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Board Walk

Briefing for Remuneration Committees

November 2012

What's really different?

In the past year there has been more noise about executive remuneration than we can ever remember. It kicked off a year ago with the first of three consultations from the Government (BIS) on potential legislation to control directors' pay and new Remuneration Principles and Guidance from the ABI. Public outrage reached a peak with the publication of the notoriously misleading IDS statistic of 49% for FTSE 100 directors' pay increases and with the High Pay Commission report. Then the shareholders took over, with unprecedented levels of votes against remuneration reports in the 2012 AGM season. According to ISS, the UK has had the third highest level of opposition in Europe – behind only Switzerland and France. The Government eventually backed off from any intervention in pay policy (except in banking and other parts of financial services) and decided instead to place the perceived problem clearly in the shareholders' hands.

And what is the problem that the government is trying to solve? Implicitly it is the public feeling that directors' pay continues to ratchet up to obscene levels despite pay constraint in the rest of society. But the latest consultation document made only the smallest allusion to pay levels – instead it talked about "restoring" the linkage with performance and stuck to the traditional line that the level of pay is a matter for shareholders only. Its planned new regulations (for which consultation closed at the end of September) are all aimed at providing shareholders with the information and votes to take better control of directors' pay and encouraging them to do so.

So are things really going to be different – apart from rather a lot of extra work in producing the remuneration report (which is hardly likely to get shorter!) and holding shareholder votes on future policy? Are remuneration committees going to find they can and have to think about remuneration policy in a different way? Is the linkage between remuneration, performance measures and long-term value creation going to become stronger? Are committees going to be less concerned with matching competitive pay levels and more with executive pay economics?

In this edition of *Board Walk* we have set out to answer these questions and to suggest to remuneration committees where you need to focus your attention to take advantage of the opportunity to engage more productively with shareholders.

This edition of Board Walk includes:

Responsibilities of NOMADS for AIM directors' pay

Paul Norris explains the current situation

The new directors' remuneration reporting regulations, coming into effect for financial years ending after October 2013, will not apply to AIM companies. However, AIM companies are required to disclose details of directors' pay under AIM Rule 19 and many have established remuneration committees.

A remuneration committee should set remuneration policies which are consistent with the company's business strategy, its culture and stage of development and the creation of sustained value. Interestingly, this is not the way 'best practice' has evolved, particularly in relation to long-term incentive plans. Ironically, the new regulations should help remuneration committees get back on track.

Changes to an AIM director's pay might require a "fair and reasonable" statement, under AIM Rule 13, if "out of the ordinary". The NOMAD, who must be consulted before the statement is released, is required to demonstrate due skill and care in considering the company's statement and to take professional advice.

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Shareholders and directors' remuneration

Damien Knight assesses the likelihood of shareholders engaging more effectively with companies

In 2012, the spotlight has moved onto the effectiveness of shareholders in ensuring listed company directors' pay is justifiable and effective in promoting sustainable long-term performance.

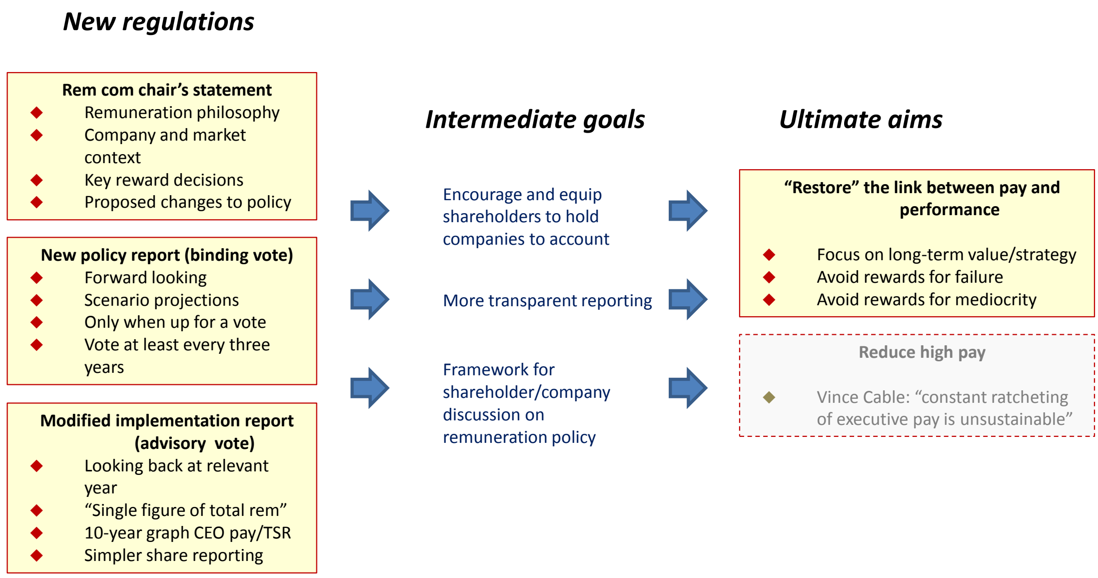
After a year's consultation on the 'problem' of directors' pay, including consideration of such radical proposals as employee votes and employee members on remuneration committees, the Government's solution is to pass the problem back to shareholders (where of course it always belonged) and to encourage and equip shareholders with clear information and votes to be able to exercise this responsibility better. Chart 1 below summaries the virtuous path BIS hopes companies and shareholders will take.

