Board Walk

Briefing for Remuneration Committees

mm&k

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This edition of Board Walk includes:

Challenges facing remuneration committees under the Conservatives - *Paul Norris*

In the early months of Conservative rule, the Government has not continued its zealous targeting of unfair and egregious directors' pay practices. That does not mean remuneration committees and top executives can rest easily.

In our view, Vince Cable presided over reforms which have resulted in overall improved transparency and reporting clarity. It is now up to remuneration committees and investors, through constructive dialogue, to agree policies which will pass a binding vote. This is as it should be and the process seems to be working.

Having intervened, it is now right for the Government to withdraw to allow the players to work out what works best for individual companies. This is an important point because no two companies are the same. Each remuneration committee must feel it can present arguments for the policy it believes works best for its company and that those arguments will be listened to by investors who understand them. This means that remuneration committees must think carefully about directors' pay and why the chosen policy is right for the business. It may be early but the Government seems to be keeping the way clear for this dialogue to take place.

Public opinion is mobilising against high pay

Nonetheless, strong feelings have been expressed about some directors' pay practices and remuneration committees would be unwise to (and, for the most-part, do not) underestimate them. Public opinion is mobilising against high levels of pay. In our experience, however, investors are not concerned primarily about absolute amounts of pay. Their principal concern is the relationship between pay, performance and value. The amount of directors' pay is not the largest expense item for most companies but it becomes an issue if the cost (whatever it is) cannot be justified. Investors should be critical of situations in which pay cannot be justified by performance and value because, in such cases, they and all other stake-holders are not getting a fair deal.

MM&K joins the Global Governance and Executive Compensation Network

This summer, MM&K became the UK partner in the Global Governance and Executive Compensation Network (GECN), a network of independent remuneration advisory firms with offices in USA, UK, Switzerland, Singapore, China and Australia. GECN membership provides access to global knowledge and expertise and enhances MM&K's capacity to advise clients on governance and remuneration on the international stage.

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What is “fair” in this context? Most people will have a view about what, in any given situation, is a fair outcome. Many would regard it as fair that the winner of an Olympic race should win the gold medal. But there is a large element of subjectivity about the perception of “fairness”. Personal circumstances, experiences and beliefs also influence an individual’s view about what is fair. Some commentators see the relationship between a CEO’s pay and the median pay of all other employees as the yardstick of fairness. Recently, US legislators passed a law requiring US listed companies to publish the relationship between the CEO’s pay and the median pay of other employees.

Whilst recognising the growing antipathy towards absolute levels of some pay awards, we think this misses a key point. Ironically, companies that would fare best in this comparison include the investment banks, criticised for excessive levels of pay and, in some circles, for having brought about, or at least accelerated, the latest economic recession. Oil & gas companies, reliant on the skills of scarce technical staff, would also show up well, despite the poor performance of their share prices owing to the fall in world oil prices.

The problem needs a different approach

It is unlikely that any company would wish to be first to reduce its CEO’s package, so the problem needs a different approach. If the workforce at large, management and investors all feel that what they take out of the business in pay and dividends is a fair distribution of the value created and fairly recognises their role in helping the business to be successful, it seems to us that the outcome will be fair, regardless of the relationship between one individual’s pay and another’s. Keys to achieving this result include:

- managing and matching expectations
- transparent performance measures and
- targets appropriate for each individual’s role and the overall business strategy.

The way in which data has been presented to demonstrate no link between CEOs’ pay and performance has added to claims of unfairness. We are currently testing the rationale for claims that links between pay and performance are mythical because CEOs’ pay has increased whilst corporate performance has declined. The results of our research will be published in a future edition of Board Walk.

Complexity is another area of concern for investors. The Investment Association has formed a committee to explore how pay policies can be simplified. Its aim is to help engagement and make it easier for investors to determine whether executives have earned their rewards or were simply the beneficiaries of good fortune. The committee is expected to publish its proposals in spring 2016.

