Executive Compensation

Rewards for success not failure

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Executive Summary

The current "Shareholder Spring" suggests that shareholders have finally had enough of executives who persist in rewarding themselves for sub-standard performance. Reform of executive compensation is clearly necessary, but we must also ensure that the UK remains an attractive and competitive place to work and do business. It is important that compensation can be structured to incentivise and reward good performance. After all, rising profits justify rising compensation and where that is the case shareholders have generally been happy to approve the remuneration.

We argue that four things must be done. First, shareholders should be empowered to hold companies to account. Second, remuneration construction and reporting must be made more transparent so that shareholders can understand the payoffs for executives. Third, executives' compensation must be more closely tied into the fortunes of the companies they work for. Finally, when executives do fail it should be possible for already awarded compensation to be clawed back.

"Reform of executive compensation is clearly necessary, but we must also ensure that the UK remains an attractive and competitive place to work and do business"

Holding companies to account – The government is proposing a binding vote for shareholders at least every three years on executive pay, the idea being that setting pay less frequently will reduce the ratchet effect on pay. They also propose an advisory vote on pay implementation, which, if lost, would trigger a binding vote on pay policy the following year. Companies are likely to be asked to issue a statement on how they will address shareholder concerns if there is a significant minority vote against the remuneration report. Whilst this is a step in the right direction we feel this is overly convoluted. The board will be incentivised to draft a broad based remuneration report to avoid annual votes. The addition of the vote on past pay and the requirement to take minority votes into account means there would be several ways in which a change to policy might be triggered.

Our proposal is much simpler and achieves the same objectives. We believe that votes on remuneration should operate on a two strikes basis, similar to the system currently operating in Australia.[1] The vote would initially remain advisory, but with higher threshold of 65% to approve the policy.[2] If the board achieves 50% approval but fails to secure 65%, the company has a year to change its policy in line with shareholder wishes. If, at the subsequent vote on the amended policy, it fails again to pass the 65% approval threshold the resolution to reject the policy becomes binding and a new remuneration policy has to be drafted and put to another vote within 90 days.[3]

Many investors indicated to us that whilst they needed to hold boards to account, they did not feel it was their job to micromanage. In our proposals

1 The Australian two strikes system has only been in operation for one full year but already 12% of companies have experienced a first strike and reports suggest it is already triggering a more inclusive process from boards.

2 We chose 65% because in the UK an investor can have up to 29.9% of a company without launching a full takeover bid. So the 75% mooted in the BIS consultation would have risked one minority shareholder blocking the wishes of the majority.

3 Until a new policy is agreed by shareholders, the previous remuneration policy would remain in force.

shareholders can reject a proposed policy but the onus remains with the Company to come up with an acceptable solution. If at any time the company fails to secure 50% approval the vote to reject it automatically becomes binding. Such votes are rare and normally indicate that shareholders have deep reservations about the policy.

Remuneration transparency – Remuneration has frequently been unduly complex and reporting too opaque, thus making it more difficult for shareholders to understand and evaluate compensation. We outline a simpler template for remuneration and its reporting, backing the BIS recommendation that an analysis should be produced showing the results of what might be paid out in terms of bonuses and long-term incentives under different conditions. That would make it easier for shareholders to see whether the risk/reward payoff is reasonable or not. Companies should outline in detail any deferral of pay and how and when it is expected to vest. Any deferred remuneration actually vesting in that year should also be disclosed in the report. We believe companies should disclose one figure for salary, bonus and other benefits and a second separate figure relating to long-term incentive payments. This is because the latter reflect performance over a number of years rather than (as in the case of a bonus) just the previous year. The BIS proposal is for the board to produce a single figure that will include all fixed and variable pay received in the previous year. We believe that this is a mistake because it will result in one figure that relates to different time periods, which will hamper, not enhance, analysis.

The remuneration report should also have a catch-all section where the board would have to disclose anything else of material interest to shareholders. This should help ensure that any other type of compensation like the pension hikes given to Fred Goodwin have to be declared and cannot be hidden.

Tying compensation to performance – Compensation needs to be tied to the long-term performance of companies. Historically, too many compensation schemes have had too short a time horizon and too high a proportion of that compensation has been paid out in cash. Recently more compensation is being paid out in shares, but the average period over which incentive programmes are normally assessed is three years, which we believe is too short a time to truly reflect the long-term performance of a company. We propose to extend that to five years, which will more accurately reflect a normal economic cycle. This would allow shareholders to differentiate more easily between an executive's management skill and their good fortune to have captured the right part of the economic cycle.

We also propose that 50% of all variable pay (bonuses and long-term incentive payments) should be deferred for a minimum of five years, with no more than straight line vesting. In other words the deferred portion of the compensation would be paid no faster than in equal instalments over five years. Deferral of pay is already happening to an extent, 74% of FTSE 100 companies and 52% of the FTSE 250 have such plans, but we believe it should apply to the entire quoted universe. Further, we recommend that deferred compensation should be paid in shares. The combination of a 50% deferral rule plus the five year vesting means that, on average, 150%[4] of all variable compensation would be linked into the

4 150% being the accumulation of 50%, 40%, 30%, 20% and 10% of the least five years variable pay that would be held in deferral.

performance of the company and available for clawback. The extension of long-term incentive plans to five years would result in some pay would be exposed to the performance of the company over ten years thereby truly linking pay to the long-term success of the company.

Clawback – Most importantly we believe all deferred executive compensation should be subject to clawback. Long-term incentive plans generally pay out when certain targets are hit. The more targets that are hit, or exceeded, the greater the payout. The bias is all one way – the better an executive performs the more they get paid but, if they fail, the worst that can happen is that they lose their post, with whatever exit package they can negotiate. We have seen this in cases like Thomas Cook (which we analyse in detail in Chapter 6). That not only leaves the shareholders with the vast majority of the downside, it also potentially incentivises executives to gamble to the upside.

We propose that in addition to the upside performance targets there should also be downside conditions, which if breached would trigger repayments back from executives from their pool of deferred compensation. These conditions would be set such that an executive would almost certainly have failed if they were breached. Examples of such conditions would be a major fall in the share price or profits or exceeding maximum leverage ratios. If all the conditions were breached, to the maximum extent, then all of the deferred compensation would have to be paid back. Such a situation could result in an executive paying more back from his deferred compensation pool than he would receive in terms of an exit payment. This should address once and for all the problem of rewards for failure. It should also adjust the risk/reward balance for executives, thus reducing the temptation to gamble a company's future in order to hit their short-term upside targets.

What should not be done? Caps on ratios of executive to employee pay are arbitrary and would politicise the pay process of executives – that is not desirable. We are pleased that BIS have not gone down this route and that the plans for an exit cap of one year's salary have been dropped. It is much more sensible for companies to determine exit payments within an agreed policy and for those details to be published as BIS propose. It gives the companies flexibility to remove underperformers quickly, an ability which the previous proposal might have hampered. The real solution to capping exit pay is through clawbacks.

Finally, we do not think the companies should be forced to have employee representation on boards or that employees should have a vote on executive pay. Aside from practical problems, shareholders own the companies and as owners they should determine the pay. Again we are pleased that BIS have also decided that this is not appropriate.

1
Introduction

Executive compensation, and corporate governance more generally, has been the subject of increased media and government attention in the last couple of years culminating in the Executive Remuneration review announced by the government earlier this year and, of course, the "Shareholder Spring". The latter has seen shareholders reject remuneration policies at companies such as Aviva and WPP and stage major revolts at numerous other companies. Policy Exchange had already started work on corporate governance programme prior to this review, including executive compensation. We have subsequently tailored this document to meet many of the issues and questions raised by the government's review. Our objective is to provide a dispassionate assessment of the issue and make recommendations that increase the linkage between performance and pay, improve transparency, reduce rewards for failure, whilst at the same time attempting to ensure the UK remains an attractive place to work for the best executives.

There has been much comment on the subject of executive pay, not all of it well informed. Our instinct is that it is right for companies to be able to pay executives well for good performance. Even median performance deserves to be rewarded given that running global companies (such as those in the FTSE 100) requires not only experience but also a major personal commitment of time and resources. Often the media categorises bonuses as being justified only in the case of exceptional performance. However, variable pay is not only a key method for incentivising performance but it also has the advantage that in adverse times those who are the best paid should (if the scheme is structured correctly) see the largest drop in their compensation. It is where this has not been the case that compensation structures have broken down. Indeed, the real problem is not that executives are over compensated per se, but that, too often, inadequate performance has been over rewarded.

"Most of the revolts in the "Shareholder Spring" have arisen because of a reluctance of remuneration committees and executives to reflect any reduction in performance in setting pay."

Most of the revolts in the "Shareholder Spring" have arisen because of a reluctance of remuneration committees and executives to reflect any reduction in performance in setting pay. The most glaring example of this was Aviva, where the remuneration report was recommending a pay rise for the CEO, Andrew Moss, with the knock on implications for variable compensation, despite a marked period of underperformance. The share price had decreased by 30% over the previous year and 61% since Mr Moss took over in July 2007. This mismatch between performance and remuneration resulted in the loss of the vote and the resignation of the CEO. Where a company has performed well, the remuneration report tends to pass with little opposition, with the notable exception of WPP.

In this paper we consider how to ensure that remuneration is competitive but fair and that where there is failure it is not rewarded. This needs to be done by a combination of measures.

