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**MM & K, on 29 September 2008, held a dinner for clients, most of whom were Chairmen of companies, CEOs or Chairmen of Remuneration Committees. Over dinner, there was a discussion about:**

> **Managers are the agents of shareholders.**
>
> **Shareholders who own only a few percentage points of a company cannot influence a company or the way its management behave. It is the Remuneration Committee's responsibility to adopt pay strategies to incentivise managers to act in the best interests of all shareholders.**

## Summary of Discussion

1. In the current climate, executives prefer cash to shares because they perceive shares as having lost their attractiveness. Arguably, with share prices depressed, it is a better time to award shares now than in the past when the stock market was much higher. However, the perceived value of shares is lower today. The cost effectiveness and impact of cash is much better than shares, but shares may not be so expensive in cash terms for the company.

2. Some participants argued that shares are a much better incentive than options. Options are inherently volatile – as soon as the share price goes down, executives are de-motivated and ask to be 'reloaded'.

3. Options usually have a 10 year life. In-the-money options continue to provide an incentive post vesting that is aligned with shareholders' long term goal of share price appreciation.

4. Companies who wish to motivate executives should set short-term targets for incentive schemes. Managers are motivated by things which are under their control. TSR is affected by interest rates, market sentiment, sector sentiment and company specific issues; and it is only the latter which is under the control of management actions.

5. In too many companies TSR and earnings per share have been used as a proxy for management performance and not a very good one at that. Managers can only manage things under their control and incentives and bonus plans should be targeted at things under their control.

6. Multiple TSR targets are confusing and do not motivate executives. "Retention is key in my business" said one participant. "This year we will use cash rather than shares as this will be valued more by managers than executives."

7. There can be a huge disconnect between the share price and the company's performance. It is difficult to motivate executives using share schemes when the share price is subject to such random behaviour that is not under the control of management.

8. Equity (either shares or share options) is not an effective incentive, below the board. If an executive is one of the top 100, then he/she could only have 100$^{th}$ of the total impact on the overall company performance. He/she would be better motivated by designing a long-term incentive linked to his/her business unit.

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9. The ABI guidelines promote a 'One-Size-Fits-All' (OSFA) approach to remuneration. In practice, companies are different. However, an analysis of long term incentive plans shows that the vast majority are very similar: They have been designed to comply with the ABI guidelines rather than to reflect the strategy of the business. In practice, there seems to be little interest in "comply or explain" at the ABI.

10. According to the ABI guidelines, LTIPs and options in quoted companies must be linked to performance conditions. These are nearly always TSR and/or EPS or a mixture of each. Companies say in their remuneration reports that their pay is linked to strategy, but the performance measures in the long term incentive plans are not strategic. A fast growth company, a recovery company and a "steady as she goes" company ought to have different performance measures which reflect their strategic goals. Currently this rarely occurs.

11. Lord Turnbull, in his Turnbull Report, stressed the importance of culture. The Turnbull Report asked Boards to consider: "*Do the company's culture, code of conduct, human resource policies, and performance reward systems support the business objectives and risk management and internal control systems?*" Did the Board's of Northern Rock, Citigroup, Merrill Lynch, Bear Sterns, Lehman, UBS and Bradford & Bingley consider this question? Boards need to pay more attention to Turnbull and establish ways to check that the incentives and pay arrangements support the culture the company wants.

12. There will be a huge backlash and a search for culprits resulting in a new set of 3 R's:

    - Retribution
    - Regulation
    - Remuneration

13. Motivating executives in today's world is crucial. Therefore, it may be appropriate to lower targets or to revise targets. The recent letter from the ABI to Remuneration Committee Chairmen stated their members' disapproval of either approach. The meeting felt that such comments were out of touch with the reality of the issues Remuneration Committees have to address in practice.

14. Succession planning is also very important. If there are good internal people who can fill vacant slots, companies will not have to recruit externally and pay top dollar. Companies should emphasise teams and recognise leadership rather than superstars. Companies must ensure the Remuneration and Nominations Committees work together and are aware of key executives' aspirations, motivations, ambitions, career plans, lifestyle goals, wealth and appetite for risk.

15. Make sure the Remuneration Committee is made up of strong independent directors, capable of standing up to the CEO's demands. Ensure the Remuneration Committee appoints its own remuneration advisers, who are independent. Critically evaluate input from advisers who also receive fees from management for other consultancy work. In most cases it should not be necessary or desirable to have separate advisers for management and the Remuneration Committee.