Board Walk
Briefing for Remuneration Committees

mm&k

July 2013

The Albatross has landed!

At last 'quoted companies' (ie UK incorporated companies with a listing on a main exchange) are faced with the full reality of the Government's new regime for directors' remuneration reporting and binding votes on pay policy. One thing is certain – companies are going to have to start their policy reviews and shareholder consultations several months earlier than they are used to doing.

In the leading article below, Damien Knight presents an overview of the new reporting regime as it has finally emerged. In the subsequent article, Paul Norris considers the now perilous task of remuneration committee members.

This edition of Board Walk includes:

Page 1 – *The Albatross has Landed*: final revised Directors' Remuneration Reporting Regulations

Page 4 – The *'Beautiful Game' just got harder to play*: implications for remuneration committees

Page 5 – Results of the Manifest/MM&K Executive Total Remuneration Survey June 2013

Page 7 – Share plans: *should you be using a JSOP now?*

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Damien Knight looks at the final version of the new reporting regime

Primary legislation: the remuneration policy vote

At the core of this regime, and in many ways the scarier part for remuneration committees, are changes to the Companies Act 2006 (CA2006), which were wrapped up in clauses within the Enterprise and Regulatory Reform Act 2013. This act gained Royal Assent on 25th April.

The relevant sections (79-82) of the latter act can be found at:

www.legislation.gov.uk/ukpga/2013/24/section/79/enacted

In short the legislation requires quoted companies with year ends of 30th September 2013 or later to put their remuneration policy to a 50% majority vote at their upcoming AGM. Thereafter companies can only provide remuneration or loss of office payments that are consistent with the policy unless they obtain shareholder approval at a general meeting to a revised policy or to the specific payments.

Any director who authorises a payment outside the policy is "jointly and severally liable to indemnify the company that made the payment for any loss resulting from it" (a civil law sanction)**.** The onus is on the director to show a court that he or she has acted honestly and reasonably. There is a question whether directors who delegate decisions to their remuneration committee are also liable. Boards may need to revisit the committee terms of reference.

The company normally has three years from the end of the year in which the first policy vote is held before it is obliged to go back to a general meeting for another binding policy vote. However, if a future AGM advisory vote on policy implementation is lost a new vote on policy has to be held the following year.

The new reporting regulations

CA2006, as revised by the new primary legislation, also enables the Government to issue its new Directors Remuneration Reporting Regulations, and we saw a draft of these in March. At the end of June the Department for Business, Innovation and Skills (BIS) laid the new regulations before Parliament, and these are now final, with significant changes.

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/138335/bis-13-717-draft-large-and-medium-sized-companies-and-groups-accounts-and-reports-amendment-regulations-2013.pdf

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Significant changes in the Regulations

1. There are signs that companies will be able to draw their future policies more generally than feared from earlier drafts.
    a. Although the maximum for any component has to be stated, this has been changed from "maximum potential value" to "maximum that may be paid…expressed in monetary terms or otherwise". *Otherwise* could embrace a percentage of salary, a number of shares, or even a percentage of equity.
    b. The final regulations have introduced a new Section 21 in which a company is required to state how it intends to implement the approved directors' remuneration policy in the coming year – eg performance measures and targets (but see 2 below) and changes in implementation details from the previous year. This new section does not have to include any items which are explicit in the approved policy; but unlike the policy it is not subject to the binding vote. There is scope, therefore, for pushing the generality of policy drafting to the limit and providing shareholders with the details under Section 21. Indeed a fair degree of wriggle room is essential if the new regime is going to function at all.
    c. The regulations do not proscribe the inclusion of discretion in the future policy. In fact, by adding a clause (24(4)) which requires the future policy report to set out the *extent* of directors' discretion allowed within the policy, there is an implied acceptance that a degree of discretion will be necessary.
2. The final version of the regulations provides a wider 'get out' from having to disclose measures and particularly targets before the event. The previously drafted exception of commercial confidentiality has been moved to a dominant position in the introduction to the regulations (Section 2 (5) & (6)) which requires only an explanation and an indication when the withheld information on measures or targets will be reported. Section 26 which describes the information to be provided in the policy table only mentions performance measures (ie the measurement dimensions) and does not refer to targets at all.
3. There are a number of changes which allow more flexibility in reporting implementation, including the use of estimated figures, averaging share prices where the final vesting price is not known, the allowable break-out of non-executive director figures into simpler tables and the exclusion of *de minimus* payments to past directors or for loss of office. But always companies are required to report their reasons and limits they are applying.
4. One important relaxation from the draft regulations is reporting the policy for recruitment remuneration. The company is now free to report only the principles, range of reward elements/approach and maximum level of *variable* remuneration expressed as a monetary sum or otherwise. In the previous draft the ratio of a recruit's salary to the CEO's salary would have had to have been capped within the policy.
5. The sections defining pension value have been revised entirely from the rather vague descriptions in the earlier draft. They are now aligned with the relevant sections of the Finance Act 2004 with use of a pension factor of 20 for defined benefit plan valuation calculations.

