objective and subjective analysis of the benchmarking data should be used. The justification of this approach is premised on the fact that each company has its own characteristics that may not make the use of the chosen benchmark suitable under the circumstances.

Finally, independence could be enhanced by appointing a chairman of the RemCo who is not just a favourite of the board but who is also a skilled negotiator and is willing to challenge management and candidly express his or RemCos opinions.

As an area of future research, it is proposed that a study is conducted on how the executive directors view the work of the RemCo and to articulate the perceptions of the executive directors of their independent, non-executive counterparts.

Research plan and timescale

The research plan will involve four phases and following the timescale below

Research Phase	Time allocation
Literature review	3 - 6 months
Research design and methodology	1 month
Data collection and analysis	3 - 6 months
Writing phase	3 - 5 months

There will be breaks between phases to allow time for reflection and consultations.

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Critique of a Research Article

Perkins, S. J. & Hendry, C., 2005. Ordering Top Pay: Interpreting the Signals. *Journal of Management Studies*, 42(7), pp. 1443-1468.

Introduction

This study is about the inner workings of the remuneration committee (Remco) of a company's board of directors. The Remco is a committee of the board that is responsible for making recommendations about the compensation of the executives of the company. Remcos are accountable to the board and the shareholders not only for the amount but also for the structure and elements of executive compensation. As an instrument of good corporate governance practice, Remcos are composed of independent, non-executive directors.

Board decisions concerning executive compensation make reference to recommendations of the Remco. Considering how much interest the media and the regulators have focused on perceived executive compensation excesses, the work of Remco has deservedly attracted the attention of researchers.

The authors of the article are academics that have written considerably about executive compensation (based on website search). This article is their response to the call of another study to "address the overwhelmingly prescriptive bias" in linking executive compensation to independent variables such as performance and board composition (Pettigrew, 1992).

Two complex, wide-ranging empirical issues have been highlighted in this study. The first issue relates to how members of the Remco discharge their accountabilities. The second issue concerns how the Remco responds to "market signals", if ever there is such a market for executive pay.

The complexities and range of the issues mentioned above were the grounds on which the authors carefully proposed research questions. The questions revolved around : first, the effect on the RemCo of their perception of the nature of its agency relationship with the company; second, the RemCo's understanding of its duties towards shareholders; third, the influence that other actors have on the RemCo's decisions about executive pay taking into consideration the executives' talent and performance; fourth, the expectations of the executives themselves as perceived by the RemCo; and fifth, how the RemCo understands its function given that the

regulators have continuously formulated ways to overcome shortcomings in executive pay practices.

Research Design and Methodology

An analysis of board turnover over the period from 1986 to 1995 in 81 of the FTSE 100 companies was conducted. Since there was no observed transfers of executive directors among the companies during the study period, the presumption that there is a market in executives and executive pay is undermined. The article emphasised, however, that what matters is RemCos perception that a market in executive compensation does exist. This perception influences RemCo's mentality and therefore its actions. And this is the justification for the authors to adopt a qualitative research design.

The article points out that the study is based on "privileged access to key actors engaged in the business of boardroom appointments and reward determination". These key actors include seven RemCo members and five executive search consultants. The participating RemCo members have either chaired or serve as RemCo members of one-fifth of FTSE 100 companies. This is a statistically significant sample size.

The study acknowledges that the type of individuals who participated in this study are reluctant to "talk frankly" about topics that are personal and controversial like executive compensation.

The data collected from RemCo members was supplemented by data from the executive search consultants. The consultants participated in telephone interviews.

Each interview with Remco members were conducted face-to face, with two interviewers / researchers. One of the researchers led the questions and the second tape-recorded the interview. The transcripts of the interviews were analysed which helped in identifying recurring themes. Data from the interviews of RemCo members were cross-validated with those of the executive search consultants.

The study made explicit reference to "grounded theory" and indicated that there should be flexibility in the interviews to elicit insights that could be a reference point for subsequent interviews. These insights could be validated in succeeding data collection interviews. The article is consistent in the application of the grounded theory approach as it attempts to set aside theoretical concepts, such as agency problem theory and market exchange theories, that may lead to partiality, in order to allow substantive theory based on the data to emerge.

