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Executive Remuneration – “Brave New World”

Paul Norris sets the scene

Aldous Huxley’s novel of a “negative utopia”, based on H G Wells stories of corporate tyranny and behavioural conditioning, shows a frightening vision of the future to which the fictional society reacted strongly. Current society is reacting strongly to executive pay and practices must change as a result. Change attracts opposition and remuneration committees will have to be brave in order to remain credible in the new world. This article illustrates the elements of change and the challenges facing remuneration committees.

Hysteria quelled

Press-induced hysteria last autumn has given way to more rational debate. This is positive. MM&K and Manifest have worked with the Confederation of British Industry (CBI) to produce its new report which shows latest-year increases for FTSE 100 CEOs averaged 9% - not the 43% widely reported. Our research also punctures the myth that executive directors sit on each others’ boards in a cosy club. There are no cases of such cross-directorships anywhere in the top 350 companies.

We have shown that executive pay increases are connected to performance - 67% of total remuneration is dependent on performance, compared with 45% eight years ago. Finally, the average annual profit increase among those FTSE 100 companies which were also around eight years ago is 19%, whilst CEO total remuneration realised increased 13% annually. (See Damien Knight’s article on Page 3 *CBI report on executive remuneration*.)

Government intervention

Also last autumn, the Department for Business, Innovation and Skills (BIS) consulted on various radical proposals to curb executive remuneration and improve reporting. In January, the Business Secretary, Vince Cable, announced wider shareholder powers on remuneration and, in March, BIS sought comments (which closed on 27 April) on specific proposals to be enacted in new primary legislation. A BIS source tells us they hope to get this through Parliament before the summer recess.

The key proposals are:

- A binding vote on future remuneration policy, and
- A continuing advisory vote on the previous year’s policy.

The Government will issue new directors’ remuneration reporting regulations at the same time. The new regulations will apply to year ends from October 2013.

Greater disclosure

There is pressure for more remuneration disclosure, which will be of value only if it is consistent and transparent. We argued that comparing the ratio of the CEO’s pay to the average employee’s pay in companies with different organisational models is unlikely to prove useful (investment banks might be shown in a good light!) and companies will not now be forced to report this. However, companies will have to compare executive pay costs with dividend costs, staff costs generally, investment and tax, thus facilitating a comparison of the returns they are generating on their various investments, including executive pay.

It is also proposed that companies should publish a “single figure for the total pay of each individual director” (see Damien Knight’s article on Page 4).

Institutions are stirring

Remuneration awarded (as distinct from remuneration realised) has increased steadily – a median of 120% (or 10% per year) for FTSE 100 CEOs over the past eight years. This increase has been achieved by increasing the expected value of short and long-term incentive awards, not by reducing fixed remuneration.

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**Directors’ Remuneration Update Seminar
at the Royal Automobile Club,
London SW1 – 12 June
*See Page 2***

Board Walk

Briefing for Remuneration Committees



May 2012

There is general concern that the level of executive remuneration is too high and long-term institutional shareholders are increasingly asserting their influence. A recent discussion paper by Hermes Equity Ownership Services, which echoes some of MM&K's views, introduces several ideas for giving executive remuneration a longer-term focus.

It also exhorts remuneration committees to be tougher in resisting pressure for more pay and more sceptical about pay benchmarking (see Cliff Weight's article *Hermes launch new discussion document on executive remuneration* on Page 4).

Tax changes

The recent Budget announced a reduction in the top rate of income tax from 50% to 45% from April 2013 and improvements to Enterprise Management Incentive share options. (On Page 9, Nigel Davies offers ideas for deferring remuneration until tax rates are lower – and beyond. On Page 10, Mike Landon summarises some recent share plan developments.)

Remuneration committee challenges

In light of the above, remuneration committees face a number of challenges, including:

- Clearly defining executive remuneration policy in the light of corporate strategy and culture
- Reviewing the current remuneration model and benchmarking methodologies
- Giving executive remuneration a longer-term focus with more emphasis on shares
- Reviewing pension policy
- Identifying KPIs which enable and support success to create a transparent connection between successful strategy implementation and performance measures for remuneration
- Preparing for the new disclosures and reviewing contract terms to reflect new shareholder votes and the "single figure for total pay"
- Planning for the 45% income tax rate and making full use of all the HMRC tax-favoured share plans.

For advice and support, please contact your usual MM&K adviser or Paul Norris, Chief Executive, at paul.norris@mm-k.com

Directors' Remuneration Update Seminar at the Royal Automobile Club, London SW1 Tuesday 12 June 2012 10.15 – 12.30 followed by buffet lunch

This seminar provides an exceptional opportunity for remuneration committee members and reward directors to get the very latest information on the executive remuneration market, proposed shareholder voting rights and remuneration disclosure legislation and to hear from different interest groups about their perspectives on developments in top pay.