The Government has promised to publish a set of guidelines for the implementation of the new regulations.

What should remuneration committees be thinking about?

Short of resigning from the board or taking the company back onto AIM, directors have got some serious and urgent thinking to do. This is now for real. Remuneration committees will face their shareholders with their new remuneration policy sometime in the coming year. For the majority, those companies with a December year-end, that means next Spring.

We advise you to **START AT LEAST THREE MONTHS EARLIER THAN USUAL** in preparing your policy and draft remuneration report. 1300 quoted companies will be competing for the time of institutional shareholders and proxy voting advisers to get informal sign-off on their new policies. There will be a huge bottleneck. Shareholders and proxy agencies will need to standardise their response to 'issuers' (ie companies) if they are to meet their own deadlines. You cannot afford to end up with a week in which to respond to a damning ISS report before it goes out to your shareholders en masse. You might consider using the services of a proxy solicitation adviser to steer you through the last 30 days before the AGM.

We will repeat our regular advice – start by ensuring that your remuneration policies are fit-for-purpose in supporting the business. If they are, you will be able to defend them with your shareholders and compliance will become a secondary issue.

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Finally, consider having a second opinion on remuneration policy and disclosure at this particularly telling time. MM&K is active in drafting remuneration reports and experienced in presenting remuneration policies clearly and in the best light. We would be pleased to help you.

Continuing weaknesses in the regulations

MM&K has participated actively in the consultation process to help ensure the new regulations make a real contribution to improved governance and clarity about directors' pay. We made direct representations to BIS about a number of concerns we had about the draft regulations issued in March and which we described in our March 2013 issue of *Board Walk*. http://www.mm-k.com/content/documents/news/board-walk-march-2013.pdf

We pointed out two weaknesses in particular:

- *Scenario Charts.* We felt that the omission of share price growth from the policy scenario charts was a mistake and made the scenario forecast incompatible with the historical reporting of the single figure tables.
- *Performance Graph.* We said the reversion to a relative TSR graph was a retrograde step at a time when the measure has been rightly criticised as a long-term incentive performance measure.

Sadly, our remonstrations have largely been ignored.

From the beginning, we have argued that the Government needed two 'single figures of total remuneration', that *Realised,* and that *Awarded* (see Cliff Weight's article below for an explanation). Vince Cable was determined to have just one 'single figure of total remuneration' and plumped for what we call *Total Remuneration Realised* (albeit including share options 'vesting' in the year rather than those exercised).

The Scenario Charts could have been a good substitute for *Total Remuneration Awarded* if the Regulations had been thought through properly. But by omitting share price growth in the illustration of policy they ignore one vital reflection of performance. And the treatment of share options has been ducked completely. Under the new regulations as written (Paragraph 34(1)(c)), there is the absurd possibility that a company could pay its directors entirely in market-priced share options and report the remuneration receivable in all performance scenarios as zero (ie face value of shares at grant less exercise price)!

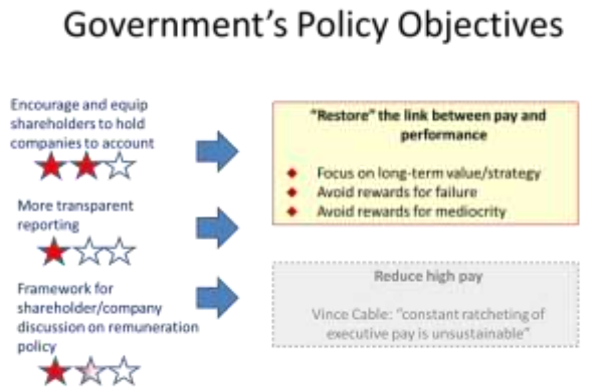
Next, the regulations require the single figure to include the value of any deferred element of any bonus with the immediate cash element, even if there is a service condition for eventual payment and it may never be paid. We think some companies might add a nominal long-term performance condition to the deferred bonus plan to make the plan a long-term 'scheme' thus postponing reporting of the deferred element.