Summary of the article

This article is a response to the call to “address the overwhelmingly prescriptive bias” in linking executive compensation to independent variables such as performance and board composition. Pettigrew suggests that the research agenda should not just be guided by investigating or testing the ability to explain agency theory or theories of managerial dominance. The direction of research should be to avoid such “prescriptive bias” and to provide descriptive observations about boards, the committees of the board, and the executive and non-executive directors. As Pettigrew pointed out, the dynamics of the relationships within and around the boardroom are hardly known.

For someone studying the processes or inner workings of the RemCos, an understanding of the board and the relationships among the board members are paramount. For instance, questions should be asked as to how they address issues that are within their sphere of influence. At the committee level such as the RemCo, how does the CEO or executive officers influence decisions and recommendations made by the committee.

The study noted that the executive pay-setting process appear to be dominated by factors that are subjective in nature. This is an important reason why a qualitative research approach was employed in this study. The respondents did not offer objective criteria in the determination of executive pay but relied on a “judgement and fit” considerations. RemCos have to appease multiple factions. One of these factions is the RemCo members themselves who have relationships with executive directors. This exposes RemCo members to the risk of being influenced by more powerful members of the Board.

Another factor that carries influence on members of the RemCo is the perception that the level of pay that they propose is “fair” across the network of companies where they serve as RemCo. This is a questionable criterion and has a potential to be more harmful than inter-linking directorships.

The reliance on consultants and salary surveys as the primary source of benchmarking data have also been alluded to as disdainful by RemCo respondents. Some have even called it “a necessary evil” as this frustrates compliance with the spirit of the Corporate Governance Code.

Executives also influence the design of executive pay as they are able to manipulate incentives as to their the form, timing and quantity.

The study discussed several specific conclusions that addressed each of the research questions in varying degrees of detail. One such conclusion that is worth mentioning at this point relates to RemCos and the impact of disclosure requirements. Even if executive pay comparisons could be easily made because of disclosure requirements, RemCos feel that their ability to objectively calibrate pay levels is still constrained due to peculiarities of the individual executives and their role.

Other specific conclusions are discussed in the Conclusion section of this critique.

Assessment/opinion

Strengths

The article made an effort to highlight important issues that would help in identifying and understanding the issues by carefully introduction. For instance, before, discussing the role of RemCos in effective corporate governance, the article devoted several paragraphs to discuss agency theory. To a reader who is new to corporate governance, agency problem is foundational as it is an important justification for the appointment of directors in the first place. The authors did this in the literature review section and again in the main section of the article.

The article also devoted considerable amount of balanced discussion on proving and disproving the presumption of the existence of a market for executive pay. This is an anchor of several findings and observations in the article

Weaknesses

The article mentions that the construction of the sample was based on one interview providing credibility and the introduction to the next. But the articles does not describe nor illustrate how this was accomplished. Researchers would benefit more from this article if details of methods employed such as the one referred to here is given more elaboration.

Conclusion

Overall, this is an authoritative article that accurately identifies the issues affecting actions and behaviour of the non-executive members of the board particularly those directly involved in

executive compensation. For example, the findings about the existence of an executive pay market were plainly explained. There is indeed a market but it is an imperfect one. It is nothing like the market for commodities or shares. Executives are not immediately exchangeable or even substitutable. There are “just key people in unique positions at a given moment in time”.

The findings on the role of consultants and the impact of their work on RemCo serve as a stern reminder that not all is in order in this area of corporate governance. It highlights one of the persistent issues in executive compensation – that consultants may be unknowingly acting as instrument in perpetuating questionable executive compensation practices. This issue will not be resolved any time soon but is still worthwhile to bring up in studies like this.

The research approach and the methodology adopted were appropriate. The selection of the sample was elegant. With just seven RemCo members, a fifth of FTSE 100 companies was represented in the study period.

It would be intellectually appealing if the main actor – the executives – become the subject of a future qualitative study like this. The executives themselves have a powerful influence in setting their own pay.

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