The Agenda includes:

- Latest findings from the MM&K/Manifest Executive Directors' Total Remuneration Survey* – joint presentation by **Cliff Weight**, Director at MM&K and **Sarah Wilson**, Managing Director of Manifest, the proxy voting agency. This will include:
 - The first market analysis to include December 2011 year ends
 - The first market analysis using the expected definition of the Government's "single figure for total pay".

- Panel debate 'Where next for Directors' Remuneration?' The panel will comprise:

Dr Ruth Bender, Reader in Corporate Financial Strategy, Cranfield Business School

Stephen Haddrill, Chief Executive of the Financial Reporting Council

Dr Daniel Summerfield, Co-Head of Responsible Investment at USS

Michael Wemms, Remuneration Committee Chairman of Moneysupermarket.com PLC.

The seminar will be chaired by **Will Wright**, the financial journalist and commentator.

*To order your survey see Page 12

To book your attendance email

emma.jarvis@mm-k.com

Please note that places are limited.

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CBI report on executive remuneration

Damien Knight describes the research behind it

At the end of April 2012, the CBI produced a report for its members *Getting the Facts Right: Examining Executive Pay*. This report was timed to coincide with the Confederation's response to the BIS consultation on shareholder voting rights, and provides its members with the CBI's own perspective on the top pay debate that has been grinding on since the autumn. The CBI decided to take a measured view based on its own thorough research of executive pay practice, to cut through the myths that have been recycled through the press over the past few months.

To carry out this research the CBI commissioned MM&K and Manifest, the proxy voting agency, which is our partner in producing the Executive Director Remuneration Survey each May and September. Early findings from this research were presented in my article in CityAM on 16 February:

<http://www.cityam.com/forum/the-real-story-high-pay-how-manipulated-statistics-misled-the-national-debate>

The research looked at the pay of chief executives in the FTSE 100, using data in annual reports up to last October. The main finding was that the pay realised by these executives went up by a median 10% in the last reported year. The CBI acknowledges that this is still high compared to general pay movements, but it is not the 40%-50% that has been bandied about in the press and repeated by politicians. The research also looked at the movement over the past eight years, comparing the latest remuneration with that in 2002 (for the 66 of the current FTSE 100 members which were listed at the time). It found that the expected value of remuneration granted went up 120% over the period (10% per annum) and that of actual remuneration realised (after performance hurdles were applied) by 96% (9% per annum).

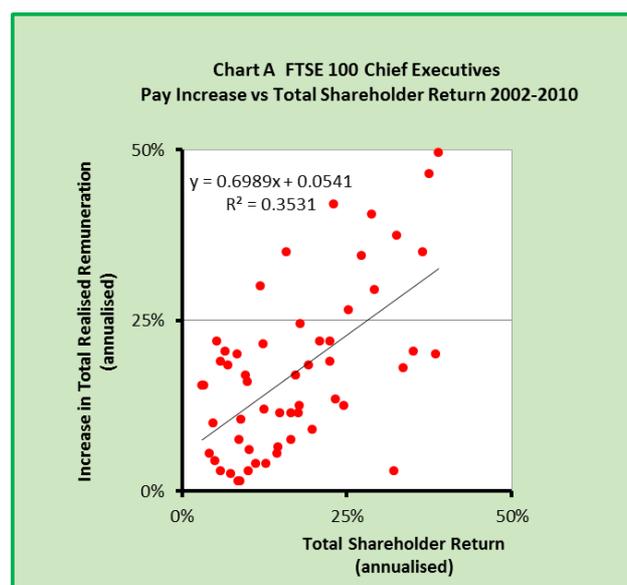
Using our research, the CBI argues (against popular misconception) that the majority of executive pay is performance-linked. Indeed increases in the performance-related elements have largely accounted for the rise in the expected value of pay. And it quotes other MM&K/Manifest research which totally scotches the myth that executive directors sit on each others' boards and fix each others' pay: there is in fact not one such case of cross-directorships in the FTSE 350.

Finally, the report presents some findings on the relationship between performance and pay increases. The CBI prefaces them by saying that measures of performance must be company specific, and are a matter for the company and its shareholders. But for

the sake of the debate it includes a couple of figures for the 66 companies. For a meaningful comparison we need to start with the median underlying cumulative growth in realised pay of 13% per annum (this is higher than the 10% annualised growth above, which just takes the final year's pay over the start year's, owing to faster pay growth before the banking crisis). For these companies the median profit increase was 19% and total shareholder return was 13%. These numbers do not fully justify the growth in pay – but they certainly put it into perspective, and give the lie to the popular myth that private sector pay is out of control.