No-one is going to disagree with the first ultimate aim in the chart – if "restore" is the right word – and we can expect both shareholders and companies to commit publicly to its achievement. Surprisingly the second aim is not mentioned in the consultation document itself as a problem to be solved – but clearly it continues to be a core political problem for the Government.

The consultation puts much emphasis on the need to improve the engagement between shareholders and the companies in which they invest, and even without the evidence in July in the BIS-sponsored Kay Review of UK Equity Markets, it has been clear that BIS sees any failure in this quarter as down to shareholders as much as to companies. Are things going to improve?

First it is important to clarify who the shareholders are. On both sides of the Atlantic the dominant players are now the major asset managers who manage funds on behalf of their clients and make buy and sell and voting decisions on their behalf. The FRC review of corporate governance developments last December found that 175 out of 234 signatories to the 2010 Stewardship Code were asset managers. The Code (reissued on 28 September 2012 with minor amendments) appears to have had positive effects on the engagement of these companies – the proxy votes in FTSE all-share companies have increased to nearly 65% of issued shares in this year's AGM season.

Chart 1: New Remuneration Disclosure and Reporting Regulations: Government's Objectives



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Nevertheless, there are several factors that are working against effective engagement:

- Asset managers' income has been squeezed, and they have less to invest in corporate governance
- Good corporate governance is often seen as a compliance not an investment/income-generating issue
- Long term for an asset manager is short term for a company. One major US-owned asset manager told us long-term holding means two years
- The time available for any individual company in a portfolio of thousands is limited. The FRC review suggests smaller companies are seeing no improvement in access
- Some asset managers are relying increasingly on the recommendations of proxy agents for voting
- ISS is becoming increasingly dominant amongst the five main proxy agencies. Many consider that the ISS approach is too mechanical
- Asset managers tend to focus on 'outrage' issues rather than improving remuneration policy across their portfolios
- Kay pointed out that the remuneration system within an asset management firm can influence its perspective on reward in portfolio companies (eg the preference for relative TSR)
- The record level of remuneration report dissent this year (10% of FTSE 100 had more than a 20% vote against) certainly indicates an increased intention of shareholders to be active in remuneration issues. But no common remuneration theme emerged
- In most cases the shareholder reaction was an exceptional event for the company in question and the problems could have been averted by an early consultation.

Companies are going to face a binding policy vote in future. Here are some ways you can improve your remuneration committee's control of the outcome:

- Be very clear about your own remuneration policies, the philosophy behind them and the way they support business strategy and long-term value creation (but be careful – ratcheting up of pay without performance improvement is no longer going to be acceptable to any shareholder)
- Identify your major shareholders and understand how they prepare for remuneration votes and who the key decision makers are. If necessary recruit the services of a proxy solicitor for this purpose
- Seek very early (and out of season) meetings to present your policy and obtain shareholder views; aim to combine these meetings with a broader presentation about company intentions
- Asset managers only publish high level governance assessment guidelines (in order to stay flexible) but they keep a more detailed set of guidelines in their top drawer. You can only tease these out by discussing concrete issues around your own policies
- Include the proxy agents in the consultation – ABI/IVIS, Glass Lewis, ISS, Manifest, PIRC
- Listen, reflect and provide further information or modify your policies where doing this does not undermine your philosophy or fundamental strategy
- And above all be seen to be trustworthy.

We expect most larger companies to be early adopters of the disclosure proposals in this coming season in order to build trust with shareholders and test out the new approach before it bites fully. This will still of course be subject to the current advisory vote: it will be a brave company that decides to have a separate vote on policy early.

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Choosing performance measures for incentive plans

Paul Norris and Damien Knight review the fundamentals and illustrate the issues using the oil & gas sector as an example

The fundamentals

Shareholder and corporate governance priorities for directors' variable remuneration plans have made a seismic shift from *justification* to *supporting long-term value creation.* This message is repeated in all the regulations and codes.