First, shareholders need to be empowered in order to hold both remuneration committees and executives to account. The government has proposed annual binding votes, except where companies choose to leave their policy unchanged, in which case the vote will happen every three years. It also proposes to have advisory votes on past pay policy, which would trigger a binding vote on future policy if lost and a response by companies should there be a significant minority vote against future policy. We think this is a somewhat convoluted approach and will not necessarily achieve the government's aim of better controlling executive pay. Moreover, many shareholders have told us that they prefer advisory votes so that they can express their displeasure with the pay policy and then give the company a chance to change it.

Our recommendation is for a simpler and more straightforward measure using a "two strikes" process, similar to that currently used in Australia. This would involve retaining advisory votes but with a higher pass threshold of 65%. Should a company lose a vote, it would have a year to change its remuneration policy before facing the next vote. If it loses that second vote, however, the board would be obliged to present a new policy within 90 days. It has the advantage of allowing shareholders to warn a board that they are unhappy and the board time to come up with a solution. If at any time the board fails to gain 50% of the vote in favour of a remuneration policy it would automatically become binding, since failure to gain a basic majority of shareholder support normally signifies something significantly wrong with the proposals.

Second, we think there needs to be more transparency so it is easier for shareholders to hold companies to account. In Chapter 5 we present a template for a remuneration report, highlighting the areas where companies can make things more evident and also creating a catch all clause at the end of the report, which would ensure that the board had to disclose any material not covered elsewhere. This would, for example, have made it much more likely that RBS would have had to disclose their decision to grant Fred Goodwin a dramatic boost to his pension. We also argue that one figure should cover salary, bonus and benefits. We do not think Long-term Incentive Plans (LTIPs) are particularly conducive to inclusion in an annual single figure as they are multi-year plans, and as such payments in any one year relate to performance over a number of prior years. However, transparency for LTIPs is vital. Many of the current structures are overly complex, which means either that shareholders have to spend considerable time trying to understand them or trust that the remuneration committees understand what they have signed up for. Neither is ideal.

Third we believe that interests of executives and shareholders should be more closely aligned in terms of the economic cycle. Most current LTIPs pay out over a three year period, which, whilst close to the current average tenure of a FTSE 100 CEO, is too short a time horizon to determine whether company performance is a result of the executives efforts or merely an upswing in the economic cycle. Cable & Wireless (which we look in Chapter 6) is a perfect example. The LTIPs paid out just ahead of a major deterioration in the fortunes of the company for which the shareholders paid the price. Our proposal is for LTIPs to be run over a five year period. It is not perfect but it is likely to dramatically reduce payouts that merely catch the right point of the economic cycle.

Fourth, and arguably most importantly, we believe that the rewards for failure are most appropriately dealt with through a clawback mechanism. This would be much more effective than the BIS proposal of a one year salary cap for exit payments because, in the event of failure, previously awarded compensation could be clawed back by shareholders. A departing executive could therefore effectively be paying back money rather than walking away with a year's salary. Most LTIPs and bonuses are structured to pay out when the executive reaches certain targets with the scale of the payout determined by which targets are met. If they do not meet the minimum target they do not receive a payout. Our proposal is that there should be a degree of symmetry here so that if certain downside conditions are breached deferred compensation could be clawed back. These could work in the same way with as upside targets with each downside breach triggering a partial clawback. In the event that all are breached all deferred compensation would be forfeited. Not only would this largely eliminate rewards for failure it would also likely change executive behaviour to a more balanced approach to risk.

The shareholder spring has already shown that shareholders can bring boards to heel if they feel sufficiently motivated to do so. We suspect that behaviour of shareholders in this regard has been permanently changed, as organisations like the ABI, NAPF and ISS are taking a much more pro-active role in the assessment of remuneration. The aim of any legislation should not be to score political points but to enhance shareholders' ability to hold companies to account. The shareholders, after all, own the companies so they should decide compensation.

We are pleased that some of the ideas in the BIS consultation document, such as employee representatives on boards or an employee vote on remuneration policy have been left on the cutting room floor. After all who would select the employee representatives? What would happen if employees were in a pay dispute and could veto executive compensation if they were not happy? Most importantly, what would happen if the employees voted against the package but shareholders approved it? In the appendix at the back we deal with each of the BIS consultation questions but have chosen to focus this report on the key issues as we see them.

This report is structured as follows:

- In Chapter 2 we look at executive compensation and ask if it has truly become detached from reality. Much of the analysis on remuneration has been poor, for example comparing equity indices (which do not even include dividends) with executive pay. Executive compensation should be compared to profitability, which, after all, is what executives can affect most directly.
- In Chapter 3 we discuss increasing shareholder powers and in particular whether votes should be binding or otherwise. We outline our two strikes proposal.
- In Chapter 4 we examine in detail how executive compensation is currently structured and discuss how it can be made more transparent. We discuss how salaries are determined and the structure and payout of bonuses and LTIPs. We look at best practice and areas where there have been problems in the past.

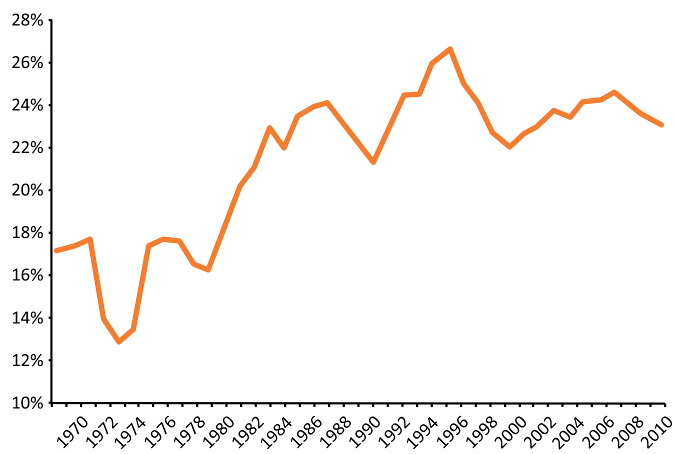
- In Chapter 5 we discuss how remuneration can be simplified and the transparency of compensation reporting improved. We outline a template for an ideal remuneration report.
- Finally, in Chapter 6 we discuss rewards for failure and how clawback can be structured to ensure, as much as possible, that they cannot happen. We then look at four high profile remuneration cases (RBS, Thomas Cook, Punch Taverns and Cable & Wireless) and what can be learnt from them.

2
Are Executives Paid Too Much?

Much of the discussion of executive pay is ill informed and the comparisons used by those who want to claim that all executives have been overly greedy have been distorted. It is easy to show that something has risen disproportionately if you choose your starting date appropriately. It is also easy to show that executive pay has become detached from performance if you chose the wrong performance measure. The best way, in our view, to look at executive pay is not to compare it to the pay of employees or equity indices; it is to compare it to profits. After all we should be interested in what the executive can affect and what the owners want him to deliver. Our analysis in this section will look at executive pay on that basis.

First, however, we should consider some of the poorly informed analysis. Much was made of the High Pay Commission[5] analysis that the ratio of executive pay to employee pay had gone up exponentially since the end of the 1970s. The comparison is distorted by the fact that the starting point was arguably at a time of the tightest ratio of executive compensation to employee compensation in the post war period. There were two reasons for this. First the strength of unions had allowed labour to claim an ever higher proportion of the GDP cake after the Second World War, peaking in the late 1970s. The Thatcher labour reforms and globalisation have meant that the labour share has fallen back, with the result that profits have risen markedly as a share of GDP from their lows of the mid 1970s (see Figure 1 below).

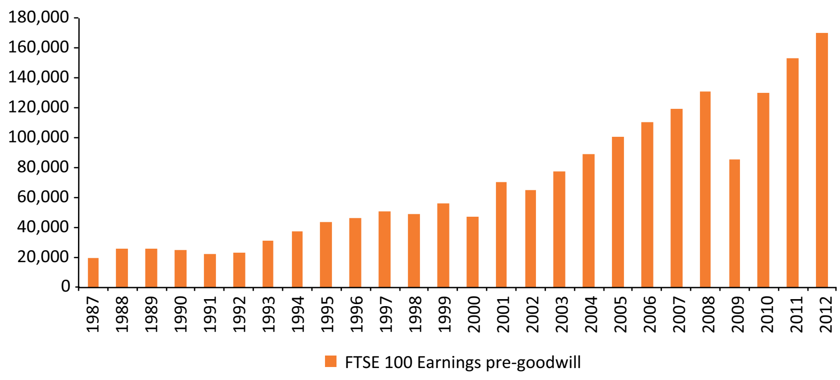
Figure 1: UK profits as a share of GDP



Source: ONS, Bloomberg

5 http://highpaycommission.co.uk

Figure 2: FTSE profits



Source: Datastream, Credit Suisse Global Strategy

Equally tax rates peaked in the late 1970s as Chancellor Dennis Healey famously predicted howls of anguish as he raised the top rate of income tax to 75%.[6] Executives were much more likely to have a chauffeur driven car, fly first class and have an extra secretary than take more pay, because pay was so heavily taxed. In the decades since then both the ability to pay executives, as a result of higher profit, and the desire by the executives to be paid, because of lower taxes, have risen. It should be no surprise, therefore, that the ratio of executive pay to employee pay has risen. Capping it artificially (as some have suggested) begs the questions of what is the right ratio and who should decide it. In a free market economy having government ministers decide pay in any way is a slippery slope as the fiasco over Stephen Hester's bonus illustrated only too well.