Cash is king

MM&K has consistently championed simplicity and transparency. The harsh lesson of recession is that cash is king. The money (for remuneration) has to come from somewhere. A key management task is to develop a sustainable business. Therefore, remuneration policy must also be sustainable. On 21 September, we hosted a dinner for Chairmen, Remuneration Committee Chairmen and Chief Executives to discuss remuneration policies designed to support sustainable businesses. A note of the points raised by our dinner guests can be found at: http://www.mm-k.com/executive-remuneration/remuneration-committee-dinners.aspx

Each company will have its own view and plan about how best to build a sustainable business. Therefore, each company’s remuneration committee must be free to develop and implement pay policies consistent with its unique plans. Key challenges for remuneration committees include:

- keeping an open communication channel with investors
- designing incentives consistent with the investment and return cycles of the business
- demonstrating that rewards reflect a fair distribution of the value created by the business.

It is the Government’s job to create an environment in which business can flourish. We think that environment exists. It is likely to be politically stable for almost five years. That stability will allow time for companies, their remuneration committees, management teams and investors to address the challenge of formulating sustainable business plans with pay

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policies tailored to match. MM&K would be pleased to help.

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What do institutional investors really want? - *Damien Knight*

Our remuneration committee clients regularly complain that institutional investors cannot agree amongst themselves what they want from the companies they invest in: what aspect of policy they favour and what they expect to see disclosed in annual remuneration reports. Worse than this, they say that, within each investor, the fund managers have different priorities to the corporate governance staff.

Not unexpectedly, investors disagree with this perspective. Speaking at the MM&K Life in the Boardroom conference on 27 May, Eugenia Jackson, Director, Governance and Sustainable Investment at F&C Investments, told participants that she has been observing increasing integration between fund management and governance teams since the Stewardship Code encouraged such integration. And she said that different investors regularly swap notes on particular companies before taking a position.

We have been given some new insights into investors' expectations of remuneration policy and reporting from research carried out by MM&K on behalf of the Quoted Companies Alliance. The QCA is an independent membership organisation that champions the interests of small to mid-size quoted companies. The purpose of this on-line survey was to provide information to support revisions to the QCA Remuneration Committee Guide, due for publication in early 2016.

15 major institutional investors responded to the survey invitation – all but one manages total funds in the range £1bn to £1,000bn. The response level itself is instructive, as several hundred firms were invited. The respondents were the same large firms that regularly make their views heard on corporate governance. It is hard not to form the impression that the majority of investment firms do not see corporate governance as a priority, at least not for smaller companies.

What do shareholders read?

The first question asked which section of the annual report investment firms typically read as part of their company analysis. 87% of respondents said they always or usually read the remuneration report and 80% said the same for the Chairman's statement. This was well ahead of the strategic report (60%) and the business model (67%) and may reflect the roles of the people responding (eleven were corporate governance professionals and four were fund managers - so the views received were somewhat biased towards the governance function.) But they were interested in the reported KPIs (73%), presumably to establish the linkage with remuneration performance measures.

Astonishingly, no firm said it always reads the Share-Based Payment IFRS2 disclosure and 47% said they never do – with a further 20% saying they rarely do. Compliance with IFRS2 (FRS20) continues to be a major cost to companies and the introduction of this accounting standard was only justified on the basis that it was desired by shareholders. But, given its international adoption and the level of negotiation that was necessary to get a common approach with the USA, we think it is hardly likely that the standard will be withdrawn any time in the near future.

Who is involved?

The corporate governance executive turned out to be the person most often responsible for deciding how to respond and vote on remuneration issues (50%). 28% of firms said the responses and voting decisions are always or usually made by the fund managers. However, actual consultation with companies on these issues is overwhelmingly left to the corporate governance people (86%).

Which parts of the remuneration report are useful?

The survey asked, in more detail, which parts of the remuneration report the investors found useful. All sections were seen as essential or useful by most investors, but the medal winners by some way were Bonus Measures/Targets, LTIP Measures/Targets and Directors' Share Interests. This is consistent with statements by institutional

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shareholders[1] saying that their principal concerns are that:

- remuneration is aligned with strategy, with a clear linkage to the strategic KPIs;
- payments are subject to stretching performance conditions;
- the arrangements deliver outcomes that reflect the outcomes for their clients.

