Board Walk

Briefing for Remuneration Committees

mm&k

March 2013

This is a special edition of Board Walk dedicated to the final draft of the Directors' Remuneration Reporting Regulations issued by BIS for comment on 8th March 2013.

The Government wants comment by 25th March and we encourage our readers to respond immediately as the latest draft includes several new items where we think BIS has got it wrong.

Directors' Remuneration Reporting Regulations

BIS risks falling at the last fence

Damien Knight reviews the new draft regulations

The Department for Business, Innovation & Skills (BIS) started its review of the Remuneration Reporting Regulations[1] back in September 2011. 18 months and three public consultations later it has just (8th March) issued its final draft Regulations.

Sadly the Department has left the cake in the oven too long – or at least tried to cram too many ingredients in. All the innovation is in danger of melding into a compromise that will only benefit the investment management community and not retail shareholders or the wider public.

There is still a chance to rescue this – we are urging our clients to write to BIS before its deadline of 25th March 2013.

Send your comments to executive.pay@bis.gsi.gov.uk

What's gone wrong? The new draft Regulations reflect a set of FRC Financial Reporting Lab (FRL) recommendations which were only made public three days earlier, giving no-one any chance to comment first. BIS had asked the FRL to develop the requirements for two of the most useful and radical aspects of its new Regulations, the ***Scenario Charts***, illustrating future executive directors' remuneration policy, and the historical ***Performance Graph***, illustrating the relationship between CEO remuneration and company TSR over several years.

[1]*The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2008.*

The Government has imported the FRL recommendations wholesale into the draft Regulations. By doing this they have diluted some of the important benefits of the proposals in the previous consultation draft, issued in June 2012.

Problem No 1. Scenario Charts

The new FRL recommendations (and consequently the draft Regulations) specifically exclude increases in share price from the scenario projections of the long-term incentive element of pay. Companies will be required to report the 'face value' of shares at grant and apply the relevant vesting factor for each of three performance scenarios (eg 0%, 25% and 100% for a typical LTIP).

The omission of share price growth is manifestly wrong. Retail investors (and the media who report on these issues) will want to see its impact on the likely outcomes of executive directors' remuneration. Share price growth is, after all, a fundamental part of performance.

But it's worse than that. The future scenario definitions now do not match the historical 'single figure' definitions. This will certainly confuse the media and retail shareholders. In three years' time (typically) companies will be required to report the outcome of an LTIP grant as part of the 'single figure' of remuneration for the year under review. And this figure *will* include share price growth. For high-performing companies the eventual single figure payout will, in most cases, turn out to be much higher than the Scenario Chart suggested three years before.

We are surprised that the 28 corporate members of the FRL went along with this. Yes, the pay package will show a less controversial figure in the first year but there will be a major media row a couple of years later if the £3m 'maximum' package turns out to have been worth £4.7m (which is what will happen if the share price grows by 25% per annum).

The treatment of share options is even more of a muddle. Having plumped for the face value treatment of LTIPs, the FRL realised that the face value of a share option at grant, after deducting the exercise price, is usually zero: so there would be nothing to report at all in any scenario if share price increase were ignored. The FRL and BIS have ducked the issue by requiring companies to use a 'fair value' of option grant as the starting point and then to apply the scenario vesting percentages to this. Companies will be free to propose and explain their own valuation methodologies. But note that the 'fair value' calculation will have to ignore the performance conditions since these are taken into

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

account in the scenario vesting percentages. So these 'fair values' when reported will look nothing like the IFRS2 valuations reported in the same annual report and accounts.

Remarkably, in their earlier report to BIS last June on the definition of the 'single figure', the FRL announced "Investors also requested some simple supplemental disclosure related to amounts awarded that will vest in the future. Expected values, calculated using option modelling methodologies, are not considered useful for reporting purposes by the majority of the investors due to the number of assumptions that necessarily need to be made to undertake the modelling".

BIS must be urged to require companies to include share price growth (and any accrued dividend entitlement) in the scenario figures.

Companies should be required to show their price growth assumptions for each scenario.

Problem No 2. Performance Graph

The earlier draft of the Regulations introduced the requirement for a 10-year graph of CEO pay against TSR performance, to replace the old relative TSR graph. This was radical, and promised to provide a genuine basis for tracking the relationship between pay and performance over time. There was a slight anomaly in the earlier proposal – the remuneration figure was to be an absolute figure for each year whereas the TSR figure was to show the one-year return for each year. We are not sure that BIS really intended this – a TSR index (with 100 in Year One) would better show the long-term and annual growth of an investment in the company.