We thought readers of *Board Walk* might be interested in seeing a fuller analysis MM&K has produced showing the individual company comparisons of growth in chief executive earnings with total shareholder return (see Chart A). This shows a fairly good correlation between total realised remuneration increases (cumulative) and shareholder return over the eight years. But, since there is an expectation of some shareholder return without any increase in pay, we should conclude that many remuneration committees have probably been over-generous in the increases they have granted.

Who came top? Tullow Oil – with the top TSR of 39% per annum and the top remuneration increase of 50% per annum. Come to our June seminar to see the full list!



Negative TSR and pay reduction cases excluded

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The Manifest/MM&K Total Remuneration Survey to be published later this month is the first published report to include remuneration information from the largest group of annual reports, those with a year end of December 2011. The main findings will be presented at the Directors' Remuneration Update Seminar on 12 June, which offers a panel of opinion-forming speakers, the latest on the Government's proposals and a special market analysis using a "single figure for total pay". To book a place on the seminar or to order your copy of the survey report see the inset panels on Pages 2 and 12.

The CBI response to BIS can be found at:

http://www.cbi.org.uk/media/1469003/cbi_response_to_bis_consultation_on_shareholder_voting_rights.pdf

If you would like to obtain a copy of the members' report **Getting the Facts Right: Examining Executive Pay**, or are interested in further information about these issues, contact Damien Knight at damien.knight@mm-k.com

- It is not yet decided if share options should be measured at vesting or exercise
- If it is at vesting, we can assume the figure will be the intrinsic value (paper gain) not the fair value. It is unlikely to be the latter because of the inconsistency of valuation assumptions needed
- It is uncertain how pensions will be valued. Using the HMRC lifetime allowance factor (currently 16 times increase in benefit) is simple, but our research suggests it substantially underestimates the value. Alternatives are the DRRR method or the Listing Rules method (which are slightly different)
- Will bonus deferrals be taken in the year earned or the year of vesting? Both methods have advantages – the latter gives a better picture of how much the executive actually received.

We expect to have a better picture in time for our 12 June Directors' Remuneration Update Seminar (see Page 2).

The "single figure for total pay"

Damien Knight gives an update

Vince Cable is determined that the section of companies' remuneration reports which explains how policy has been implemented in the previous year will include a "single figure for the total pay of each individual director", to allow shareholders and other readers to relate this to company performance over time.

BIS received many representations on the definition of this single figure, including a recommendation from a group of remuneration consultants who are members of the Remuneration Consultants Group (MM&K included). BIS is now working closely with the Financial Reporting Council who have set up a 'lab' for companies and shareholders to share views.

Some companies have already started to report a single figure. A notable example is Legal & General, which shows the build up from the normal emoluments table. However, BIS is some way off from settling on a final definition.

What can we work out so far?

- There will be a single remuneration figure specified
- It will be realised remuneration not the expected value of granted remuneration

Hermes launch new discussion document on executive remuneration

Cliff Weight describes a radical new entry in the top pay debate

Hermes Equity Ownership Services have launched some radical new ideas for executive remuneration for the UK's largest companies. They believe that companies' legitimacy in the eyes of their stakeholders – their licences to operate – are in danger of being revoked by public opinion on pay.

They think that now is the time for the non-executive directors of these companies to reconsider the pay of executive directors and ensure it is aligned to companies' long-term success and the shareholding experience of their long-term owners. Long-term retention of shares by executive directors is seen as crucial. They also believe that boards have a responsibility to set the cultural tone throughout the organisation, of which remuneration is a vital part. Hermes will support boards which show leadership in good remuneration practices.

The document is a discussion paper. It proposes items for discussion not firm proposals. /cont'd...

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Main themes of the discussion document:

- Boards should focus on the interests of long-term investors
- Remuneration committees should be tougher on quantum and self-serving executives
- Too much emphasis is put on supposed market forces
- The solution is to pay a substantial proportion of remuneration in shares to be held over the genuinely long term
- 3 years is nowhere near long enough for this purpose
- Share retention policies are currently minimal
- 'Extra' pay should be in shares
- Future projections of remuneration ratios should be disclosed
- Economic profit is a better return measure than EPS
- Binding votes might be counterproductive.