Sounds right – but what exactly does it mean? What does a short-term or long-term remuneration plan that is aligned with long-term value creation look like? The answer is likely to be very different for different industries and business circumstances. Unless companies are quite clear about this they are going to end up with some pretty bland statements in their new *future policy table* and are not going to be in a position to defend their policies against those institutional shareholders and proxy agencies who have displayed an over-simplistic view of how to measure and reward performance.

To begin with a rather obvious statement, there are three stages to designing variable remuneration: defining performance; choosing the reward currency; and designing the linkage to performance. As alignment is principally determined by the definition of performance and the use of shares as reward vehicle, this article will concentrate on these. We will look at the problems of linkage in a future article.

Defining performance has to cover:

- The organisational level at which performance is to be measured
- The performance criteria
- The timescale over which performance is best recognised and measured
- The generic standards against which performance will be calibrated
- The method of measurement
- Recognition of the sensitivity of performance outcomes
- The specific targets and range of performance over which reward is to be varied.

What definition of performance is best aligned with the creation of long-term value creation? Ultimately performance for shareholders is measured by long-term shareholder returns and there is something appealing about the idea of giving executives a shed load of shares that they have to hold for many years. This is in essence the Hermes and John Kay idea and one that HSBC have implemented. 'Career shares' are now catching on as the latest fashion.

We should not ignore old-fashioned share options, which are still very popular in the US. They have often been criticised as providing a less perfect alignment than shares because there is no downside for executives and because the upside is more highly geared, encouraging undue risk. That said, there are situations (eg new-ventures or exploration companies) where they provide the ideal incentive.

But, setting aside the battles companies would have awarding shares or share options with no performance conditions, most companies would see long-term shareholder value or share price as too uncertain a measure to rely on as the principal determinant of a variable reward plan if it is to be both motivational and justifiable. In this respect we disagree with Kay's view that career shares are sufficient LTI. We make an important distinction – between reward plans that provide a *share in the success* of the company (for good or bad), and plans that seek to *reward genuine management performance* ie dealing effectively with the circumstances in which the company finds itself. Examples of share-in-success plans are restricted shares, 'vanilla' share options and profit-sharing. Management performance plans include target-based bonuses and performance shares.

Both types of plan have a part to play in a reward programme for top executives, for the simple reason that these people are charged with both formulating a good strategy and with implementing it successfully. As no-one can know if a strategy is good until after the event and so much depends on the luck of market circumstances, there needs to be a good element of share-in-success in the reward mix. Strategy implementation, on the other hand, is circumscribed by plans and targets, and needs reward which recognises executive delivery of results. In most company situations it is only a reward for genuine management performance that can both motivate executives and justify to the shareholder the payment of high levels of reward that the talent market demands.

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It is confusion over this distinction that has led to the UK LTIP hybrid and to all intents and purposes killed off full-priced share options (with some help from IFRS 2). It gave rise to the present muddle of 'best practice' plans that companies (with the encouragement of some shareholders) are now trying to break out of. This situation is characterised by the continuing dominance of relative total shareholder return as a measure (a fund-manager's *justification* measure that neither motivates executives nor provides a share-in-success) and the standard three-year performance vesting period for all share-based plans (a prescription that has been blatantly avoided by the burgeoning expansion of deferred bonus plans).

Career shares without performance measures are a welcome innovation which will provide a clean share-in-success reward. But they do not address the need for equally clean variable elements which reward for management performance. Whether this element is paid in cash, deferred cash, shares or deferred shares is a secondary consideration. What really matters is that the performance measures are correctly aligned with the actions necessary to implement the strategy. This is what will build long-term value and this is (for most companies) the way you align rewards with long-term value.

Since every company has a different strategy, different business circumstances and a different stage of development, it follows that the definition of performance will be specific to a company (and consequently the performance pay plan design, both short-term and long-term).

A sector perspective on LTI measures in the oil & gas sector

Whilst guests at our recent oil & gas remuneration dinner agreed that incentive plan design should recognise the diversities within the sector, the generally accepted model of 'best practice' for long-term incentives works counter to this. No stranger to change and the need to adapt, the sector has become set in its ways, following the investor-led convention that LTI awards should be linked principally to relative total shareholder return (TSR) and/or earnings per share (EPS) performance conditions measured over three-year periods. Table A demonstrates the use of TSR.