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Make more use of tax-advantaged share plans - *Mike Landon*

The UK has perhaps the best employee share plan legislation in the world; but companies are not taking full advantage of the tax exemptions which these plans offer. The latest HMRC statistics, published on 30 September 2015, show a considerable decline in the number of employees participating in both all-employee and executive tax-advantaged share plans in comparison with the mid to late 1990s.

Plans can be made simple

This is surprising at a time when companies have to keep costs tightly under control and could be expected to take full advantage of this tax-efficient form of remuneration, which is fully endorsed by the government. One reason for the decline is that the all-employee plans, in particular, are often seen as complicated to set up and administer.

However, even a Share Incentive Plan (SIP) can be made very simple, for example:

- By offering Partnership Shares only, employees can buy up to £1,800 worth of shares each year out of their earnings before income tax and NICs. The taxman is effectively giving a discount of between 32% and 47%, depending on the employee's marginal tax rate. Moreover, the savings in employer's NICs are often enough to more than cover the full running costs of the SIP.
- By offering Free Shares only, each employee can benefit from up to £3,600 worth of shares tax free every year. To ensure ability to pay, the size of the Free Share award can be linked to performance – either of the group as a whole or of each participant's business unit.

On the other hand, if full advantage is taken of the SIP, each employee can acquire up to £9,000 worth of shares tax effectively every year, including £3,600 worth of Matching Shares if the full 2 for 1 match is offered. Alternatively, the matching ratio can itself be linked to performance.

Using CSOP to make tax-efficient PSP awards

The main reason for the decline in Company Share Option Plan (CSOP) options has been a general trend away from market-priced share options, partly due to changes in the accounting treatment in 2005. However, the CSOP legislation can still be used to make tax-advantaged Performance Share awards over up to £30,000 worth of shares to each participant. Although an amount equivalent to the value of the shares on the date of grant will become subject to income tax when the options are exercised, the increase in value over this period will be subject to capital gains tax, at 18% or 28%, and then only when the shares are actually sold.

Of course, companies with fewer than 250 employees and no more than £30 million of gross assets may qualify for granting Enterprise Management Incentive (EMI) options. These offer income tax relief for options over up to £250,000 worth of shares for each individual and so are a simple and effective way of rewarding executives and other employees in many smaller companies.

For those companies which do not qualify for the above tax-advantaged plans, it is well worth considering providing shares to employees with Employee Shareholder status. Now that the general election and Finance Bill have passed by, there has been renewed interest in these arrangements, particularly by private equity backed companies. Up to £2,000 worth of shares

[1] *Iain Richards, Head of Governance and Responsible Investment at Threadneedle Investments, article in Boardwalk December 2013*

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per person can be awarded tax-free and there is complete capital gains tax exemption for gains made on shares worth initially up to £50,000. This can offer the prospect of substantial tax savings for companies with high growth potential.

These are not dodgy tax avoidance arrangements, but genuine ways to encourage employee share participation which are actively supported by the government. Is your company taking as much advantage of them as it could be?

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Growth Shares – they are staying! - *JD Ghosh*

Historically, heavily backed private equity or venture capital investee companies have been unable to qualify for any of the tax-efficient equity incentives that the legislation provides, for example, EMI or CSOP options. This is mainly because such investee companies are under the control of their financial backers.

Such companies have been adopting 'growth share' arrangements to provide incentives to their employees which could prove to be tax-efficient. With the introduction of the Employee Shareholder status scheme legislation, 'growth share' arrangements have grown in importance, especially in the private equity arena, mainly because employees can acquire their interests wholly or partially free of tax and also receive any gains completely free of tax.

In the unquoted arena, 'growth share' arrangements typically involve the creation of a new class of shares, which has no or little economic value until such time as the value of the company grows beyond a pre-determined 'hurdle'. As the shares are acquired when they have a very low value, the acquisition cost or income tax liability on acquisition on the acquiring employees are relatively modest. However, if the company turns out to be successful and grows in value, the employees can receive the rewards of that success, for example, on an 'exit' (a third party sale or listing) taxed as a capital gain, at up to 28% opposed to income tax and NICs up to 47%.