Ideas in the Hermes paper aimed at executive long-term share ownership

- Defer into shares all pay rises and a minimum of 50% of bonuses after tax
- Pay in shares all fixed pay of executive committee members and executive directors which is above the team average
- Prohibit share sales for 10 years after receipt of shares from an LTIP or other plan (except to fund tax obligations). At that point an individual would be able to sell up to 5% of his or her stake in any 12 months whilst still in employment or quasi employment (provided a minimum level of share ownership had also been achieved)
- Following resignation, allow the individual to sell one third of his or her stake per year starting a year after leaving
- Allow any bad leavers to transfer shares no more frequently than in 10 equal annual instalments commencing a year after departure
- After 10 years following first award (and having reached the required ownership level) or as individuals approach retirement, some ability to diversify an element of their ownership could be considered.

MM&K sees this document as perhaps the most radical and constructive in the current debate on executive pay. Whilst Hermes repeat many of the themes we have seen in documents such as the ABI Principles and the BIS consultations, they have come up with a core solution – that higher levels of remuneration should be

paid mainly in shares – and tabled several ideas for bringing this about.

We do not know of any company that has implemented many of the specific ideas that the paper puts forward. The closest perhaps is HSBC, which has required its executives in their Group Performance Share Plan to hold all shares from the plan, net of tax, until retirement.

I understand that Hermes are more than happy to debate the ideas and develop something that achieves the same long-term alignment.

To discuss the points in this article and the practical issues of implementing the Hermes principles contact Cliff Weight at

cliff.weight@mm-k.com

Quoted Companies Alliance publishes its Remuneration Committee Guide

Damien Knight reviews this valuable new tool

The Government (BIS) complains that executive remuneration reporting is opaque. What odds will you give me that the planned new disclosure rules will make it simpler and clearer?

Well, here at least is a set of remuneration guidelines that is easy to read and totally to the point. I recommend all remuneration committee members to keep it in their briefcase (it's small and compact enough) – and not just those from the smaller quoted companies it is primarily intended for. It is a useful document for FTSE 350 companies and for large private companies as well.

The Quoted Companies Alliance (QCA) is a not-for-profit organisation working for small and mid-cap quoted companies, campaigning and educating in regulation and tax issues in order to improve the functioning of the capital markets.

The new *Remuneration Committee Guide for Smaller Quoted Companies* is the product of a working group drawn from its Corporate Governance and Share Schemes Committees (MM&K's Cliff Weight was a member).
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The Guide covers:

- The objectives of the remuneration committee
- Factors to consider in setting remuneration policy
- Communicating with shareholders
- Remuneration committee membership, organisation and functions.

Its appendices include guidance on setting non-executive director remuneration and pointers to useful sources of information.

Much of the advice is familiar and echoes the UK Corporate Governance Code, Listing Rules and ABI Principles – the advantage here is the clarity of presentation. But the Guide does have its own voice, reflecting the different problems of smaller companies and the strong shareholder presence in the working group.

Notable views include:

- Remuneration committees need to be just as independent in smaller companies (although this is often hard to achieve)
- Executive directors' pay should be used to promote the sustainable success of the company and to align their interests with shareholders' interest *in the long term*
- Smaller companies should avoid the temptation of boiler-plate policies to save time and development costs. There is no ideal scheme suitable for all companies at all stages of development
- The starting point for developing remuneration policy is the strategic milestones, key performance indicators and value drivers of the company
- There should be a range of remuneration performance measures – without over-reliance on one metric. The Guide offers an interesting critique of the strengths and weaknesses of EPS as a measure
- Companies should think about the proportion of cash, revenue and profit which is appropriate to expend on executive pay and the level of dilution that is acceptable
- As the chairmen of smaller companies are usually less 'executive' than in large companies, it is appropriate for the board as a whole to set their pay, rather than the remuneration committee.

There is a strong exhortation for remuneration committee chairmen (in particular) to consult with key shareholders. The Guide suggests that shareholders are likely to be more flexible in assessing smaller companies' policies and very open to unusual solutions

provided the long-term objectives are right. But they can only respond in this way if they are properly consulted at an early date in a spirit of openness and trust.

Copies of the guide cost £40 to non-members, and can be ordered at:

<http://www.theqca.com/shop/guides/53492/remuneration-committee-guide-for-smaller-quoted-companies-february-2012.thtm>

There is also a downloadable pdf version, but I recommend the booklet!

Contact Damien Knight for more information, at damien.knight@mm-k.com

Lessons from America

Cliff Weight describes how UK companies can learn from the USA.

First, we need to recognise the weaknesses in the US model of CEO compensation. CEOs have too much influence in setting their own pay. Enron, WorldCom, Tyco and Hollander are classic examples, and it is still the case, as is shown by the recent large payoffs to the CEOs of NYSE, Citigroup and Merrill Lynch. Their compensation committees approved the awards. Why?