Lastly, we note that the Government has abandoned the clause which required companies to report the value of fees for other professional services collected by the firms advising their remuneration committees. The conflict of interest clearly remains – in the accounting firms, these other fees have been estimated to average 11 times the fees for remuneration committee advice. No wonder accounting firms have been fulsome in their praise for the new regulations.

Overall assessment of the Albatross

The chart below shows our final assessment of how the Government did against its own objectives, defined at the start of its two-year journey leading up to the implementation of the new reporting regime. NB Vince Cable and his team never explicitly voiced 'reduce high pay' as an objective. But, of course, it was their ultimate hope all along.

Readers who have seen this chart before may note that we have downgraded the Government's performance in this final assessment. Regretfully, we think the Government has failed on executive remuneration despite its early promise. The new regulations are fearfully over-engineered and will do nothing to improve clarity of reporting. And we think there is little prospect of them leading to pay restraint. Our hunch is whoever is in Government will have to revisit all of this again after the next election. Not everyone is going to agree. There are some big winners and big losers in all of this (see panel overleaf).



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New Directors' Remuneration Reporting Regulations *(The Large and Medium-sized Companies and Groups (Accounts and Reports)(Amendment) Regulations 2013)* – who won and who lost?

The winners	The losers
Large Accounting Firms: big time winners. Not only have they fended off the requirement for companies to report the global fees of their remuneration consultants but the gates have been opened to endless compliance and extra audit work	**Smaller quoted companies**: the new Schedule 8 has 49 sections compared to 20 sections in the existing regulations. The administrative burden offers no value for these companies or their shareholders. (At least the QCA was successful in warding off an annual binding vote!)
ISS (and other major voting advisory firms): they really hold the power now provided they can persuade shareholders to pay for their advice	**Retail shareholders**: the new report is going to be a tougher read. The opportunity of forcing a meaningful historical performance and pay record has been lost. And they will be deceived by the future policy illustration
Lawyers: the threat of civil action against directors is the hook for lawyers to win the compliance advisory work as well	**General public**: the perceived excesses of executive pay will not reduce, although they may increase more slowly under shareholder pressure. Future payouts will frequently exceed the policy illustrations by a large margin, causing more outcry
Institutional shareholder corporate governance staff: they will be in business for years to come	**Specialised shareholder and company advisers**: economies of scale and low value tick-box approaches by the larger firms will become increasing dominant – if these firms can continue to dodge anti-monopoly moves
Fat cats: there is nothing in all of this that is going to bring down supposedly excessive levels of remuneration. The executives still hold the cards	**Beneficial shareholders generally**: none of this reporting burden is going to add to shareholder returns – show us the hedge fund which uses remuneration reporting compliance as a selection criterion!
Financial Reporting Council: the wholesale adoption of the FR Lab's recommendations in these regulations has reinforced its influence	**Remuneration committees**: who would want to do the job? See Paul Norris' article
Journalists: there will be a lot to get hot under the collar about for a long time yet	**The Government (in the longer-term)**: Another policy that will not really deliver

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The 'Beautiful Game' just got harder to play

Paul Norris considers the now perilous task of remuneration committee members.

Who would volunteer to be chairman of a listed company's remuneration committee? It is like being a premier league goalkeeper and requires similar skills. All the pressure is on you - one mistake and the ball is in the net.

To succeed goalkeepers must combine bravery with a hint of madness, strength of character, judgement and good luck. If you have ever watched a top-class goalkeeper dive at an advancing striker's feet to save a certain goal, you will understand the reference to madness is not pejorative. Technical competence is a given but, without the other characteristics, technical ability alone is not going to be enough. So it is with remuneration committee chairmen, beleaguered by government, investing institutions, regulators and proxy advisers, all laying down their views about executive pay and complaining when those views are not taken into account.

The latest attack comes from The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013. Damien Knight's leading article examines the regulations and their implications in detail and points out a "game-changer" in the underlying primary legislation. Any director who authorises a payment which is inconsistent with the policy approved by the binding shareholder vote will be jointly and severally liable to indemnify the company for any loss.

Apart from raising a raft of questions likely to leave lawyers salivating and remuneration committee members uncertain, this undermines the principle of comply or explain. Compliance is as much about complying with the spirit as with the letter but, as far as remuneration is concerned, the new regime places greater emphasis on compliance with the letter.