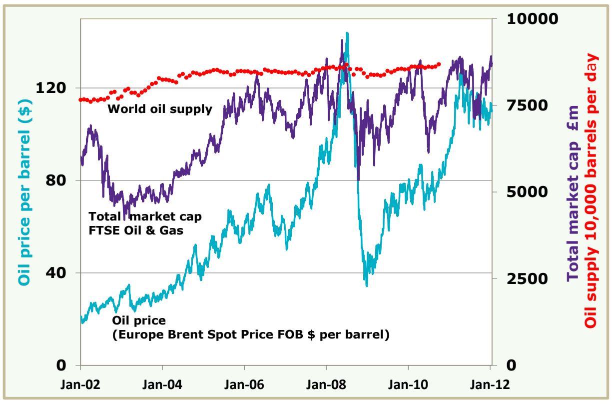
Table A: TSR the most common LTIP vesting measure for exploration and production and associated service companies

Sector	FTSE 350	Co's using TSR as LTI measure
Exploration & production	14	12
Service companies	5	4

Source: Hemscott

These are not sound measures of management performance in the sector since they are at the mercy of the politics of oil – which governs the share price and therefore the market capitalisation of listed established exploration and production (E & P) companies – and the investment/return cycles of an E & P business (see Chart 2).

Chart 2: Oil company prices follow price of oil



But recent developments are likely to drive oil & gas companies towards designing incentive plans which are fit for purpose from a company perspective and consistent with the economics of the sector.

First, the forthcoming regulations governing the reporting of directors' pay by listed companies will require statements showing the relationship between each element of remuneration and business strategy and active engagement between companies and their principal (institutional) investors.

This relationship is not currently well explained. In April, we published a study of remuneration and performance measures in the E & P sector. This shows consistency among E & P companies as regards their stated KPIs but no close relationship between KPIs and remuneration performance measures.

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It is a Companies Act requirement to include KPIs in the annual report and we have a suspicion that companies might be ticking this compliance box without paying too much attention to the links with remuneration. If that is right, practice must change.

Secondly, within the E & P sector, there are 'E' companies and there are 'E & P' companies. 'E' companies tend to be smaller, have their shares traded on AIM, have no cash in-flows but require capital for investment. These companies are leaving AIM and private equity is entering the sector (eg Riverside Capital's recent investment in Fairfield Energy). Consolidation deals are being done (eg Petroceltic/ Melrose Resources) with more likely to follow.

For a capital intensive sector, we found surprisingly little incidence of LTI targets which reflect the efficient use of capital. A requirement to show clear linkages between performance targets and strategy, together with the emergence of private equity investment are likely to change this.

A final observation concerns oil services companies. Their fortunes follow closely those of the companies they serve. Our research shows there is an equally strong link between the share price of service companies and the price of oil.

Remuneration committees throughout the E & P sector should recognise the share price problem when designing incentives and selecting LTI performance measures. This may seem difficult to achieve as the market recognises share price performance and does not necessarily recognise the measures that would be used in a good remuneration structure. Kay's advice may be helpful: stop trying to manage the market and focus instead on your major shareholders.

In summary, for oil & gas remuneration committees there is some work to be done on:

- articulating the pay strategy
- identifying short and long-term KPIs which reflect progress towards achieving business strategic goals
- linking incentive plan performance measures closely to those KPIs
- developing a constructive dialogue with investors.

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2013 remuneration review: what companies are doing

Cliff Weight provides information from MM&K market surveys

Total remuneration. The combination of the items described below means that companies need to increase total remuneration by 7% to 10% p.a. in order to stay competitive. Some companies review bonuses one year and then LTIs another year and may perhaps review their salaries and total remuneration in a third year. We caution against this piecemeal approach to remuneration as it is inherently inflationary. It is better to do a comprehensive total remuneration review once every three years and then stick with it.

Salaries. After three years of pay freezes (for half of companies) salaries are rising again. The median executive increase is around 3% but before adopting this figure, we suggest you take account of what the average employee in your company is getting and put salary into the context of total remuneration. Large increases will attract attention (eg WPP 30%).

Bonus maximum. Other companies have been increasing the bonus maximum, particularly larger companies. BP now has a maximum of 225%, Shell 250% and HSBC 300% (if you include the expected value of matching shares the figures for Shell and BP increase to 375% and 310% respectively).

Bonus target. On-target payout is now 60% of maximum in many large companies, compared to the traditional level of 50%, eg BP, Shell, BAT and Legal & General. GSK is 62.5%. Moving on-target payments from 50% to 60% of a maximum of 100% salary is akin to a 10% salary increase but is less transparent and less likely to attract negative feedback from shareholders. We would not advocate this unless it were part of an integrated remuneration strategy. The combination of such large bonus opportunities and higher target payouts means that much of bonus is effectively deferred salary, as it is difficult to pay below target to a major company CEO without implying that he or she is not up to the job.

Bonus deferment. These plans are increasingly popular but their structure requires careful thought. Shell has mandatory deferment of one-third of bonus

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and optional deferment (at the executive's request) of another third into shares that have to be retained for three years.