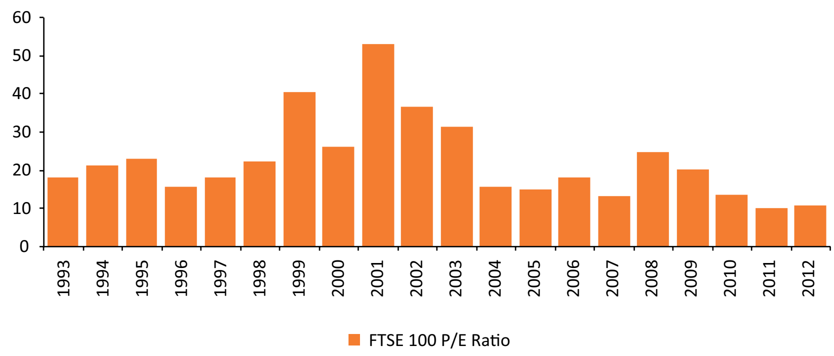
The comparison of share price performance with pay has often ignored the fact that global equity markets have struggled because of falling valuations rather than falling profits. The FTSE 100 has seen valuation compress by around three quarters since 1999, with the price earnings ratio falling from 40 to around 10 today (see Figure 3). In other words, even to keep the share price constant a CEO would have to have raised profits by 300%. The BIS consultation document makes this very mistake in comparing the rise in CEO pay to the performance of the stock market. It also quotes data from Manifest[7] showing that average CEO pay has risen from £1m in 1998 to £4.2m in 2010. Over the same period FTSE 100 profits had risen by more than 250% and had further risen to over 300% by the end of 2011 (just about enough to offset the de-rating of the equity market). So while CEO earnings have risen rapidly so has the key measure upon which they should be based – profitability. Profitability is the key factor that management can influence and it is management performance that we should be trying to reward through remuneration.

Nevertheless it is true that executive pay has even outpaced profits over the period concerned. According to Manifest, CEO earnings over the last 12 years have risen by around 13.5% per annum. On our calculations corporate profitability has risen by a little under 9% per annum. So whilst there has been some ratcheting up of executive pay, it is not as dramatically out of proportion as some have argued.

6 The Times, Tuesday 2 October 1973

7 www.manifest.co.uk Executive Director Total Remuneration Survey 2011

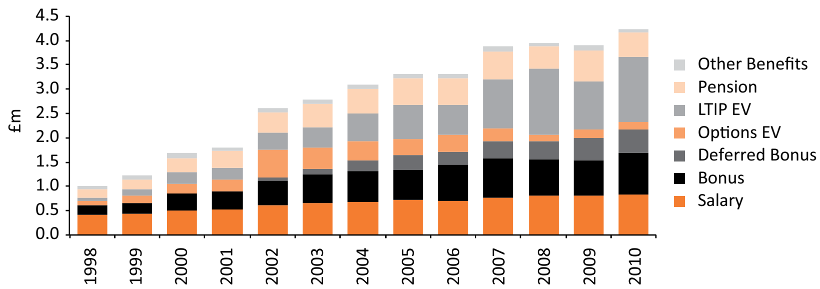
Figure 3: FTSE 100 price earnings ratio



Source: Bloomberg

It is also worth noting that pay tends, not surprisingly, to increase where there has been an increase in the size of the company. A CEO of a company with less than £100m in turnover receives median remuneration of £414 000, rising to £1.9m in a company with a turnover in excess of £1bn and to £5.1m in a company with a turnover in excess of £10bn. The same is true of market capitalisation, the higher the value of the company the higher compensation tends to be. Since 1998 the average size of a FTSE 100 company has increased significantly. Markit data shows the average turnover has risen from £5.8bn to £13.2bn in 2010, while the average market capitalisation has risen from £10.3bn to £14.7bn. We suspect that that, in part, reflects some non-UK based companies listing on the London Stock Exchange. Both of these trends may also in part account for the rise in executive compensation.

Figure 4: Average remuneration of FTSE 100 CEOs by type



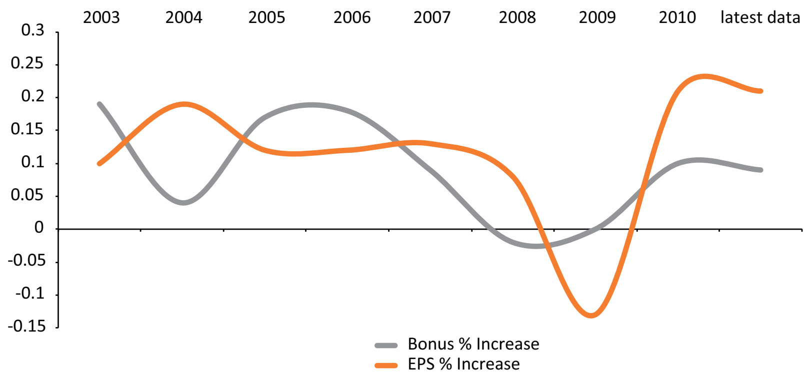
Source: The Manifest/MM&K Executive Director Total Remuneration Survey September 2011, page 26

Manifest's own analysis[8] also highlights how the rise in executive compensation has been dominated by variable pay (see Figure 4 above). While salaries have slightly less than doubled since 1998, bonuses have more than quadrupled and Long-term Incentives Payments are up tenfold. This reflects the guidance provided by the Corporate Governance Code which states that "A significant proportion of

8 The Manifest/MM&K Executive Director Total Remuneration Survey September 2011

executive directors' remuneration should be structured so as to link rewards to corporate and individual performance". Indeed, if we look at Figure 5 it is can be seen that bonuses and EPS growth have broadly tracked one another. It is also the case that the larger the company the greater the proportion of pay is driven by variable compensation, so again here we have some explanation of drift.

Figure 5: CEO bonus and EPS relationship for companies > £10bn turnover



Source: The Manifest/MM&K Executive Director Total Remuneration Survey September 2011, page 43

This analysis shows that there have been trends – rising profitability, rising turnover and rising market capitalisation – that can go some way to explaining the rise in executive remuneration. If profits are rising and executives are managing larger companies then it is reasonable for them to be paid more. The decisions of senior executives can have a marked effect (both good and bad) on the performance and profitability of companies. It is therefore logical that shareholders are prepared to pay them more and allocate more of their compensation to be performance related.

Our contention is that if a CEO is successful they should be paid accordingly. The fatal flaw in the system is that executives do not suffer a loss if they fail – there remain rewards for failure. This is a key issue of the principal agent problem.[9] If you are an owner/entrepreneur and the company you run fails you bear the loss. Currently, if you are an executive and you fail the shareholders bear almost all of the loss. Our desire to introduce clawback into executives' compensation is in order to bring a better balance to that asymmetric relationship.

9 The principal agent problem is a function of the fact that managers, unlike entrepreneurs, do not own the company. They are the agent of the owners, in this case shareholders, so the issue is how to incentivize them to act in the best interests of the owners. The asymmetry here relates to the fact that while both shareholders and management share in the upside, currently it is the shareholders who bear almost all of the downside.

3

Holding Companies to Account

One of the concerns expressed about executive pay is that it has become too incestuous, with the issues decided by a small group of directors in partnership with remuneration consultants. It is often argued that remuneration deals are so complex that it is difficult for even the most dedicated of shareholders to decipher who will get what in different circumstances. In the event that they can understand it and do not like what they are presented with shareholders currently have limited powers to change things, because their votes are only advisory. In the light of this the government has sought new powers for shareholders to ensure that they can exercise control over executive compensation, including binding votes on remuneration policy.

It is vitally important that the issues of transparency are addressed. Without the ability to decipher exactly how the remuneration policy is going to work, it is difficult for shareholders to decide whether it is reasonable or not. We deal with this in the following chapters where we outline how pay works and how the reporting of it could be improved. In this chapter we will focus predominantly on the issue of shareholder voting on remuneration policy.

Votes on remuneration policies

How quickly the world can change. Earlier this year when BIS launched their consultation on shareholder votes on remuneration the argument for binding votes, rather than advisory ones, was that companies can and do ignore significant votes against the policy, and that there was little shareholders could do about it. Interestingly, a number of the institutional shareholders we spoke to at the time disagreed with the latter point. They told us that they did have power if they chose to use it and that companies who saw sizeable votes against their remuneration policies would be under significant pressure to change them. Indeed, it was argued that as low as a 20% dissension against a remuneration policy was deemed to be damaging to the remuneration committee, often triggering a change in policy.

The shareholder spring has gone a long way to vindicating this view. In 2011 none of the FTSE100 failed to secure 50% or more support, only two failed to secure 65% of the vote and only 5 failed to secure less than 75% of the vote. This year we have seen the Aviva CEO forced out after losing a vote on pay and major revolts at Pendragon (67% voted against), WPP (59.5% against), William Hill (49.9% against), United Business Media (36% against) Xstrata (36.5% against), and Trinity Mirror (45.9% against). The latter also saw the CEO stand down, this time prior to the vote. The fact that many companies have been forced to either make concessions in advance of the shareholder meetings (for example Barclays) or agree to make adjustments for the coming year after a significant protest vote suggests companies are being forced to pay attention to shareholder wishes.