Too many CEOs in the US still have the combined chairman and CEO role. They strongly influence the choice of their independent directors and ensure the compensation committee consists of people minded to continue to vote through excessive pay awards. On the positive side, the trend toward separation of the chairman and CEO roles has increased, with 41 per cent of S&P 500 boards now splitting the roles, up from 26 per cent in 2001, according to a November 2011 Spencer Stuart survey.

Laws and regulations about caps on pay have not and will not work. An example of unintended consequences, is Section 162 of the US Tax Code which limits tax-deductible pay to \$1m p.a. unless it is performance related, which led to a huge increase in the use of options and a rise in previously sub-\$1m salaries up to the \$1m limit.

Analysts contribute to the excessive pay levels of CEOs. Shares surge on the appointment of a big name CEO. Usually such CEOs command much higher compensation packages than lesser known internal appointments. To justify themselves, new CEOs have to do something. They adopt new strategies, which entail more risk: more risk = higher share price volatility = more chance of a large payout. /cont'd..

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Often this means merger activity. Academic research is conclusive: 70% of acquisitions and mergers do not add value. Nevertheless, CEOs are urged to do deals by investment bankers, strategy consultants, accountants and lawyers, whose fees are paid when the deal is done, irrespective of whether the deal generates superior shareholder returns in the long term.

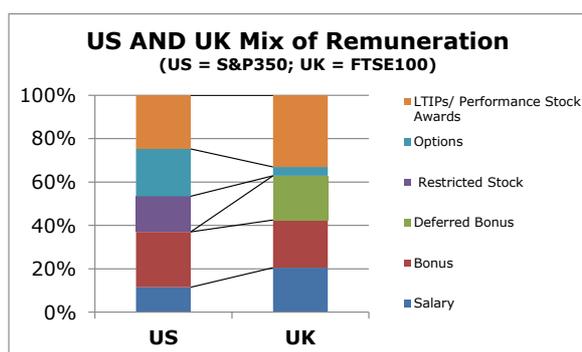
New hires, not unreasonably, negotiate safety nets, in case things don't work out as planned. Consequently they win both ways. The shareholder has to suffer the burden and cost of an asymmetric reward package. It is not the existence of the parachute that is the problem – it is the circumstances in which it can be opened. Once an executive has been in post for 3 years, 6 months' pay on leaving should be adequate – a good performer should be able to find a new job within 6 months.

But, despite these weaknesses, there are also positive lessons to be learnt from America.

US remuneration is more long-term – giving better alignment with long-term shareholders

The US mix of pay is (on average) 10% salary, 25% bonus and 65% long-term incentives. The UK mix is 20% salary, 40% bonus and 40% long-term incentives. The US model is more long-term and can therefore be considered better in this respect than the UK model (see Chart B).

Chart B



Pay levels in the US are 60% higher than the UK mainly because companies are bigger. If we adjust for size differences, then US pay levels are 20% to 30% higher than the UK in gross terms (although more so when taxes and cost of living are also taken into account).

Better disclosure

US disclosure of executive pay is better than the UK disclosure.

Most of the data is in a standard format of tables that are easily analysable. This format makes it easy for users to spot things or quickly to see if something is not there. In contrast in the UK there is no prescribed format and finding information can be very time consuming – at times it feels as though one is searching for a needle in a haystack. This increases the 'risk' of shareholders not fully understanding the implications of a package or full remuneration. For some companies it currently is a game of hiding the devil in the detail.

- Data is shown for the 5 highest paid executives. In the UK, companies only have to disclose the directors' data and this creates an incentive not to promote executives to the board. Non-board pay is hidden from shareholders in the UK
- There is a total remuneration figure calculated on a standardised agreed format (the expected value of awards made in that year). In contrast, in the UK there is no current requirement to add up total remuneration, the data is often spread over several pages in the annual report and the fair values of share awards are disclosed in a footnote to the accounts, which requires further cross referencing.

The UK Government's proposals on remuneration disclosure appear to address some of the above but we will take some time to catch up with the US in this respect.

TARP money repaid early

The US government lent its banks money on favourable terms in 2008, under the Troubled Asset Relief Program (TARP) arrangements. However, banks with TARP loans had severe restrictions on what they could do in terms of executive compensation.

This proved to be a very effective incentive for banks to repay their loans as soon as possible.

In contrast, the UK government injected capital in the form of equity and now owns large parts of RBS and Lloyds Group but without an effective incentive for these banks to get back to a more normal capital structure. Bank pay has fallen but remains high and the Government seems powerless to reduce it faster.

Executive consultants' independence

Executive compensation consultants in the US reached pariah status and have been blamed for the financial crisis. US politicians have reacted by making it very difficult for consultants to advise both the compensation committee and management. /cont'd...