The matching is so generous that the optional deferment is a no-brainer. Such plans add complexity with little benefit to shareholders, other than to meet the over-prescriptive guidelines of the ABI and others. It would be more straightforward to say that two-thirds of the bonus is deferred into shares for three years and that part of the LTIP award is linked to the size of the bonus payout.

Bonus performance measures. The use of multiple measures and balanced scorecards continues to grow. This is often the right approach: company performance is far too complex to be measured in a single metric. Balanced scorecards usually involve qualitative assessment of performance and require judgment. Whilst this may result in a more appropriate assessment of performance, it may reduce the chances of very high and (especially) very low bonus payouts. Such approaches are attractive for executives but remuneration committees need to consider the cost implications.

Bonus performance targets. Annual growth targets are reducing to reflect the new economic reality. It is important that companies ensure their incentive plans reflect this. Otherwise the incentives are unfair to executives and this can be demotivational.

Long-term incentives length. Too many plans have three-year performance periods (the minimum period in the Corporate Governance Code/ABI guidelines. Remuneration committees have often been afraid to go longer for fear of demotivating executives). LTIs should reflect the business strategy and few of these are neatly measured over three-year periods. HSBC has moved to a five-year period, the initial award is based on assessment against long-term criteria (as measured in the preceding year) and then the amount that vests can be clawed back if subsequent performance is not as expected. It appears that HSBC does not expect to use the clawback provision - it did not discount for it in its table of total remuneration.

Long term incentive measures. As stressed in the article on Page 4, three-year relative TSR is the wrong metric for most companies: it rewards volatility and too much of the result is beyond the control of the executives. Comparing your company with banks is not a good idea unless you are a bank and even then the different leverage of different banks has a huge impact on the end result. You might consider more measures or the balanced scorecard approach. Or be radical and abandon forward-looking performance measures, like HSBC.

Long term incentive quanta. The trend has been to reduce LTI awards and increase bonus opportunity, but with deferment. Aggregating the two, overall levels have grown substantially over the past decade. LTIP annual grant maxima now are 600% salary for HSBC, GSK, Shell and BAT, and 550% for BP, whilst the median for small cap companies is only 100% salary.

Career shares. These involve incentive awards of shares which executives have to hold until, say, two years beyond their retirement or date of leaving the company They form part of the new HSBC plan. Long-term share ownership is encouraged by the Quoted Company Alliance, Hermes and the NAPF.

Contracts. Payments for failure continue to attract negative publicity. Companies should consider asking executives to show leadership in this area by agreeing to reduce their contractual maximum termination payment to 6 months' salary

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NYSE proposals for compensation committees

Borja Castelar reports on this change in the US

On 25 September 2012, the New York Stock Exchange proposed amending its Listed Company Manual with regard to two main issues: compensation committee independence and compensation committee advisers.

Compensation committee director independence

The idea here is to set up an "independence test" for any compensation committee member in a listed company. The relevant factors for this are:

- The source of compensation of the member, including any consulting, advisory or other compensatory fee paid by the listed company
- Whether the member is affiliated to the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

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No director will qualify as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company.

Compensation committee advisers

According to the amended rules the compensation committee has the authority, and sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel or other compensation adviser. Hence, the committee must be directly responsible for the appointment, compensation and oversight of the work of such adviser. However, a compensation consultant will be selected only after taking into account the following factors:

- The provision of other services to the company by the firm that employs the adviser
- The amount of fees received from the company by this firm
- The policies and procedures of this firm designed to prevent conflicts of interest
- Any business or personal relationship of the adviser with a member of the committee
- Any stock of the company owned by the adviser
- Any business or personal relationship of the adviser, or his or her firm with an executive officer of the company.

The new revised rules will take effect from July 1 2013.

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BIS directors' pay consultation

Cliff Weight outlines MM&K's response

The UK Government (BIS) published in July its proposals for the new directors' remuneration reporting rules and associated shareholder votes. The consultation ended on 26 September and the Government is planning to bring out the final version of the regulations and primary legislation on the votes early in 2013.

MM&K submitted a detailed response. We expressed concerns that, in direct contrast with the aims of the new regulations, there will be a loss of transparency in some areas and increased complexity to remuneration reports. We also predicted that the proposed regulations will not reduce directors' pay.

Nevertheless, we supported the thrust of BIS' suggested changes in most areas, as fostering a better dialogue with shareholders which will improve the linkage between remuneration and company performance. We agreed that the requirement to produce a 10-year graph of TSR performance and CEO pay will highlight those cases where high pay is being received for mediocre performance, and said we expect that companies will choose to disclose their KPIs as well as TSR over the 10-year period so they can explain the linkage of pay and performance. The votes on policy and implementation will allow shareholders to exercise their power to control pay in cases where it is necessary to do so. This will encourage the adoption of many of the good ideas in the Kay Review of UK Equity Markets and the BIS Narrative Reporting proposals.