With this in mind, do we need the binding vote that the government is proposing? In their final proposals,[10] the government have opted for a binding annual vote with a 50% threshold, unless policy is not changed in which case the vote is every three years. It is proposed that significant minority votes against the policy would trigger a written response from the company and there would be an advisory vote on the previous year's implementation of the remuneration policy, which, if lost, would also trigger a binding vote on future policy the following year.

Interestingly a number of investors who we spoke with argued that shareholders were more likely to vote no in an advisory vote than a binding vote, as it was felt a way of putting a shot across the bows of a company. It was argued by some that since the amount of time investors put into consultations with companies was already considerable, the prospect of having to do it all over again straight after the first vote might be a disincentive to vote against the proposal.

"Without the ability to decipher exactly how the remuneration policy is going to work, it is difficult for shareholders to decide whether it is reasonable or not"

Our proposal would be to keep the vote on future remuneration as an advisory one but with three tweaks. First we would raise the threshold for approval of the advisory vote, as we have considerable sympathy with the view that a significant minority vote against would tend to indicate real problems with the remuneration report (given the inactive nature of some investors). We would suggest 65% rather than 75% because, under UK law, it is possible for a shareholder to hold up to 29.9% of a company as a minority shareholder without launching a full bid for a company. A 75% threshold could therefore give one minority shareholder an effective veto over all other shareholders, which we would regard as inequitable. Interestingly, with a 65% threshold all of the companies mentioned above would have lost the vote under these rules.

Second, there would be two ways in which the advisory vote would become a binding vote. If the company failed to gain a minimum of 50% support for the advisory vote it would automatically become binding triggering the 90 day review process originally suggested by BIS. This reflects the fact that, given how rare such votes are, it would likely have to be a remuneration policy containing serious flaws. We believe it is no coincidence that Aviva's CEO felt he had to resign having lost such a vote.

The second way in which a vote would become binding would be via a two strikes policy, similar to that currently in operation in Australia. In other words, should a company fail to reach the 65% threshold in year one it would be an advisory vote but if it failed again to reach 65% in year two the vote would become binding. This would result in a new remuneration policy having to be proposed within 90 days. Such a two strikes policy is already used in Australia. The advantage of such an approach is that it enables shareholders to warn companies that they are unhappy with the policy but also give the company an opportunity to work with shareholders to amend the policy over the following year. The legislation has only recently come into force in Australia but some 12%

10 http://www.bis.gov.uk/assets/biscore/business-law/docs/d/12-900-directors-pay-guide-to-reforms.pdf

of companies have already experienced a first strike.[11] It also seems to be the case that companies are being much more pro-active to avoid losing votes as a result of this legislation.

Such an approach would meet the government's and the public's desire to ensure that companies are more responsive to shareholders, while maintaining the advantages of the current system and avoiding putting an unnecessary additional workload onto investors.[12] We feel it is better than the final BIS proposal, since their proposal would encourage companies to draft broad remuneration policies in an attempt to avoid an annual vote.

BIS have also proposed to have an advisory vote on the implementation of pay policy in the previous year. If the company fails the advisory vote they will be required to put thr overall pay policy back to the shareholders for re-approval in a binding vote the following year. The Financial Reporting Council has announced that it will consult on changes to the Corporate Governance Code, so that where a substantial minority vote against the advisory vote a company should publish a statement saying what they will do to address shareholder concerns.

We feel that this is all rather convoluted. Our two strikes proposal allows for a clear warning to the company should 35% or more shareholders vote against it, so that it would be incentivised to change that policy to avoid the vote becoming binding the following year. And if at any point a company fails to secure a majority of its shareholders' support the vote would become binding. It is clear and concise and everyone would know what they had to do.

Shareholder representation on nominations committees

The BIS review also asked whether shareholders should be required to be represented on nominations committees. We do not believe they should be required to do so, particularly if those shareholders do not want to become insiders and therefore retain their ability to buy or sell their shares. Similarly as BIS note the Companies Act already requires company directors to act in the long-term interests of shareholders and other stakeholders.

BIS also raise the question about the diversity and independence of non-executive directors asking whether there is not too much crossover between boards. It also asks whether non-executive directors should come from a more diverse background thereby giving the remuneration committee a more balanced view of compensation.

Our view is that this is best dealt with by an increased professionalisation of the non-executive director role. We would like to see non-executives take on fewer roles so they can put more time and effort into understanding the companies where they sit on the boards (recognising the consequence that they would be paid more for each role). That way they would be more able to question the executive directors about the business in an effective way. We will return to this in a later note.

Employee representation or votes

Our preference is for a professionalisation of the non- executive community. We do not feel putting employee representatives on boards is likely to do anything to solve the problem of making executive pay better balanced. Who would

11 http://www.smh.com.au/business/shareholders-strike-only-twice-at-executive-and-board-pay-reports-20120212-1szo0.html

12 http://www.icmresearch.com/executive-pay-survey-for-the-high-pay-centre

select the employees on the board? The UK does not (unlike Germany) have dominant unions who are used to constructive interaction with management. So presumably it would have to be via a vote of employees. The result would likely be the opposite to that of increasing the professionalisation of boards. Moreover, if an employee representative was on the board who would determine his compensation – the very management on whose pay they are voting? We do not see any advantages in this approach. In our view it is the owners of the business who should decide pay, and everything we recommend in this paper is aimed at enhancing their ability to ensure remuneration is appropriate.

Employee votes on remuneration reports have even less appeal. What if the employees and management are in a pay dispute? Could the employees threaten to vote down the management's remuneration report? And what would happen if shareholders said yes and employees said no? We can only see problems and yet more headaches for shareholders if such proposals were ever to be implemented.

Employees are an important part of any company and they are as vulnerable to bad decision making as shareholders, but in the end shareholders own the companies and should take the key decisions. Shareholders need to appoint management that can take the right decisions and engage the workforce, but that is a separate issue.

BIS have proposed that in the remuneration report companies should explain how employee and shareholder views have been taken into account when setting the pay policy. That seems to be a very sensible response.

4

A Detailed Look at Executive Pay

The complexity of executive pay has been a source of much criticism both in the BIS consultation document and from investors. Indeed, some investors have told us that merely understanding how an LTIP programme works takes a significant amount of both time and effort. What we have tried to do in this section is to shed some light on the current structure of pay at large UK listed companies. Pay design is broadly the same across the FTSE350 but normally with higher quanta at the larger companies.

Pay structure

Senior executive pay typically comprises of a base salary, an annual bonus, a long-term incentive scheme or schemes and pension arrangements. Executives may receive other non-cash benefits (such as private healthcare, accommodation allowances etc) as well, but these are generally small in comparison to the other elements of reward.

These elements can be divided into two categories: a fixed element not related to performance, and a variable element that is. Salary, pension and other benefits are usually not performance related. The annual bonus and long-term incentives are performance related and payment is subject to meeting certain performance criteria. In most companies these incentives are almost all based on performance against pre-determined targets with only a small fraction at the remuneration committee's discretion. The setting of the targets and their associated payouts at the outset are therefore key in determining the eventual compensation (aside, of course, from performance).

Salary

Executives receive a salary which, in the FTSE100, generally ranges from between £600,000 and £1,200,000 (we estimate this covers around 85% of CEOs)

As examples, a selection of CEO annual salaries at FTSE 100 companies are set out below:

ARM Holdings[13]	Warren East: £490,000
AstraZeneca[14]	David Brennan: £997,223
Johnson Matthey[15]	Neil Carson: £733,000
RBS[16]	Stephen Hester: £1,200,000
Tesco[17]	Phillip Clarke: £832,000
Vodafone[18]	Vittorio Colao: £1,110,000

13 Arm Holdings 2011 annual report, page 93

14 AstraZeneca 2011 annual report, page 114

15 Johnson Matthey 2011 annual report, page 71

16 RBS 2011 annual report, page 280

17 Tesco 2011 annual report, page 80

18 Vodafone 2011 annual report, page 67

The salary itself may be a small part of the overall pay package especially in a good year, however the salary element is still important as often the other parts of the remuneration package are linked to it – and not just the pension as might be expected. For example, the maximum annual bonus opportunity might be expressed as 150% of salary. Therefore, any increase in salary will also increase the value of the other parts of the package. Shareholders are therefore particularly sensitive to salary increases. This explains, for example, some of the reaction to the proposed 30% increase in Sir Martin Sorrell's salary at WPP despite the strong profit and share price performance at the company.[19]

Salaries are generally reviewed annually with increases being made where the remuneration committee considers it appropriate. Before 2008, executive director salaries increased steadily at roughly 5% to 10% p.a. However, since 2008, companies have often taken a more conservative approach and have either made increases consistent with that of the wider workforce, or, in many cases, frozen salaries (particularly the case for the 2009/10 reviews). Current salary increases are typically around 1% to 3% p.a.[20]

Short-term incentives

Almost all executives will be eligible for an annual bonus. Performance is measured over a one-year period with the bonus (or part of it) typically being paid in cash roughly three months after the year end. The remainder might be deferred (further details on this practice are set out in the 'bonus deferral' section below).