Growth shares in a listed company context

The 'growth share' concept is fairly common among unquoted companies but variations of the structure described above can be found also among listed companies, in the form of either joint share ownership plans or awards of a separate class of growth shares in a subsidiary company. Some institutional investors oppose share plans in subsidiaries of listed companies, so it would be prudent to communicate any proposals and consult investors well in advance.

Whilst HMRC have always been aware of the existence of 'growth share' arrangements and have not challenged such structures, practitioners could never be certain that HMRC would not change its mind in future. Recently, however, HMRC released a research document (to which MM&K's Mike Landon contributed) which concluded that 'growth share' arrangements have an important genuine business purpose and that tax saving is not the primary objective. The research found that "growth shares have a definite and important role to play in encouraging the growth of businesses".

It must be said that HMRC have not adopted the research conclusions as a reflection of HMRC or, indeed, government policy. However, given that HMRC published research which does not indicate that the 'growth share' arrangements are tax abusive, it seems unlikely, in our view, that the government will bring in legislation to counter these arrangements in the near future.

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Latest survey shows CEO total remuneration is increasing again – *Cliff Weight*

Total remuneration awarded to the chief executives of the Top 100 companies **reduced** for two consecutive years: by 5% in 2012 and 8% in 2013.

The latest data from the Manifest/MM&K survey shows the rate of **increase** is now 3% p.a. but the median figures suggest that the underlying rate of increase is less than the average.

The survey gives detailed breakdowns of total remuneration for all sizes of quoted companies. It includes tables on salaries, bonuses, LTIs, pensions and benefits. Differences by sector are also included.

Remuneration committees, wanting independently to verify the competitiveness of their executive directors' pay, will find this a most useful source of data.

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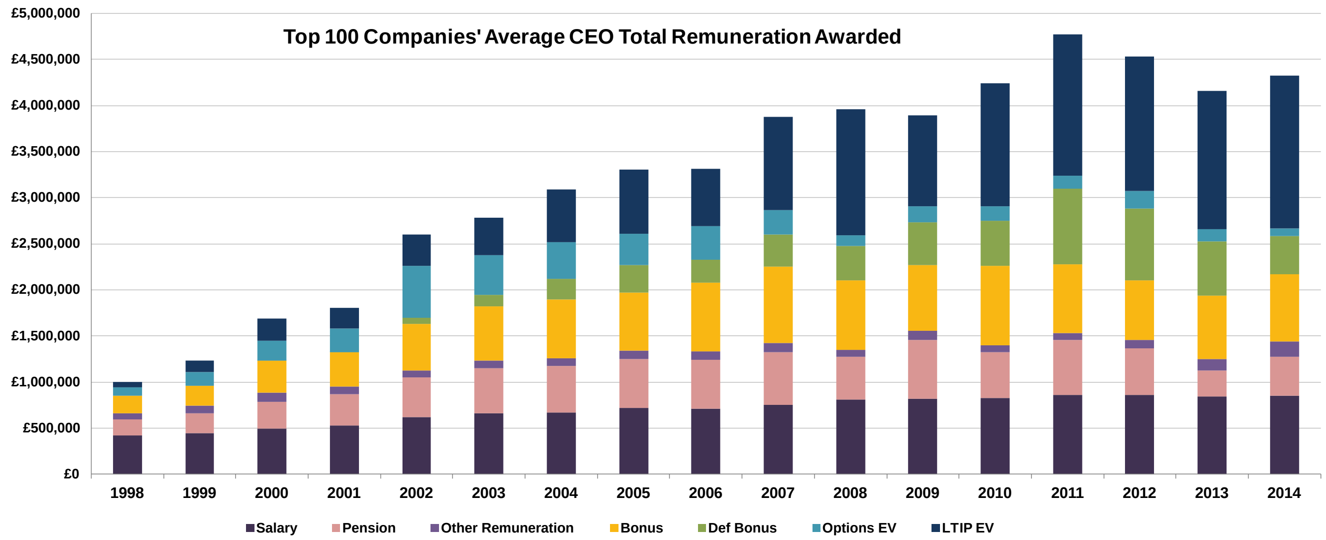

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Private Equity Corner

Changes to the taxation of carried interests – *JD Ghosh*

Private equity and other investment managers commonly acquire carried interests in fund partnerships which allow them to participate in the performance of a fund. Due to the way the taxation rules on capital gains are applied to partnerships, the managers inherit a portion of the investments which were contributed to the fund partnership by the investors on a tax free basis. This is known as 'base cost shift'.