With the new graphs in mind, we conducted research where we looked at the average FTSE 100 CEO remuneration and annual changes in the FTSE 100 index over the past 10 years and found little relationship (see Chart 3 opposite). The proposed 10-year graph of CEO remuneration and TSR is going to mean much head-scratching in most FTSE 100 remuneration committees. They will have to try to explain why they decided what they did in past years. It is those decisions which have resulted in the figures that are arising now.

We commend BIS for doing a good job on balance. The creative approach of combining additional voting and better disclosure will force companies to rethink their approach to remuneration. We just hope the 10-year graph does not get buried in the depths of the remuneration report. It should be the headline story that underpins the whole logic of why the company is paying the way it is.

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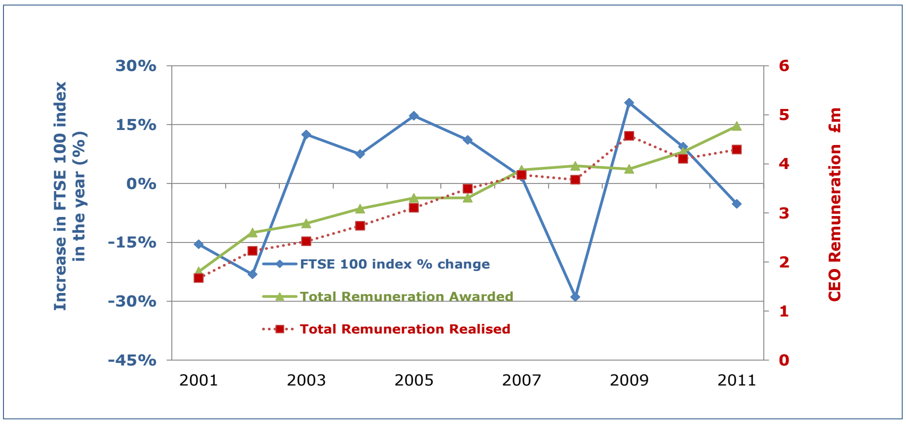
Chart 3. Comparison of FTSE 100 index performance and average FTSE 100 chief executive remuneration



Source: Manifest/MM&K Executive Director Total Remuneration Survey

Alternative Investment Fund remuneration regulations

Nigel Mills reviews the latest developments

Background

The Alternative Investment Fund Managers Directive (AIFMD) was published in the Official Journal of the EU back in July 2011. UK AIFMs within the scope of the Directive are required to seek authorisation from the Financial Services Authority (or more likely the proposed Financial Conduct Authority) by 22 July 2014 in order to continue to manage funds from the UK.

The Directive seeks to regulate the non-UCITS fund sector (i.e. those exempt from normal EU-controlled investor protection), in particular hedge funds, private equity funds and real estate funds. Decision makers within AIFMs need to be aware of the additional responsibilities placed on their firms and should plan to implement any additional policies and procedures to ensure those responsibilities are met.

The AIFMD included a set of 18 principles which mirror closely the principles laid down in the Capital Requirements Directive (CRD3) for banks and other large financial institutions a year before. They include requirements for:

- Deferment of 40% or 60% of variable remuneration
- Payment of 50% of variable remuneration in shares – unlike the banking principles this should be a share in the alternative investment fund managed
- Clawback
- Separate remuneration of control functions to avoid conflicts of interest
- Constraints on guaranteed joining bonuses and severance payments.

Consultation on Guidelines

On 28 June 2012, the European Securities and Markets Authority (ESMA) published a consultation paper *Guidelines on sound remuneration policies under the AIFMD*, aimed at ensuring the consistent application of the AIFMD remuneration requirements across member states. The consultation closed on 27 September.

The main points in the ESMA consultation

Governance

The governing body of each AIFM will have responsibility for approving and maintaining the AIFM's remuneration policy and overseeing its implementation. More significant AIFMs will be required to have a remuneration committee comprising independent non-executives and including sufficient experience concerning risk management and control activities.

Proportionality

It is primarily the responsibility of each AIFM to assess its own characteristics and to develop and implement remuneration policies and practices which appropriately align the risks faced and provide adequate and effective incentives to its staff. Consequently not all AIFMs will have to comply with the AIMFD requirements in the same way and to the same extent. Each principle may be adapted on the grounds of proportionality.

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There is limited guidance on how far proportionality adjustments can be made, AIFMs must be able to explain their rationale in detail.