Companies are free to choose the performance measures that they consider fits best with their overall strategy. Measures are often profit-related, commonly being:

- profit before tax
- profit after tax
- earnings per share
- cashflow

The annual bonus is often based on more than one measure. Severn Trent operates a balanced scorecard approach and uses 18 'key performance indicators' in order to assess the level of bonus[21] (although this is quite an extreme example). Some companies use measures that are specific to their sector and strategy. For example, Vodafone uses customer satisfaction, Rio Tinto looks at safety performance and some industries use very specific measures such as water quality and leakage (Severn Trent).

Total shareholder return and other share price related measures are hardly ever used over this short time-scale.

Some remuneration committees have the discretion to change the level of award if it deems that the formulaic result is not consistent with a qualitative 'bigger-picture' assessment of performance. For example, in 2004 AstraZeneca scaled back the then CEO's bonus because the company had problems with its drug development. This had a negative impact on the share price but shorter-term profitability was not affected. The AstraZeneca remuneration report for that year reads as follows:[22]

19 http://www.guardian.co.uk/business/2012/apr/30/wpp-executive-pay-rise-martin-sorrell

20 Manifest/ MM&K, The Executive Director Total Remuneration Survey May 2011, page 36

21 Severn Trent 2011 annual report, page 47

22 AstraZeneca 2004 annual report, page 61

> *"The Chief Executive was eligible for an annual bonus related solely to the achievement of the targeted performance of earnings per share. The bonus payable was on a scale of 0-100% of salary and 50% of salary was payable for the achievement of target performance.*
>
> *This was derived from the financial targets set by the Board and took into account external expectations of performance. The bonus was not pensionable. In the light of the disappointing setbacks with Exanta and Iressa in 2004, the Remuneration Committee and Sir Tom McKillop agreed a reduction in his bonus. It was agreed that his bonus for 2004 should be reduced to a sum equivalent to 50% of the bonus he received in respect of 2003. This amounts to £430,000 ($782,000). The Remuneration Committee was also mindful in setting the bonus for 2004 that all employees, including Sir Tom McKillop, who had an interest in shares throughout 2004, had seen the value of their shares fall significantly during the year, in common with other shareholders."*

It is not clear that, in this particular case, the remuneration committee did have the ability to unilaterally scale back the award, although it did have some influence in the negotiations with the CEO. However, since then, remuneration committees have increasingly been granted the power to scale back awards in such a way.

Bonus deferral

In order to encourage a longer-term perspective, many companies have been moving toward having a part of the annual bonus deferred in shares, normally for a period of three years. This trend started before the financial crisis started in 2008 and has not been restricted only to the financial services sector. 74% of the FTSE100 and 52% of the FTSE250 have such deferred plans.[23]

Over the last few years there has been a general trend in the FTSE100 towards a more significant annual bonus element (mainly over the period 2005 to 2008, when profits were growing strongly). This has also been accompanied by an increase in the proportion paid in shares, with the long-term deferral of those shares becoming standard. The deferral of those awards has also made such proposals more acceptable to shareholders. The regulations that have been brought in following the financial crisis, especially in relation to pay practice in financial service companies,[24] have helped to cement deferral as a common and generally approved aspect of annual bonus design.

The deferral exposes the executive to subsequent movements in the share price thereby, in theory, aligning their interests with those of shareholders. Obviously this will not always prevent decisions that lead a company to failure, as we saw notably in the case of Lehmans, but it should at least make the executive consider the share price when taking decisions.

Some companies operate 'co-investment' or 'matching' plans. Under these plans, the executive defers in shares a part of the annual bonus (typically about a half) and that deferred part is then eligible for a matching award. Sometimes this deferral is voluntary rather than compulsory, however executives typically do elect to make such a deferral. As an example, a matching award may be described as a '2:1 match', meaning that for a deferral of 100,000 shares the executive may earn a further 200,000 shares after three years, but only as long as the company's performance has met certain criteria. This performance test is often structured in a similar way to that of long-term incentives.

23 Manifest/ MM&K, The Executive Director Total Remuneration Survey May 2011, page 41

24 See Financial Services Remuneration code http://www.fsa.gov.uk/about/what/international/remuneration

As an example, BSkyB has the following description of its 'Co-investment LTIP':

> *"Participants in the plan invest their own money in the Company's shares and then are granted a conditional matching award of Company shares based on the amount they have invested. These matching shares vest at the end of a three-year period, subject to achieving EPS targets. The shares are matched up to a maximum of 1.5 shares for every one share invested on a pre-tax basis. The investment eligible to receive matching shares is limited to an amount equivalent to 50% of a participant's gross annual bonus."*

In our view, bonuses should be linked to clear objectives but with substantial deferral. As we point out in the clawback section in Chapter 6 below we believe 50% of all variable compensation should be deferred over five years with no faster than a straight line vesting. That would mean there would be 150% of the average bonus in the pot of deferred compensation available for clawback. We would also argue that all deferred compensation should be in shares so as to further help align executive and shareholder interests.

Long-term incentives

UK listed companies almost always use equity-based long-term incentive plans (LTIPs). The companies that do not use them are typically run by a founder, who has a significant shareholding. Very few companies settle such awards in cash.

Equity-based plans usually allow for the release of either shares or options after a certain length of time (usually three years) and only after certain performance criteria have been met. This is where most of the complexity of pay comes from. It also makes it difficult to declare one figure for pay since LTIPs payout over time and are subject to performance criteria which by definition cannot at the outset be certain to be met.

The Association of British Insurers (ABI) guidelines have set the framework within which long-term incentives have largely been designed.[25] These guidelines state: "Challenging performance conditions should govern the vesting of awards or the exercise of options under any form of long-term share-based incentive scheme. These should (i) relate to overall corporate performance, (ii) demonstrate the achievement of a level of performance which is demanding in the context of the prospects for the company and the prevailing economic environment in which it operates, (iii) be measured relative to an appropriate defined peer group or other relevant benchmark, and (iv) be disclosed and transparent." Various measures are suitable under these guidelines but items (i), (ii) and (iii) above all indicate the suitability of using total shareholder return as a measure – and many companies use such a measure for part of their LTIP. This measure is explained below.

In the UK there has been a recent trend towards using shares rather than options. This can partly be explained by the change in accounting that took place with the introduction of IFRS accounting[26] which changed how a grant of options to executives was to be treated. "*It requires an entity to reflect in its profit or loss and financial position the effects of share-based payment transactions, including expenses associated with transactions in which share options are granted to employees.*" It made options less attractive from an accounting perspective. Today, options are only granted at a minority of larger listed companies, although their use is more common at the smaller listed

25 ABI guidelines available here: http://www.abi.org.uk/Media/Releases/2005/12/ABI_UPDATES_GUIDELINES_ON_EXECUTIVE_REMUNERATION.aspx

26 INTERNATIONAL FINANCIAL REPORTING STANDARD FEBRUARY 2004 http://ec.europa.eu/internal_market/accounting/docs/arc/ifrs2/ifrs2_en.pdf

companies – e.g. FTSE small cap and AIM. In the latter the objective is often to preserve cashflow making options a more suitable tool.

Companies typically use one or two performance measures in order to determine the level at which awards may vest, i.e. how many shares will be given to the executive at the end of the performance period. As part of a regular long-term incentive, shareholders will not accept the granting of shares without performance conditions. 'Restricted stock' as it is known in the US, i.e. a grant of shares that are subject only to time-vesting, is therefore very rare in the UK.

Some measures are 'market-based' and relate to the company's share price. By far the most common of these is referred to as total shareholder return (TSR). The objective of this measure is to reflect as closely as possible what gain or loss shareholders experience – and therefore the use of TSR goes some way to aligning the financial interests of managers and shareholders. In practical terms, TSR measures the increase in a company's share price over the (typically) three year measurement period, but also accounts for the fact that dividends may have been paid over the period as well. Similarly the impact of rights issues and other capital actions are taken into account. TSR is generally measured on a relative basis and not on an absolute basis (that is not only on the actual performance of the share price). The relative benchmark is normally set in relation to other listed companies in the company's peer group (i.e. those in the same or similar sectors).

As an example, we can take BAT's remuneration policy as set out in its 2011 remuneration report, which is a typical representation of how such policies work.[27] Here the CEO received an award with a face value of 400% of salary. Performance is to be measured over a three year period with the award split into two equal portions with one half measured on TSR and the other on EPS growth (growth in earnings-per-share). The TSR measure is then further split into two halves.

Performance for the first half of the TSR element of the award is measured by comparing the TSR for BAT against the TSR results of the constituents of the FTSE100. If BAT finishes in the top quartile of this comparator group then the 'FTSE100 element' of the award will vest in full. If performance is in the second quartile (i.e. above the median) then the level of award varies continuously with performance down to 6% of the overall award at median position (i.e. 6% of 400% which is 24% of salary). No award vests if performance is below median against these comparators.

The second half of the TSR element of the award is organised in a similar way but instead of measuring performance against the FTSE100 constituents it is measured against the following 25 peer companies: Anheuser-Busch, InBev, Campbell Soup, Carlsberg, Coca-Cola, Colgate-Palmolive, Danone, Diageo, Heineken, HJ Heinz, Imperial Tobacco Group, Japan Tobacco, Johnson & Johnson Kellogg, Kimberly-Clark, Kraft Foods, LVMH, Nestlé, PepsiCo, Pernod Ricard, Philip Morris International, Procter & Gamble, Reckitt Benckiser, SABMiller, Sara Lee and Unilever.