We are concerned that the new reporting regime may have unintended consequences for the majority of companies. The worst reported excesses have occurred in the biggest companies but the new reporting regulations do not recognise this and apply to all UK main board listed companies. Also, the new reporting regime will require more time from remuneration committees and will place committee members at greater financial risk. The burden is likely to be greater for smaller listed companies whose remuneration committees bear the same level of responsibility as their counterparts in the FTSE100 but have to discharge it often with a lower level of internal support.

Whilst it seems that the forward policy statement may be written in fairly general terms; more detail being provided in the statement of intended implementation which looks forward only one year, all companies and their investors stand to lose if the supply of non-executive talent perceives the game not to be worth playing - or if they decide to forego listed status, in favour of a lighter regulatory regime.

But it is not all bad! Recent research by Reuters indicates that the average vote against pay deals at FTSE 100 annual general meetings is down by 18% from two years ago. This indicates that remuneration committees in the biggest companies are doing a difficult job increasingly well. Some commentators might argue that they need to but it is equally important that remuneration committees of smaller listed companies (the majority) feel they have the support necessary to enable them to continue to provide the support which those companies need.

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Executive Survey findings

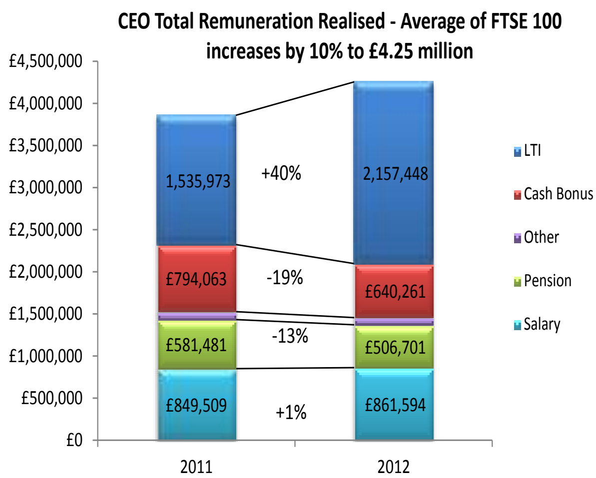
Cliff Weight summarises the findings of the June 2013 Manifest/MM&K survey

The annual Manifest-MM&K Executive Director Total Remuneration Survey was launched on 10th June 2013 and reveals the latest trends in UK director pay.

Call MM&K on 020 7283 7200 to order the survey, price £500, or download a free copy of the launch presentation, which summaries the key results at www.mm-k.com/events/