Whilst on the face of it this provides a welcome degree of flexibility, it also results in uncertainty. We hope ESMA will provide more specific guidance as a result of the consultation responses.

Disclosure

An AIFM applying for authorisation under the AIFMD will be required to disclose details of its remuneration policies and practices to its regulator. The AIFM must also prepare an annual report in respect of each fund it manages with details of the total amount of remuneration, split between fixed and variable and stating the number of beneficiaries and carried interest, together with the aggregate amount of remuneration broken down by senior management and other members of staff whose actions have a material risk impact. The annual report should contain information on its remuneration policies and practices for Code Staff and general information about the basic characteristics of their AIFM-wide remuneration policies and practices. ESMA allows for some proportionality in the level of disclosure.

ESMA proposes that similar, or more detailed, disclosures should be made to staff, though not confidential quantitative information.

UK Implementation

The UK Financial Services Authority (FSA) has been tasked with overseeing the implementation of the remuneration requirements under the AIFMD.

The revised FSA Remuneration Code, issued in December 2010, implemented the CRD3 remuneration principles. As noted above, these were designed principally for large multi-function institutions including deposit takers and investment banks.

Most private equity firms and hedge funds firms were either outside the scope of the FSA Remuneration Code or fell into Tier 4 (or Tier 3 at worst) and were little affected.

On 23 January 2012, the FSA published a discussion paper setting out its initial thoughts on the implementation of the AIFMD. The period for responses to this paper closed in March, but the FSA has not yet published its consultation paper. We understand it intends to align the new AIFMD remuneration rules with the FSA Remuneration Code, either by bringing AIFMs into the scope of the Code or by developing a separate and specific code, modelled closely on it.

What Next?

ESMA is expected to publish its final report adopting the final text of the Guidelines sometime in Q1 2013. On receipt of this, we hope we will be in a better position to advise clients on what they will need to do to be compliant come July 2013.

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Pay still stagnant for private equity partners

James Watts draws on MM&K's specialist PE surveys

2012 has been another challenging year for private equity houses. The European sovereign debt crisis, slow economic growth and instability in the financial markets have impacted private equity investment activity, which in the first half of 2012 declined from the same period last year. The old days of cheap debt and clever financial structuring seem to be a distant memory and PE houses are having to add value the 'old-fashioned way'. Even once all the hard work is done, exiting through IPO is more difficult.

Houses are also facing pressure on their revenues. Firms generate operating revenue from the fees they charge on the funds they manage, so revenues are a function of both the size of the fund and the percentage charge. Both are being squeezed.

Economic uncertainty has not helped. Fundraising is more difficult, taking longer and costing more. Many smaller firms have now joined the biggest houses in employing specialist investor relations staff, a new cost which does not go unnoticed in their P&L accounts. In the last year a number of high profile European firms have abandoned their fundraising programmes temporarily or permanently and others have instigated temporary fundraising measures or agreed agreeing extensions with their current investors.

The balance of power continues to shift from PE houses to investors. There are an increasing number of houses which are looking to raise capital from a pool of investors who maintain a tight grip on their own purse strings. Investors are now shopping around, both in terms of geography (as the BRIC private equity markets

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open up) and in terms of investment strategy. Investors are using the market conditions to negotiate more favourable terms with PE firms.

What appears to be accentuating the shift is the emergence of a new breed of representatives within the investors. This new breed is more suspicious, less friendly and more determined and aggressive. Renewing existing fund commitments is no longer as straightforward as it used to be.

So how are PE houses dealing with rising costs and falling short-term revenues? In the last year some houses have sought to reinvigorate or reinvent themselves through a change in personnel and reduced headcount. Others have become more flexible in their approach to short-term remuneration. Generally the managing partners seem to have borne the brunt as firms attempt to focus pay increases on those investment professionals at the junior level who are yet to receive any carry distributions.

The findings from the MM&K Thomson Reuters 2012 European Private Equity Compensation Report show that the median increase in base salary for managing partners was again 0% this year. In terms of base plus bonus, managing partners in the large mid-market LBO & mezzanine firms have been most affected as median pay has decreased.

Managing partners increasingly have to rely on allocations from their carried interest plans (the commonly used long-term incentive in the industry) as the primary reward for all their efforts. Although these allocations are potentially lucrative they are entirely dependent on the funds achieving successful exits, which in current conditions is requiring hard work at the portfolio level. Furthermore, partners cannot realistically expect to receive any form of realisations from their most recent carried interest awards for at least five or six years. Even then they are most likely held in escrow or subject to clawback for a few more years.

Whether this truly is a long-term trend remains to be seen, but the challenges do not stop there. At this stage it is difficult to tell what will happen with the European economy next quarter let alone next year, but what we do know is that the industry will embark on a period of unprecedented increase in regulation.