According to BAT "These comparator groups, which are regularly reviewed to ensure that they will remain both relevant and representative, are chosen to reflect the Company's financial and business trading environments." This illustrates that a simple intention of measuring performance against a relevant benchmark, as

27 BAT 2011 Annual Report, page 74

well as incorporating the impact of the prevailing economic environment (as suggested by the ABI guidelines) is not always simple to achieve in practice as it is in theory.

Absolute TSR is not often used because the vesting of awards is seen as being more down to the state of the general economy, and not so much reflective of management's performance. However, RBS had part of the award of its long-term incentive for the 2009 and 2010 grants[28] based on certain share price targets. In this case it was understandable since the major shareholder (the government) had a strong interest in the absolute performance of the shares given its political desire to avoid a loss on its investment.

The other measures are 'non-market based' and are often accounting-based measures of performance. For example growth in earnings-per-share (EPS), return on capital employed (ROCE) and return on equity (ROE) are commonly used. Less common measures include sales growth (as at Unilever), growth in net asset value (as with some non-life insurance companies). More rarely but increasingly non-financial measures are used, for example at BP:

> *"The 2012-2014 share element will vest based equally on the following three performance metrics: (i) total shareholder return versus oil majors, (ii) operating cash flow and (iii) strategic imperatives [which consist of] reserves replacement versus oil majors, process safety and rebuilding trust."*

EPS is almost always measured on an absolute basis, i.e. not with reference to the performance of other companies. The reasons for this are theoretical as well as practical.

It is very hard to find a group of companies for which the level of profit growth should (for the same management performance) be identical to that at the company for which pay is being designed. There also may be practical considerations such as different company year ends, different accounting treatments from company to company and the timing of the publication of results.

The most common way for an EPS performance measure to be expressed is through the use of a compound annual growth rate (CAGR) over three years. As an example, a growth rate of 6% p.a. might be used as the threshold for the initial vesting of part of the LTIP, with full vesting occurring at a CAGR of say 12%. Threshold vesting might mean that 25% of the award vests when the initial target growth rate is met. Following this would typically be a linear increase of the percentage vested in line with EPS growth until the full vesting is reached, in this example at a CAGR of 12%.

As a real example of this we can look at Diageo's 'senior executive share option plan (SESOP) 2008'.[29] *"Options granted under the SESOP 2008 are subject to a performance condition based on compound annual growth in adjusted EPS over a three-year period, with growth targets set by the company's remuneration committee for each grant. For the purpose of the SESOP, an underlying measure of EPS is used to ensure that items such as exceptional items and movements in exchange rates are excluded from year on year comparisons of performance. Options will only vest when stretching adjusted EPS targets are achieved. Vesting is on a pro rata basis currently ranging from a threshold level of 25% to a maximum level of 100%. The remuneration committee reviewed the targets for 2011 SESOP awards and decided to increase their stretch to ensure that they remain aligned with long-term shareholder value creation."*

28 2011 RBS Annual Report, page 285

29 Diageo Annual Report 2011, page 90

For the 2009 award the threshold was 3% p.a. and the level required for maximum vesting was 7%. For the 2010 award, 6% was the requirement for threshold vesting and 10% for maximum vesting.[30]

Alternatively, many EPS growth performance conditions are expressed as being relative to RPI or more often these days, CPI.

We can see an example of this trend at Diageo, and an examination of the option plan previously used (the senior executive share option plan 1999). "*These options were subject to satisfying a performance condition based on adjusted EPS growth relative to RPI over a three-year period.*" The vesting schedule that applied had no vesting for a CAGR of less than RPI+12%, then 50% vesting at a CAGR of RPI+12% and rising up to full vesting at RPI+15%.

For example, if RPI was 3% p.a. over the performance period then a CAGR of 18% was required in order for the award to vest in full.

BAT have what is a relatively complex long-term incentive plan as 50% of the award is based on EPS growth targets, 25% against a UK general comparator group of companies, and the remaining 25% based on a global sector peer group.

Long-term incentive plans are often the most complicated part of the remuneration package. Our preference is for them to be simpler rather than more complicated, with payments to be made in shares rather than options, although exceptions can be made for smaller companies where options can be more appropriate. The duration of an LTIP should be a minimum of five years to better align executive incentives with the economic cycle. Otherwise there is a risk that executives can be paid out merely due to a period of strong economic growth rather than their own skill (at least in terms of the EPS growth). As for bonuses we also argue for a 50% deferral of any payouts over a five year period. At least part of the LTIP will pay out over as long as ten years, again tying the executive into the long-term performance of the company. We also think the BIS recommendation of a scenario analysis showing how much pays out under the LTIP in different scenarios is a good idea.

Clawback is increasingly being introduced as a more formal aspect of a long-term incentive. For example, at BAT "*the new rules increased the maximum annual award under the LTIP scheme from 300 per cent to 400 per cent of annual base salary and also introduced a 'clawback' clause giving the Committee the discretion to reduce (or to forfeit entirely) a participant's unvested award. This would be considered in circumstances where there had been a material misrepresentation involving the participant in connection with a prior vested award.*"[31] Such a clawback scheme, though a step in the right direction, would fall short of the proposals in this report (see Chapter 6) since we would like future failure to trigger clawback, not just a material misrepresentation in the past. Our proposal should trigger both a shift in behaviour, because executives would seek to protect past rewards, but also trigger repayments in the case of future failure.

Pension

Senior executives are almost always in an employer-related pension scheme. Although often closed to new-joiners, many executives are still on 'defined benefit' or 'DB' schemes. For example, these may offer an executive an income stream based on (i) the number of years he or she has worked at the company and (ii) the final salary at retirement. Under these schemes incentives do not

30 Diageo Annual Report 2011, page 91

31 BAT Annual Report 2011, page 74

feature as part of the pension calculation, however, this is seen at some major US companies and so, very occasionally, legacy pension arrangements may remain for US executives at UK companies following the acquisition of a US company.

At British American Tobacco, most executive directors are eligible for membership of the 'Pension Fund'. *"The Pension Fund, for members who joined before 1 April 2005, is a non-contributory defined benefit scheme. The early retirement rules in the Pension Fund permit a member to draw the accrued retirement pension within five years of Fund normal retirement age without actuarial reduction, subject to the employing company's agreement. Alternatively, an Executive Director may choose to leave and take a pension at any time on or after his or her 50th birthday without the employing company's agreement, subject to a reduction as determined by the Pension Fund trustee in conjunction with the Pension Fund actuary. Accrual rates differ according to individual circumstances but do not exceed one-fortieth of pensionable salary for each year of pensionable service. Pensionable pay covers base salary only and therefore bonus awards and the value of benefits in kind are not pensionable."*[32]

At Tesco, the 'career average', not final salary is used: *"the final salary scheme is now closed to new entrants but has been replaced throughout the organisation by a defined-benefit pension scheme based on career average earnings"*[33]

Other companies offer a defined contribution plan, or a salary supplement in-lieu of a pension contribution. This does not provide for a guaranteed income at retirement, but allows the executive to buy an annuity with the fund that he or she accrues over time.

For example, at HSBC, *"Mr Gulliver received [from 1 April 2011] employer contributions of 4% of basic salary into a personal pension plan and an executive allowance of 46% of basic salary. The employer contributions and the executive allowance for the whole of 2011 amounted to £625,000"*[34]

As far as reform of pensions is concerned we think the main reforms should centre around clarity, so that shareholders are aware of what they are paying for. Where companies want to retain an earnings link for pensions we would prefer career average rather than final salary pensions, as is the case in much of the pension reform the government is introducing in the public sector.

Benefits

In the UK, benefits typically represent a very small proportion of pay. If this is not the case, the reasons might be more of a one-off nature, rather than a generous annual entitlement.

For example the former CEO at GKN received a car allowance of £14,000 and other benefits totalling £20,000, of which *"£13,208 [was paid] in respect of holiday cancellation costs in order to take charge personally of the management of events at Hoeganaes, Gallatin following closure of the plant in May 2011."*[35]

Vodafone set out the benefits for executive directors as being:[36]

- Company car or cash allowance worth £19,200 per annum
- Private medical insurance
- Chauffeur services, where appropriate, to assist with their role

The Vodafone CEO received £55,000 during the year to March 2011 and £146,000 for the prior year.[37] According to the footnote in the annual report these payments include "amounts in respect of cost of living allowance, private healthcare and car allowance."

32 ibid, page 84

33 Tesco Annual Report 2011, page 77

34 HSBC Annual Report 2011, page 271

35 GKN Annual Report 2011, page 63

36 Vodafone Annual Report 2011, page 64

37 ibid, page 69

Executive director shareholdings

Executives typically are required to hold shares in the company that they manage. This will generally be a guideline, rather than a contractual obligation, but the remuneration committee may decide not to grant long-term incentive awards if the executive is not seen to be fulfilling this requirement. An executive does not often have to have the full amount at the start of his or her tenure, but is likely to be expected to hold on to awards that vest from the share wards (i.e. not sell them) until the requirement is satisfied.