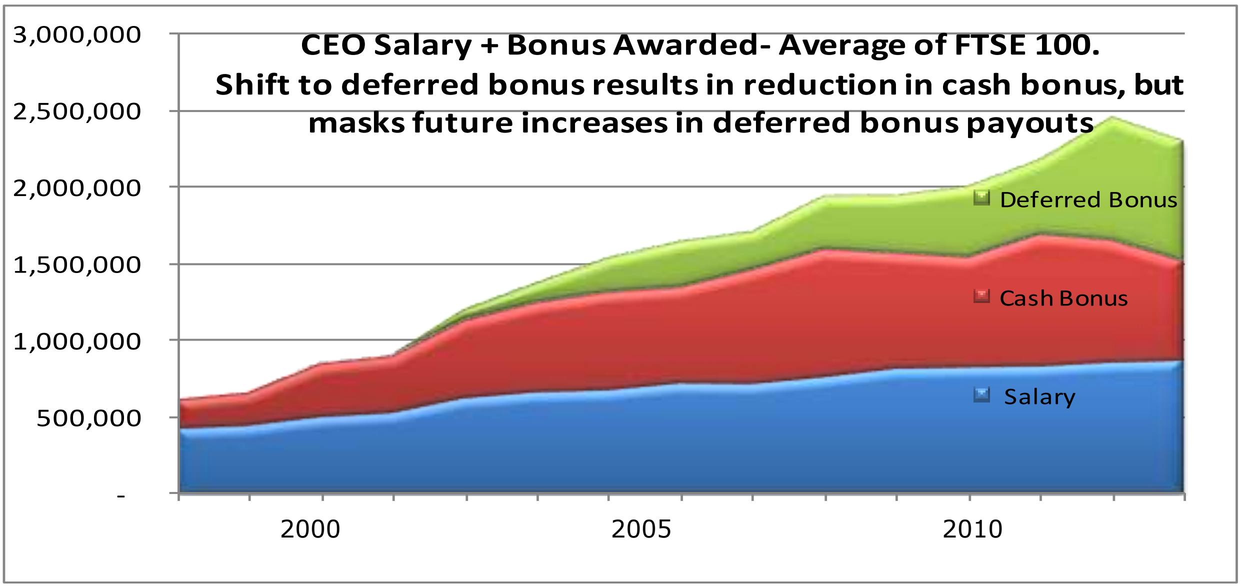
Key findings

- The CEOs of the UK's top 100 companies were paid £425 million in 2012, up £45 million (10%) from 2011. This increase in *Total Remuneration Realised** has been almost entirely due to a 40% average increase in long-term incentive plan (LTIP) payouts *realised:*
  - The average value of shares vesting went up with the general increase in all share prices
  - A higher proportion of LTIP awards vested in 2012 compared with 2011 – a reflection of either higher average performance or easier performance standards
- The median increase in *Total Remuneration Awarded* for FTSE 100 CEOs' was 1%, but the median increase in *Total Remuneration Realised* was 8% (for the same reasons as above)
- Bonuses decreased on average. The mean cash component of the bonus went down by 19% (median decrease 5%)
- Two-thirds of directors received a salary rise, with a median increase of 3%
- LTI awards increased in the biggest companies.



Long-term trend

The trend since 1998 (below) reveals a huge growth in bonus payouts and the more recent move to defer part of bonus:



Deferred bonus is not counted in our survey definition of *Total Remuneration Realised* until it is paid out, and we include deferred bonus as part of LTIs when paid in shares. We believe this is the correct methodology, because we do not know how much a deferred bonus is worth until it vests, usually 3 years later when share prices may have changed dramatically.

We note that the new Directors' Remuneration Reporting Regulations (see lead article) include deferred bonuses in the 'single figure' in the year the bonus is earned. We think this is misleading. Nevertheless, the time lag in our method combined with the increasing value of deferred bonus has led to a short-term understatement of underlying inflation of *Total Remuneration Realised*. The average Top 100 CEO total remuneration is probably about £300,000 higher than the figure illustrated above.

The Manifest/MM&K survey is the most comprehensive survey available and provides a complete picture. It is the first survey to report data from all listed companies with 31st December 2012 year ends.

There are separate analyses of **FTSE100, FTSE250, Small Cap, AIM and Fledgling companies,** with tailored analysis and commentary. Data breakdowns by turnover and by market capitalisation enable you to assess precisely comparability with your own business.

NB In our survey we distinguish between Total Remuneration Realised and Total Remuneration Awarded. Both include the sum of salary, pension and benefits and bonus for the past year; however, the treatment of the LTI element is different. Total Remuneration Realised includes the market value of LTIs Realised, ie those which vested in the past year (or in the case of share options, the gains on those which were exercised in the year); Total Remuneration Awarded includes the expected value of new LTI awards and share options granted in the year. The former is the better measure for assessing whether total remuneration was justified by company performance; the latter is the better measure for assessing changes in policy.

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Should you be using a JSOP now?

Mike Landon looks at the benefits and drawbacks of this equity incentive

Over the last few months there has been an increasing interest in Joint Share Ownership Plans ('JSOPs') as a way of rewarding key executives. The main attraction is that much of the potential gain will be subject to capital gains tax ('CGT'), currently at 28% for higher and additional rate taxpayers, as opposed to income tax (at 40% or 45%) and national insurance contributions ('NICs') (2% for executives and 13.8% for companies).

Under a typical JSOP, executives are awarded an interest in a specified number of shares which is equivalent to any future increase in the value of those shares above a hurdle rate of, say, 5% per year. The remaining interest in the shares is held by the trustee of an employee benefit trust ('EBT').

An executive's interest in the JSOP is treated as an interest in restricted securities. The executive enters into a joint election with his employing company, under section 431 of the Income Tax (Earnings and Pensions) Act 2003, to be subject to income tax on the unrestricted market value of his interest at the acquisition date, which results in any future gain being subject to CGT. The taxable value of the interest is calculated in a similar way to the fair value of a share option at the date of grant. (For the example below, it is assumed that the executive's initial interest in the JSOP shares is valued as 10% of the value of the shares – this proportion will vary according to the company's particular circumstances and the design of the plan.)