In MM&K's representations to BIS, we recommended the juxtaposition of a table showing for each year the value of Key Performance Indicators from the Enhanced Business Review section of the annual report – to improve further the ability of shareholders to compare pay and performance in the long term.

What has happened? The FRL recommended a reversion to the old chart of relative TSR! To be fair they asked in addition for an (oddly transposed) table showing corresponding annual figures for CEO total remuneration and for the percentage awards or vesting in the incentive plans. But any other measure of performance has disappeared from the chart.

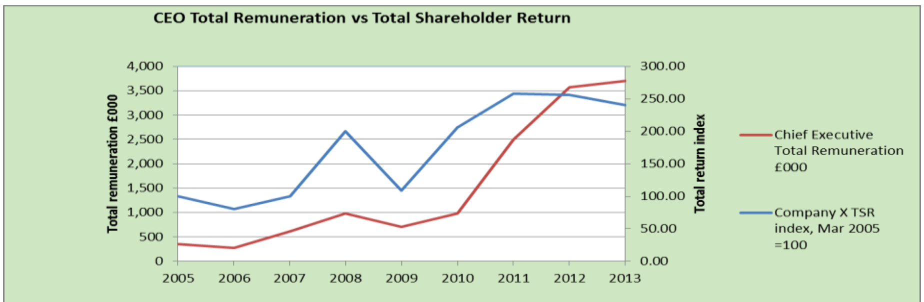
The FRL arguments are weak: firstly that inclusion of two vertical axes on the graph, for TSR and for remuneration, would be confusing and open to manipulation; and secondly that the annual TSR figure was too short term – but, as we have explained, the substitution of a TSR index would immediately make it a long-term measure. The FRL report also claims, without showing any evidence, that retail investors find the existing graph helpful.

BIS has followed the FRL recommendation (with a nine-year historical period rather than the old five-year one).

This is a disappointment. The only measure of performance shown is relative TSR – the one that institutional shareholders love because that's how, as intermediaries, they themselves get measured for pay purposes. Professor John Kay, in his own report to BIS on short-termism in the equity markets, demonstrated the unfavourable consequences of such a measure – but BIS seem to have forgotten this.

BIS must be encouraged to stick to its guns and continue to insist on the ten-year historical graph of CEO pay vs TSR, preferably requiring KPIs to be added as well.

The chart below illustrates what MM&K considers would be the most helpful form of this graph.



KPI	2005	2006	2007	2008	2009	2010	2011	2012	2013
New orders £m	650	945	932	1752	1308	2406	2414	2290	2352
ROC	15%	18%	17%	17%	22%	21%	23%	18%	19%
EBITDA £m	80	115	121	187	165	210	210	225	197

1 Bengal Court, Birchin Lane, London, EC3V 9DD
t: 020 7283 7200 f: 020 7283 4119
e: info@mm-k.com www.mm-k.com

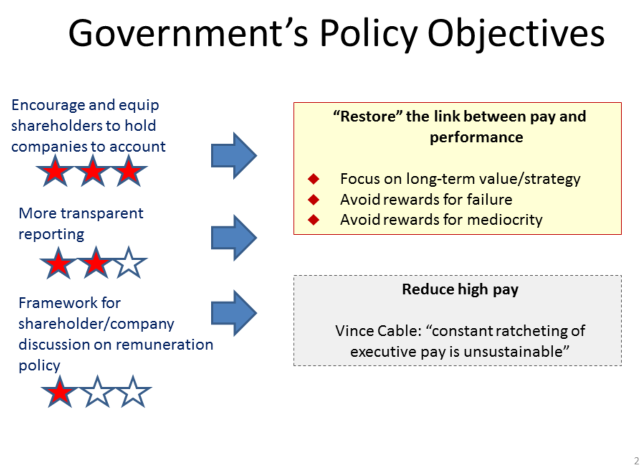
A narrow interest group

The Government needs to understand that the 13 institutional investors and four investor organisations in the FRL have information needs which are different from the mass of retail investors and the media that informs them and institutional investors have corporate governance and analyst resources not available to the broader audience.

The layout of the FRL report suggests that the 28 corporate members had a secondary role compared with the investors. This is unsurprising as they are mainly concerned that the new reporting requirements are not too onerous or will not lead to an unjustifiable outcry directed against them. But they seem not to have spotted the risks attached to ignoring share price growth in the Scenario Charts.