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Consequently many executive compensation consultants left the larger firms and set up their own independent boutique firms.

The SEC now (Dodd-Frank Act 2010) requires the fees paid to executive compensation consultants to be disclosed and this highlights potential conflicts of interest.

Say on Pay and the 'outrage' model

Say on Pay is not working. The average Say on Pay vote was 91% in favour in the 2011 AGM season in the US. Of the remaining 9%, just 36 out of 2,200 votes went against the board resolution. The US corporate governance model of pay has for many years worked on the 'outrage' model (Diagram 1). In this model, so long as pay is not too outrageous it is approved by shareholders. Such an approach is of course inherently inflationary as anyone who is paid less than the 'outrage' level will try to get their pay increased.

Diagram 1: Outrage model

If performance is ...	Shareholder reaction	
High	ok ✓✓	good ✓✓✓
Low	ok (-ish) ✓	OUTRAGE!!!
	Low	High
	If pay is...	

The problem is further exacerbated by the proxy adviser ISS (now part of MSCI, which acquired its previous owner Risk Metrics) only signalling that pay was worthy of shareholders' attention if it was in the top quartile (ie top 25% of comparable companies' pay practices). Thus, any company which paid below this level knew it could increase its pay without attracting too much negative attention. ISS even offered a service to companies so they could benchmark where they were (which seems to be a bit of a conflict of interest).

Bebchuk and Fried

But perhaps the best lessons are to be learnt from the work of Lucien Bebchuk and Jesse Fried, Harvard professors, who have done extensive research into executive compensation in the US. Their books and research are well worth reading. Some of the points they make are:

- It is not just a few rotten apples. The problems of executive compensation are widespread, persistent and systemic
- Executive compensation is not designed to tightly link pay and performance
- The pay of the top 5 executives accounted for 7.5% of profits last year. This is less than the 10% peak

in the period 1998-2002 but remains a significant cost for shareholders

- The ability to unwind equity positions provides incentives for executives to make short term profits from their shareholdings, which are not available to shareholders. They are not saying executives trade on inside information – that would be illegal. However executives are better informed than most shareholders about markets, customers and trends. As a result they can come to a decision to reduce their exposure to their company's shares earlier than others might do
- Non-executive directors are not operating as independents. The gift of their continued role is open to influence by the CEO and it is usually safer not to upset the apple cart by disagreeing about executive compensation issues
- Pay is not unlimited. But only at a certain level does the 'outrage' factor come into play
- Companies routinely camouflage their disclosure of executive compensation so as to make it difficult or impossible for readers of the annual reports to see how much executives have been paid and how much they might receive in the future
- The devil is in the detail, particularly with equity pay and pensions. Executives are often able to persuade their compensation committees to exercise discretion in respect of performance conditions in favour of executives.

Conclusions

The UK has, in the main, avoided the worst excesses of egregious pay, whereas there have been numerous bad cases in America. Yet although America is not perfect we should learn from its strengths and its mistakes.

The 'best practice' remuneration model that has emerged in the UK is very short term. The timescale for incentive measurement for bonuses and LTIPs is one to three years. The use of deferred bonus plans has further shortened the timescale of performance measurement. This reflects the systematic short-termism amongst most investors as well as the media. Chief Executives are expected to 'do something' to get results in the short term.

Share options are now sadly neglected, despite the fact they potentially create an interest in the share price for up to ten years. Rules for retention of shares acquired from incentive plans, together with agreed rules for building up significant stakes in the company are the best way to create alignment with (long-term) shareholders.

For further information contact:

cliff.weight@mm-k.com

Remuneration delivery following the 2012 Budget Statement...

act now for deferral to 2013-14 and beyond

Nigel Davies, Principal at ITEP Advisors, offers some ideas for tax advantage through deferral

In the world of remuneration delivery, this year's trend will be income deferral into 2013-14 - and beyond - to take advantage of the reduction of the top tax rate from 50% to 45%. There are to be no anti-forestalling measures and HMRC estimate that some £6.25bn of income will be deferred (compared with £16 -18bn of income that was accelerated to 2009-10 prior to the introduction of the 50% rate): "This behavioural response is entirely legitimate, and difficult to prevent using anti-avoidance legislation" (see HMRC's publication:

<http://www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf>

Deferral of remuneration can be mandatory (eg under the FSA Remuneration Code) but our focus is on voluntary deferral of cash-based remuneration, whether

in response to the reduction in the additional tax rate or otherwise. Remember, it is possible to defer salary as well as incentive pay.