When the underlying shares are sold in due course, the executive becomes entitled to any sale proceeds in excess of the hurdle share value. The table below compares the net gain to the executive under a JSOP to that which he would realise under an unapproved 'market value' share option. The shares are assumed to increase in value from £100,000 on the date of grant to £200,000 at the time of their sale, three years later.

Calculation of gain to executive	JSOP	Unapproved Option
Taxable value at acquisition (10% share price)	£10,000	n/a
Taxable value at exercise	n/a	£100,000
Chargeable gain after annual CGT exemption (£11,000)	£63,238	£0
Share sale proceeds	£200,000	£200,000
Income tax & NICs at acquisition (47%)	-£4,700	n/a
Hurdle value of JSOP/option exercise price	-£115,763	-£100,000
Income tax & NICs at option exercise (47%)	n/a	-£47,000
CGT on sale (28%)	-£17,707	£0
Net gain to executive	**£61,831**	**£53,000**

In this example, an executive with a JSOP will receive £61,831 net, after payment of income tax and NICs at acquisition, deduction of the hurdle value which is retained by the EBT and the CGT on sale. This is 17% more than the net gain of £53,000 which would be realised if the executive had exercised an unapproved share option over the same number of shares.

This example makes the JSOP look very attractive. However, how many companies can expect their share price to double over a three-year period? The following table compares the net gain to an executive depending on different levels of increase in the share price.

If the share price does not exceed the hurdle value, the executive will get no value from the JSOP but will have paid some income tax. As can be seen from the table, under the assumptions used, the share price would have to increase by more than 50% for the executive to be better off under the JSOP than under a share option.

Share price increase	Gain from JSOP	Gain from Unapproved Option
-10%	-£4,700	£0
0%	-£4,700	£0
10%	-£4,700	£5,300
20%	-£463	£10,600
30%	£9,537	£15,900
40%	£18,631	£21,200
50%	£25,831	£26,500
75%	£43,831	£39,750
100%	£61,831	£53,000
200%	£133,831	£106,000
300%	£205,831	£159,000

The JSOP is therefore only likely to be attractive to executives if there is the potential for a substantial increase in the share price – for example in a start-up, turnaround or launch of a significant new product.

Other points to take into account when considering the introduction of a JSOP are:

Share ownership rights	The executive may be given some voting and dividend rights under a JSOP, but not normally for a share option.
Share valuation issues	The executive's interest in a JSOP can be complex to value and HMRC is less willing to agree very low values than they have been in the past.
Corporation tax deduction	This is only available to the employing company for the part of the gain which is subject to income tax, which is usually very small for a JSOP.
Administration	Share plan administrators are now becoming used to looking after JSOPs, so this should not be a big issue.
Communication to participants	The JSOP is not as easy to explain as a share option.

The JSOP can be a very useful way of rewarding executives but only in certain limited circumstances. If a CSOP or EMI share option plan can be used, this gives even more valuable tax advantages, including a corporation tax deduction for the employing company for the whole gain realised by the executive.

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Alternative Investment Fund Management Directive (AIFMD)

On 4th July 2013, MM&K jointly hosted a client seminar on AIFMD remuneration requirements, with Bovill, the financial services regulatory consultancy. Nigel Mills discussed remuneration policy developments generally in the private equity and hedge fund industries and how these were likely to be affected by AIFMD, whilst John Everett of Bovill presented the implications of the Directive from a more technical viewpoint. The financial services industry is currently facing more European regulation in several areas: CRD4 will introduce a 100% limit on bankers' bonus and extend the definition of regulated staff in the current bankers' remuneration code; UCITS V seeks to introduce similar regulation for fund manager remuneration (the previous day the European Parliament voted down an equivalent 100% bonus limit for fund managers – but there are other potential restrictions being considered).

AIFMD is aimed at alternative investment funds (AIFs) – covering private equity and hedge funds in particular, but with a wide definition of AIFs. The European Securities and Markets Authority issued their final guidelines in February. Measures required include part-payment of variable remuneration in investment fund units. (See the March 2014 edition of Boardwalk for a fuller briefing.) The new UK Financial Conduct Authority has a tight deadline to 'comply or explain' in relation to the Directive and Guidelines and to consult on its own proportionality rules in time for final implementation by July 2014.

For information and advice about AIFMD and the MM&K AIF remuneration surveys contact nigel.mills@mm-k.com