Other issues with the draft Regulations

We need to remind ourselves that a principal aim of the new Regulations was to make remuneration reporting simpler, clearer and shorter. From the various consultation documents and statements by the Business Secretary, Vince Cable, we distilled the Government intentions into the following chart:



When I presented this to the ICSA conference in September, I rated the Government's likely success under each objective. I awarded 'More transparent reporting' two stars. I'm afraid right now they are struggling to hold on to the second star. The latest draft of the Regulations has included many last minute add-ons that will ensure remuneration reports in future will be even longer than they were in the past. Look at all these additional requirements:

- There is a new Part 6 which deals with the 'Revised Remuneration Report' (a document a company may choose to publish after the annual general meeting).
- If the Company decides not to have a binding vote in a particular year the report must give information about the last vote. And if there is no future policy report that year, the report requires the reporting of incentive performance targets for current year policy.
- The so called 'single' figure table now contains at least 12 figures for each director. Each column in the table (i.e. element or total) has to show the previous year's figure as well (this promises a messy and very large policy table!).
- There is a new requirement to explain *how* the level of incentive reward was determined against company and individual targets.
- Companies can add extra columns for more elements of pay or for sub-totals, but have to provide notes to explain the content and/or calculation.
- Payments to past directors need to be reported. This was omitted in the earlier draft, although it was in the original Schedule 8 of the 2008 DRRR.
- Paragraph 18(b) (ii) and (iii) of the draft Regulations replace the earlier BIS ideas for

reporting outstanding share incentives which were neither granted nor vested in the year (these are picked up elsewhere in the report). It now requires 'details' of LTIPs and ESOs in this 'continuing' category, but does not define 'details'. (For example they could include date of grant, earliest exercise date/vesting date, price at grant, exercise price, price at year end, numbers outstanding at start of year and end of year, numbers lapsing.)

- The comparison of directors' pay with various company measures for the year under review now has to be in graphical form. It includes an item for the total single figure for directors against overall expenditure on pay. (But the comparison with the previous year seems to have been omitted.)
- As a purely political add-on, the comparison also includes *tax paid in the financial year*!
- There is a new section containing some general requirements for the future policy report eg clarification about what items of policy have been carried over from the previous report.
- The future policy table now has to include any policies specific to individual directors as well as the general policies.
- There is a new requirement to explain why any new or revised items of remuneration policy have been introduced.
- Reporting on incentives includes a new requirement to include targets as well as measures but there is a let-out for items that would be 'seriously prejudicial' to the interests of the company.
- Paragraph 29 provides a whole new section on director recruitment remuneration policy:
  - Principles
  - Elements of remuneration and approach to each element
  - Maximum level of salary expressed as a percentage of the (single figure) salary of the highest paid director

Modifications to the Companies Act

The Directors' Remuneration Reporting Regulations are a statutory instrument enabled by Section 421 of the Companies Act 2006. In order to make the new regulations work (particularly in respect of the binding policy vote and revising the remuneration report) the Government has had to amend the Companies Act. It has done this by including relevant legislation in the current Enterprise and Regulatory Reform Bill which is at the report stage in the House of Lords and is likely to receive Royal Assent next month. The Government has produced a short note which explains the relevant content of the bill.

The Quoted Companies Alliance has been concerned about the red tape that the new reporting regulations present to small quoted companies. Their view is that there is no remuneration problem to be solved with small companies, which are being dragged into a regime designed for FTSE 350 companies. When they learned that there was a Lords amendment to the Bill proposing an *annual* vote, they mobilised a lobby against this. The amendment was defeated on 12th March so at least the vote will only be mandated every three years.

For further information contact:
damien.knight@mm-k.com

Record participation in Non-executive Director survey

MM&K's 2013 Chairman and Non-executive Director survey *Life in the Boardroom* was published in February in conjunction with Directorbank. This year a record total of 502 individuals participated, representing 1,328 separate directorships. 316 of these held at least one chairmanship. This is now the largest survey of its kind in the UK.

On 5th and 12th February we held breakfast meetings at the RAC one with a listed company and one with a private equity-backed focus. 60-80 participants attended each session. The presentation slides and notes of the subsequent discussion can be found on the MM&K website.

If you missed the seminars there is another opportunity to hear the content when Cliff Weight and Ken Brotherston of Directorbank present their findings at the High Pay Centre on 29th April, followed by a discussion involving also Theresa Wallis, Chairman of LiDCO Group and Deborah Hargreaves, Director of the High Pay Centre

29th April Seminar booking link