Now is the time for employers to consider their actions. There is an obvious short-term benefit for executives who suffer tax at the additional rate to defer income into next year (see Table 1 below) as HMRC predict. However, we believe that the change will act as a spur for employers to offer longer cash deferrals on a voluntary basis as a cost-neutral means of retention and motivation, because the value of deferral to a participant may well be worth more than just the value of the tax reduction (see Table 2 below), especially where deferral is for extended periods or where investment switches are made.

Historically, the most common method of cash-based deferral was via an employee benefit trust. The introduction of the so-called 'disguised remuneration' legislation has all but closed down this route, especially in relation to voluntary deferrals. However, contract-based deferrals are alive and well and continue to thrive.

Remuneration terms are a contractual matter between employer and employee. To achieve deferral from a tax perspective, however, there must be no 'receipt' of earnings. Generally, earnings are 'received' on the earlier of payment or entitlement, so just delaying payment will not be effective; there are special rules for directors that may further accelerate receipt.

Table 1: Benefit of short-term deferral	Payment year	
	2012-13	2013-14
Gross award	100	100
Income tax and NICs on payment (52% or 47%)	-52	-47
Net of tax award	48	53

Table 2: Benefit of short and longer-term deferral	Net deferral 2012-13	Net deferral 2013-14	Gross deferral
Gross award	100	100	100
Income tax & NICs when earned (52% or 47%)	-52	-47	0
Amount invested	48	53	100
Investment return (say 40%)	19	21	40
Gross amount of investment	67	74	140
CGT (say 28%)	-5	-6	0
Income tax and NICs at end of deferral period (say 47%)	0	0	-66
Net value realised	62	68	74

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Through being contractual, cash-based deferral can be on any terms that the employer wants to offer. It is common for all but the shortest of deferrals to include investment return on the value deferred, which can be based on anything (eg the performance of the business, of a basket of funds, etc). In the case of deferrals designed solely to take advantage of the reduction of the tax rate, we expect investment return features to be relatively rare. Note that performance or other forfeiture conditions are not a necessary requirement for achieving deferral for tax purposes.

Traditionally, to ensure that no tax is due until sums are actually paid, deferral periods have been fixed (eg until 30 April 2013, to take advantage of the reduction in the additional tax rate) or based upon an event (eg retirement). We contend that employees place greater value on cash-based deferrals that afford flexibility, and have developed and implemented plans that allow participants control over both investment selection and timing of award settlement within the parameters set by the sponsor.

Contractual cash-based deferral arrangements are relatively straightforward to implement and administer. The main objection is the risk to the participant that the company may default, but it is possible to introduce features to address this concern: whether the promise is secured or not, it is normal for employer liabilities to be fully hedged to avoid fiscal exposure.

The employer's tax (there may be no impact) and other costs resulting from cash-based deferral should be incorporated into award terms, so that cost-neutrality (or better) is achieved.

For further information e-mail Nigel Davies at nigel.davies@mm-k.com

Share plans update

Mike Landon summarises below the the OTS Share Plans Review and other current share plan issues

OTS Review

On 6 March 2012, the Office of Tax Simplification (OTS) published the report of its review of the four tax-advantaged employee share plans – approved Share Incentive Plans (SIP), approved Savings-Related Share Option Plans (SAYE), approved Company Share Option Plans (CSOP) and Enterprise Management Incentives (EMI). The Government's response is expected early in May.

The report contained detailed recommendations for improvements, which included improving consistency

between the three approved plans, in particular the provisions for participants leaving employment.

Future of the CSOP

A worrying development is that the OTS called into question the future of the CSOP, the simplest and most flexible tax-advantaged share plan and the only one available to many companies. The report recommended that further work should be carried out to investigate whether the CSOP was still "relevant for UK business".

Assuming that the CSOP survives this review, the OTS recommended that it should be merged with EMI to form a single discretionary share option plan. The EMI limit to the value of shares under option (which the Budget announced will be increased from £120,000 to £250,000) would apply to companies which currently qualify for EMI and the current £30,000 CSOP limit would apply to other companies.

Merging the two plans would result in some welcome improvements to CSOPs, for example:

- Options could be granted at a discount or nil cost (though any discount at grant would be taxed at exercise, as for EMI); and
- Options would benefit from income tax relief even if exercised within three years of their grant date.

Abolition of the approval process

The OTS's other radical recommendation was to replace the requirement to obtain HMRC approval for SIP, SAYE and CSOP with a self-certification process, as already applies for EMI. Companies will welcome any reduction in the time it takes to secure HMRC approval, which has increased markedly over the last year due to reductions in the number of their share scheme advisers.

However, many are reassured by the fact that their share plans have official approval. They will be alarmed by the OTS's related recommendation that if HMRC discover that plans do not in fact meet the requirements for approval, companies will be liable for the underpaid income tax and will not be able to recover it from their employees.