For example, at BHP Billiton the 2011 report states that:[38] *"the CEO is required to hold BHP Billiton securities with a value at least equal to 300 per cent of (i.e. three times) one year's pre-tax (gross) base salary under the Group's Minimum Shareholding Requirements policy. For other members of the GMC, the minimum requirement is 200 per cent of (i.e. two times) one year's pre-tax (gross) base salary…All of the members of the GMC currently hold sufficient securities to meet these requirements."*

The CEO at BHP has a salary of $2,215,200[39], which corresponds to a shareholding requirement of value of $6.6m or a little over £4m.

We generally think that executives should have large shareholdings in the companies they manage. Our proposals for all deferred compensation to be in shares will ensure a sizeable exposure in any case. This is not a panacea as Lehmans and indeed some of our high profile reward cases, discussed in Chapter 6, show. Large holdings or exposure to the share price will not necessarily deter managers from taking risks. Other mechanisms such as clawback would, we believe, be more effective.

38 BHP Billiton 2011 Annual Report, page 140

39 ibid, page 133

5

Reforming Remuneration Reports

Narrative reporting

Some have argued that directors' remuneration reports (DRR) are difficult to read and information is sometimes missing or hidden. BIS has asked for views on the best way to improve narrative reporting.[40] Our intention in this section is to set out what should be included in a report and in what format in an attempt to ensure as much transparency as possible.

Given that company situations can vary greatly it makes sense not to prescribe too closely what should be written. However, having a more consistent report structure may enable a shareholder, or potential investor, to find relevant information more quickly, as well as making a DRR easier to understand.

There is already quite a substantial set of requirements as to what information the DRR needs to contain. These are set out in Schedule 8 of 'The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008'. It is not the intention of this document to suggest removing any of these sections from the DRR.

The disclosure in the UK is, in comparison with other major markets, both clearer and fuller than most. The US has a similar level of disclosure to that in the UK. The length of reporting is often greater but this does not particularly help shareholders understand arrangements with more clarity. Moreover, there is less consistency in the way the reports are constructed. Set out below is the approximate length of some recent UK remuneration reports taken at random, but matched with a similar sector report from the US. Twelve pages is indeed a typical length of report in the UK for the FTSE 100 (smaller companies typically have a smaller length of report), but it is just chance that these four below are all of that length.

- BP 12 pages, Chevron 42 pages
- ITV 12 pages, News Corp 18 pages
- Barclays 12 pages, Citigroup 40 pages
- Vodafone 12 pages, AT&T Inc 37 pages

As general context, it is probably worth noting that certain sections of the remuneration report (DRR) are always going to consist of 'audited financial information' and are therefore it is not reasonable to expect it to be substantially easier to understand than the profit and loss statement, cashflow statement or balance sheet. There will inevitably be a certain level of knowledge required to understand fully what the report means.

40 This is meant to outline the details of the remuneration policy.

Set out below is a template structure for the review of historical pay arrangements as well as a section on remuneration policy. We have split it into two sections as per the BIS consultation document. The first would cover remuneration policy of the last year. The second then sets out remuneration policy going forward.

A template for directors remuneration reports

Introduction from the chairman of the committee

This section contains the overall comments of the committee chairman. This may be a very short section if the company does not consider it to be particularly necessary. Here there should be comments from the committee regarding the previous vote on the remuneration report setting out the percentage of votes cast 'for'. If this percentage is less than 80%, then the report should also set out the major issues that arose in its discussions with shareholders and how, if at all, the company plans to react to these comments. Given our suggestion that there should be a two strikes proposal with a threshold of 65% the failure to reach this threshold should trigger a much more extensive outline of how remuneration policy is to be changed.

This section should also set out how long the remuneration committee expects it to take a reader to read the narrative sections of the report. This approach is more common in the US on various forms of documentation and can act as a brake on the temptation to make the various disclosures too long.

Figure 6: Remuneration committee activity at prudential 2011

In 2011, the committee met seven times. Key activities at each meeting are shown in the table below:

Meeting	Key activities
February 2011	• Review the requirements of the latest governance guidelines and consultations, including the FSA's revised Remuneration Code • Approve the 2010 Directors' remuneration report; • Consider 2010 annual bonuses and the vesting of 2008 long-term incentive awards.
March 2011 (2 meetings)	• Determine 2010 annual bonuses and the vesting of 2008 long-term incentive awards in light of audited financial results for 2010.
April 2011	• Review of the reward implications of M&G's business model and KPIs; • Approve the performance measures to be used for annual bonuses and long-term incentive awards.
June 2011	• Consider the remuneration of the Group Leadership Team (comprising around 100 senior individuals including the Group Executive Committee), senior risk staff and of employees with a remuneration opportunity over £1 million per annum; • Consider trends in remuneration corporate governance and the competitive landscape; • Review current executive remuneration structures; • Note the dilution levels resulting from the Company's share plans.
September 2011	• Review the structure of remuneration for staff in the Group Risk function; • Monitor performance against long-term incentive targets to the mid year; • Agree the timeline for the review of executive remuneration structure.
December 2011	• Note the level of participation in the Company's all-employee share plans; • Review the requirements of the latest governance guidelines and consultations; • Provide feedback on a number of executive remuneration structure alternatives; • Consider the initial draft 2011 Directors' remuneration report; • Review the salaries and incentive opportunities for executive directors in 2012; • Consider the measures to be used for 2012 annual bonuses; • Approve the shareholding guidelines policy; • Approve the Committee's Terms of Reference and 2012 work plan; • Appoint the independent adviser to the Remuneration Committee.

Source: Prudential 2011 Annual Report

Activities of the remuneration committee

As with the current regulations, this section should set out the 'name [of] each director who was a member of the committee at any time when the committee was considering any such matter' and the name of any person who provided to the committee advice, or services, that materially assisted the committee in their consideration of any such matter and the nature of any other services that that person has provided to the company during the relevant financial year. If other services were provided the report should set out why the committee considers that no conflict of interest has arisen.

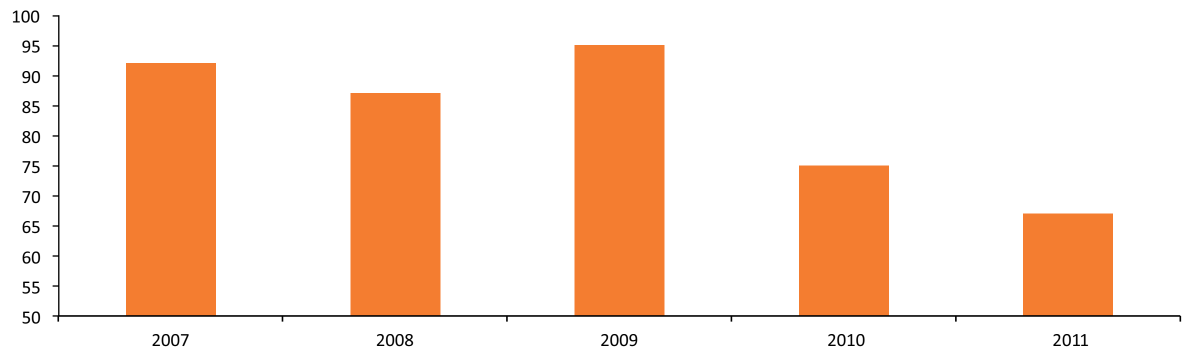
Shareholders should be provided with an overview of the meetings that took place throughout the year and a short description of the matters that were discussed.

As an example Figure 6 shows the table that Prudential uses to set out the RemCo's activities.

Company context

History of AGM voting. Here there should be a figure that has an x-axis that starts at 50% and rises to 100% and, if possible, the last five years' of voting on the DRR. The percentage of votes cast 'for' should be displayed (see Figure 7 below).

Figure 7: A voting template



Source: Policy Exchange

Five-year TSR performance chart, as is currently required.

Any other comment that the remuneration committee wishes to make about the company performance. Specifically this should include any measures of company performance that are used in the calculation of executive remuneration, such as EPS, Return on Capital etc, again over the last five years.

Report on pay for the previous year

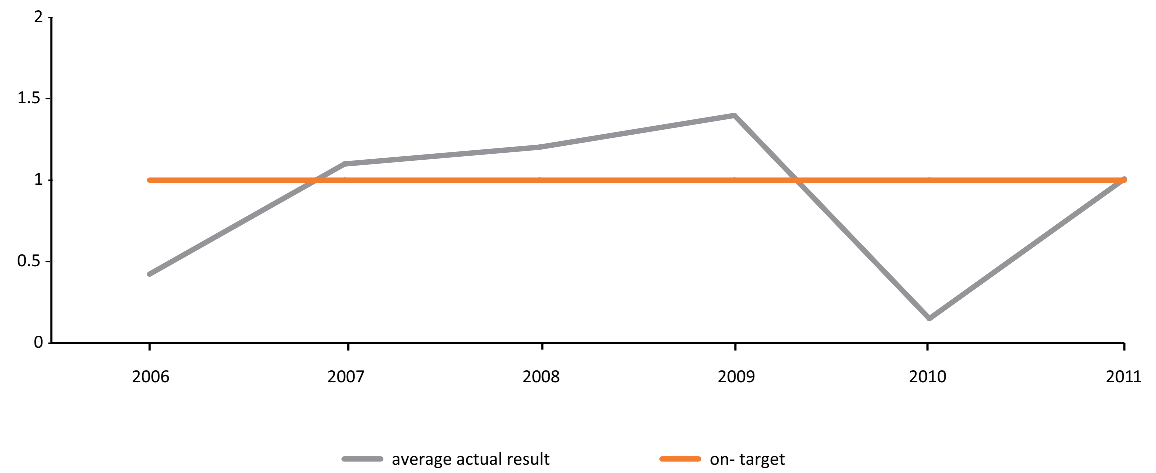
Here there should be, for all the executive directors a section that sets out:

- Last year's salary received
- The total annual bonus awarded
  - The annual bonus that was delivered in cash
  - The annual bonus that was deferred along with details of the deferral process
- The vesting of any long-term incentive plan
- The progress of any outstanding long-term plans as well as any deferred awards
- Total executive directors compensation

We drew up this list prior to the BIS proposals being published and the only addition they have suggested is a single total figure for remuneration, total pension entitlements, shareholdings of directors and exit payments awarded in the year. All seem sensible, with the exception of the single total figure for pay, which we deal with below.