For example, if a fund partnership bought an investment for 100 and sold it for 200 at a time when the 'carried interest' had kicked in, only 50% of the cash received by the managers would be subject to capital gains tax. The remainder would be received by them free of tax.

Abolition of the 'base cost shift'

From 8 July 2015, the 'base cost shift' has been abolished for carried interests. Accordingly, the full rate of capital gains tax (currently 28% for higher earners) will apply to the proceeds received by carried interest holders, less the acquisition cost of carry. Taking the above example, the entire 100% of the cash received by the managers will be taxable, less any money paid or any income tax charges incurred in relation to the acquisition of the carried interest.

These rules should not affect the taxation treatment of co-investment returns.

Changes for non-doms

The second change affects non-UK domiciled individuals. Carried interest gains are treated as having a UK source to the extent the individuals perform their investment management services in the UK.

Prior to 8 July 2015, where a fund partnership disposed of non-UK assets, UK resident but non-domiciled carried interest holders could shelter their share of the gains from UK taxation if the remittance basis rules applied to them. The new rules will treat the carried interest gains (irrespective of the location of the assets) as having a UK source. This means they will be taxable on an arising basis, effectively overriding the application of the remittance basis rules to carried interest gains. Therefore, for wholly UK based non-domiciled individuals, the remittances basis rules will no longer apply to carried interest gains.

There are anti-avoidance rules which will counteract schemes to avoid these changes.

Consultation on carry

Taxation of performance linked awards paid to asset managers

HMRC published its consultation document on 8 July 2015 with the aim of determining which carried interests should benefit from capital gains tax treatment and which should be treated as income because they relate to 'performance linked rewards' on trading activities.

HMRC seem to be targeting hedge funds converting their annual performance fees to carried interest. However, it appears that it is not intended that venture capital and private equity carried interests should be treated as income, and holding-period linked exemptions may be included in the rules. Draft legislation is expected to be published this autumn.

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2015-2016 European PE/VC Compensation Report – *Jonny Brigginshaw*

This month we are publishing the 20th annual edition of the Private Equity and Venture Capital Compensation Report. MM&K produces the European Report and we work in partnership with Holt Private Equity Consultants and Buyouts Insider, who produce a sister report in North America.

The number of firms participating in the European survey has increased this year from 30 to 34 and we have introduced an additional analysis for real estate investment and infrastructure firms. We have also added some important new features in response to requests from participants:

- We are producing the report tables in both pdf and spreadsheet formats, to allow users to download and manipulate the survey data;
- We have added individual firm reports to show how each firm's remuneration levels, by survey role, compares to the market. Previously we just provided the market data.

We expect these innovations to maintain our survey's leading position in the market.

The healthier investment climate has led firms to continue the trend last year further expanding the size of their teams after the recession and increasing pay levels for investment staff.

Across all investment strategies recruitment activity has been high, particularly in Venture Capital, where 70% of firms have been recruiting both investment and non-investment professionals. This demand has been reflected in changes to salary and bonus levels, with 80% of firms increasing salaries for investment professionals below partner level.

Bonuses were more varied, with 25% of firms increasing bonuses to investment staff but 20% reducing them. Those that did pay higher bonuses increased them substantially.

In general the median increase in salary was higher for junior investment positions: 1.5% at partner level, 3% at principal level and 8% for analysts. But higher bonuses have led to higher increases in the median total cash (salary plus bonus).

The largest median total cash increases were for senior associates and principals (20%-25% on last year); but at around 13% at partner level and about 15% at associate and analyst level.

The survey provides full information on salary and total cash for all investment and non-investment positions, as well as on the level of carried interest participation. It is available to participants only at an order price of £2,000.

To participate in future surveys or for more information, please contact:
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