As referred to in Nigel Mills' article, in July 2013 the European AIFM Directive will come into force and PE houses will have to comply within a year (ie 22 July 2014) with the provisions on remuneration policies and structures and their governance and disclosure.

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Where next for employee share plans?

Mike Landon reviews recent employee ownership initiatives

Over recent months we have seen a number of initiatives from the Government and the Coalition parties relating to employee ownership and share plans. These have sent mixed messages about the Government's intentions.

The OTS share plans review

The Office of Tax Simplification's review of tax-advantaged share plans, published on 6 March 2012, was deliberately cautious and did not recommend any radical changes. However, it did make a large number of detailed suggestions for removing unnecessary requirements and improving the consistency of provisions, such as the treatment of good leavers.

The Government's response, in a consultation paper published on 27 June, was disappointing.

It accepted the recommendations which could save money, including the replacement of the approval process with self-certification and an investigation of the relevance of the Company Share Option Plan (CSOP). It rejected proposals likely to cost money, such as the reduction of the period before shares in a Share Incentive Plan (SIP) can be removed with full income tax relief. For certain of the OTS's other recommendations, it has sought further views for possible implementation next year.

The Nuttall Review and Liberal Democrat paper

A review by Graham Nuttall, launched on 4 July, made 28 recommendations for raising awareness of employee ownership, increasing the resources available to support it and reducing its complexity. It put particular emphasis on employees acquiring either control of the business or a substantial stake (at least 25%), through direct ownership or collectively, for example through an employee benefit trust.

The Deputy Prime Minister, Nick Clegg, responded

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enthusiastically to the recommendations and the Government's response, published on 30 October, accepted almost all of them.

A policy paper issued by the Liberal Democrats at their autumn conference supported similar proposals to those advocated by the Nuttall Review. It also recommended several of the improvements to the SIP legislation which had been suggested by the OTS but rejected by the Government.

The new owner employee contract

One of the surprises of the Conservative Party conference was an announcement by the Chancellor, George Osborne, of a new type of employment contract. Companies will be able to make staff 'employee owners' by giving them between £2,000 and £50,000 worth of shares that would be exempt from capital gains tax when eventually sold. In return, staff will lose certain of their employment rights, such as unfair dismissal, flexible working, training and redundancy pay.

More details were provided by the Department for Business Innovation & Skills in a consultation paper issued on 18 October. The main aim of the proposal is to remove the perceived barriers which are deterring businesses from hiring new employees. The paper confirms that employees will be subject to income tax on the value of the shares which they acquire. This new type of contract is therefore likely to be most attractive to employees joining businesses whose share price has potential to increase substantially, so that they can benefit from the CGT exemption.

The case for increasing employee ownership

There is now a considerable body of evidence to demonstrate the economic and social benefits of employee ownership and share plans. This is set out in some detail in Chapter 2 of the Nuttall Review. In addition, a recent three-year research study carried out at Loughborough University on behalf of *ifs* ProShare has confirmed that the HMRC tax-advantaged share plans have a positive impact on employees' attitudes and behaviours at work.

When the previous Government first introduced the SIP, in 2000, it said that it wanted to encourage more companies, particularly smaller and unquoted ones, to offer all-employee share plans. Unfortunately, as can be seen by HMRC statistics, the number of companies offering these plans fell significantly over the following 10 years. For example:

- While in 2000-01, more than 1,500 companies operated approved Profit Sharing Schemes, in 2009-10, only 520 companies awarded shares under the SIPs which had replaced them
- 1,320 companies operated SAYE plans in 2000-01, but only 720 in 2009-10.

5,170 companies operated CSOPs in 2000-01, but only 1,910 operated CSOPs (and 2,190 granted EMI options) in 2009-10.

The way forward

None of the Government's current initiatives looks likely to result in a significant expansion of employee ownership. The only realistic way of doing this is to increase the flexibility of the tax-advantaged share plans. CSOP is currently the most flexible of these plans but it only allows for full-priced share options to be granted. It would fit in much better with current remuneration practice if CSOP options could be granted at a discount, or at nil cost, while (as for EMI options) only giving income tax relief for any increase in the value of the shares over the price at grant. The requirements for the two all-employee share plans – SIP and SAYE – are far more detailed and prescriptive than they need to be. By removing the unnecessary provisions, these plans could be much simpler to implement, administer and communicate to employees.

The Government could of course argue that, by making tax-advantaged share plans more popular, this would increase the cost of the tax relief. But if it really believes the evidence of the economic and social benefits of share ownership, the resulting boost to the economy should more than compensate for this extra expense.

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