To read MM&K's detailed comments on the OTS report, please follow:

<http://tinyurl.com/cfty463>

Budget 2012: improvements to Enterprise Management Incentives (EMI)

Two potentially valuable improvements were announced for EMI share options in the Budget on 21 March 2012.

Individual limit

First, the individual limit on the value of shares subject to qualifying EMI options is to be increased substantially from £120,000 to £250,000. This will be done as soon as possible, subject to state aid approval under European Union rules.

There was no mention of changes to the requirements that companies granting EMI options must have gross assets of no more than £30 million and fewer than 250 full-time equivalent employees or to the overall limit to the value of EMI option grants of £3 million. Therefore, although a welcome increase, only a limited number of individuals are likely to benefit.

Entrepreneurs' relief

The second improvement is that gains made on shares acquired through the exercise of EMI options will become eligible for capital gains tax entrepreneurs' relief, potentially making gains taxable at 10% instead of 28% (for higher and additional rate taxpayers) regardless of the number of shares held. Currently, to qualify for relief an individual must have held at least 5% of the company's share capital and 5% of the voting rights for at least a year before disposing of them.

The relief will only apply to EMI options which are exercised on or after 6 April 2012. The one-year holding requirement will still apply, so no individual will be able to benefit from the relief for share disposals before 6 April 2013 at the earliest.

In many cases, EMI options are only exercisable on the occurrence of an 'exit event', such as a flotation or change in control of the company. Under the government's current proposals, entrepreneurs' relief will not normally be available in these circumstances. However, if the consideration for a takeover can be taken in the form of a loan note, it may be possible to qualify for the lower CGT rate by delaying the sale or redemption of the loan note until a year after the option was exercised. We are awaiting confirmation from HMRC.

Payments of share-based earnings after employment has ceased

Since 6 April 2011, the 0T (zero T) tax code has applied to payments of PAYE income made to employees after cessation of employment, which have not been included in Form P45. This requires PAYE to be operated on a non-cumulative basis at 20%, 40% or 50% (depending on the size of the payment) applying no personal allowance. For the tax year 2011-12, the 0T code did not apply to share-based payments. PAYE was a deducted instead at the basic rate of 20%.

The difference in treatment for different kinds of payment has caused difficulty for many payroll administrators. The PAYE regulations have therefore been amended so that, with effect from 6 April 2012, the 0T code has also applied to share-based payments.

HMRC recently issued some questions and answers which can be found at:

<http://www.hmrc.gov.uk/thelibrary/tax-payee/share-payments.pdf>

In particular, they clarified that, where there is more than one payment in the same pay period, the 0T code must be applied separately to each share-based payment and separately from any cash-only payments.

Annual share plan returns to HMRC

The annual returns for unapproved share plans (Form 42), SIP (Form 39), SAYE (Form 34), CSOP (Form 35) and EMI (Form 40) for the year ended 5 April 2012 must be submitted no later than **6 July 2012**.

Form 42, in particular, is complex because of the wide range of potential chargeable events. Please contact MM&K if you would like assistance with completing these forms.

For further information contact Michael Landon at:

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Board Walk

Briefing for Remuneration Committees



May 2012

ORDER the 2012 Executive Director Total Remuneration Survey ***Including tables of the "single figure of total pay"***

MM&K and Manifest collaborate to produce a survey of the total remuneration of executive directors, which will be published in May or early June when all the companies with a December year end have been analysed. The MM&K/Manifest survey will be the first to publish reliable data covering December 2011 year-ends.

Survey Contents

The survey covers all quoted and many AIM companies. There are separate analyses of FTSE100, 250, Small Cap, AIM and Fledgling companies. Detailed analyses include:

- Salaries and salary increases
- Bonus plans (actual payments in £, as % salary, maximum potential, actual as % of maximum, deferred amounts and terms)
- Long-term incentives (expected value of awards, % as options and as LTIPs, maximum face value of awards and EPS and TSR performance criteria vesting targets, threshold and maxima)
- Pensions (with separate value data for DB, DC and cash allowances)
- Total remuneration both in total £ and % mix
- Internal differentials
- Sector differences
- Long-term trends in salaries and total remuneration.

September Update Included!

In addition to the May/June report, purchasers will receive a complimentary copy of the September update of the survey. The update is produced as soon as all the companies with 31 March year ends have published their annual reports. Very useful for planning 1 January 2013 pay reviews.

Pre-ordering the survey now

The survey costs £500 and you will be invoiced only when the survey is sent out in May/June. To order your copy contact Emma Jarvis at:

emma.jarvis@mm-k.com or 020 7283 7200