For the annual bonus, the company should set out a graphical illustration that sets out the bonus payments (both the value that is deferred as well as the cash amount) for the last three years as an average for all executive directors. Also on the figure should be the maximum and target payouts. The x-axis should be in pounds (or other currency as appropriate) and not in percentage terms, so it is immediately clear how much has been paid in the way of a bonus, rather than having to refer back to the salary to work it out. This is simply another step towards increasing transparency.

Figure 8: BP annual bonus results



Source: BP Annual Report 2011

BP produces a figure that goes some way towards this disclosure, although here the data is expressed as a percentage of target bonus (Figure 7 from page 146 of the 2011 Annual Report).

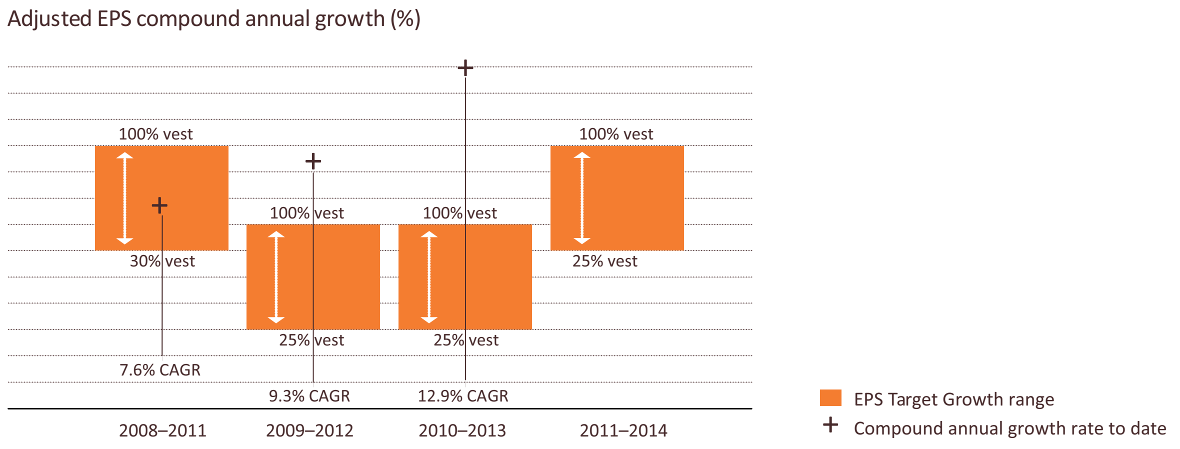
In addition, the metrics for the prior year should be set out along with the actual targets against which performance was assessed. BIS have suggested a figure comparing company performance and CEO pay.

Regarding the long-term incentives, there is currently a gap in what has to be disclosed. Shares that vest are currently disclosed through RNS announcements, but some awards are structured as options (either as nil-cost options, closely replicating a share award or as at-the-money options). These awards may only be announced when actually exercised and this can leave some delay before shareholders gain a clear picture of how executives have been paid (i.e. what value they have received from their incentive plans).

In order to improve this situation, the company should set out in the DRR the vesting levels of any long-term incentive as well as a value (in pound terms, or equivalent) of those awards at the date of vesting. Any options that were granted with an exercise price above nil-cost or par-value can be valued simply using an appropriate options valuation tool. The assumptions used to value the award should also be set out.

As with the annual bonus, the vesting of the long-term incentive should be detailed. The figure below sets out clearly how performance has been in comparison with the targets under all outstanding awards for Diageo plc. Other companies should follow this example.

Figure 9: Performance vs targets from Diageo annual report 2011



Source: Diageo 2011 Annual Report, page 91:

Single figure for pay

It is very hard to put a single figure on the pay that an executive receives. Pay is comprised of several different elements, each with different ways of being valued. It could, for example, be an expected value of what is granted, but there are many technical difficulties with this and more importantly, it is unlikely to be well understood by many observers. If a single figure of pay is to be produced then the most robust figure would be to set out what was received in the last financial year relating to that financial year. We would exclude long-term incentive payments from this because they can reflect a succession of previous years' performance. On top of this, any accrual under a defined benefit scheme becomes hard to value well.

Our suggestion would be to have the single figure as the sum of (i) the salary paid in the prior year, (ii) the annual bonus paid in cash, (iii) the annual bonus that is subject to deferral, and (iv) the value of any benefits received. There are still timing issues with these disclosures though. The annual bonus might be earned over a financial year, say, January to December, but paid in the following year (as it takes time to measure and then compare actual performance against the targets). Where possible, the single figure should align an annual bonus with the year in which it is earned.

Long-term incentive payments would be declared separately, with an explanation on how they were arrived at and over what period they relate to. Those payments can then be compared to the period in question. At the moment Manifest, for example, include realised LTIP payments in their calculation of executive pay in any one year. If not interpreted correctly, this can prompt misleading conclusions when pay for that year is compared to either profitability or the performance of the share price of a company.

The pension disclosure should be maintained as it is and not included in the 'single figure' as often too many assumptions are involved to give a number that can be comparable across years and companies. BIS have accepted that this needs to be disclosed separately.

Non Executive Director fees during year

This section sets out the fees paid during the year to Non Executive Directors (NEDs) and what roles they performed.

Other matters that the remuneration committee considers that shareholders would be interested in knowing about

This section is a new idea and important one. It should be designed to capture material matters that might fall outside of any required list of information. Regulations over disclosure can never capture everything, and this gives the remuneration committee the space to air any unusual arrangements that might be in place. For example, the increase to the number of years of service that Fred Goodwin received to his pension in 2003[41] – and that was not disclosed at the time – could and should have been discussed in such a section had it been in place.[42] Although the information might still not come to light under this heading, we would hope it would place pressure on the remuneration committee to avoid setting up pay arrangements that can avoid shareholder scrutiny.

All of the suggestions above are about increasing transparency to give shareholders more information on which they can make a judgement about whether remuneration is reasonable or not. If all companies were to follow such a template it would not only make comparison easier but also mean shareholders (and other interested parties) would more easily be able to find key information.

Remuneration policy

This section would cover the remuneration policy going forward and this is generally where issues will arise about changes to pay and objectives, so it is crucial that it is both comprehensive and transparent. There are already many requirements regarding policy as to what the DRR should set out and below we outline how we would supplement them.

The report "*must contain a statement of the company's policy on directors' remuneration for the following financial year and for financial years subsequent to that.*"[43]

The pay policy should set out the current level of salary and its previous figure as well as when it was last changed (if applicable). Ideally, those parts of pay that are linked to an increase in salary (e.g. annual bonus maximum opportunity) should also be listed here in the event that a pay increase is proposed. Any proposal to increase salaries would have to outline why this decision was taken and how it can be justified in terms of the performance of the company. BIS propose that a table should set out key elements of pay and how it supports the achievement of the company's strategy. It should also contain the maximum potential value and performance metrics. All of this seems very sensible.

For the annual bonus, the policy should be set out. Normally it should state what objectives need to be met in order to trigger the bonus and what the payout would be. The payout is normally expressed in terms of percentage of salary. We believe a scenario analysis should be presented of the possible payouts, including what proportion is likely to be paid in cash versus shares. Deferral policy should also be stated. As we note in the clawback section in the next chapter we would expect 50% of all variable compensation to be paid in shares and deferred for up to five years. Vesting procedures should also be explained. We advocate vesting to be no faster than liner over those five years.

For the long-term incentives, there is already a requirement to make detailed disclosures. It is already the situation that the DRR must include, for each director, a "*detailed summary*" of any performance conditions of any equity awards as well as an "*explanation as to why any such performance conditions were chosen*".

Also required are "*a summary of the methods to be used in assessing whether any such performance conditions are met and an explanation as to why those methods were chosen*" and "*if any such performance condition involves any comparison with factors external to the company:*

(i) a summary of the factors to be used in making each such comparison, and

(ii) if any of the factors relates to the performance of another company, of two or more other companies or of an index on which the securities of a company or companies are listed, the identity of that company, of each of those companies or of the index".

41 Pollock, I. 'Sir Fred's fantastic expanding pension', BBC News, 18 March 2009.http://news.bbc.co.uk/1/hi/business/7949929.stm

42 See Chapter 6 for more details of this pension award.

43 http://www.legislation.gov.uk/uksi/2008/410/schedule/8/made

Regarding bonuses we would expect a scenario analysis to be carried out with possible payouts shown. Deferral and vesting policies should also be disclosed. As per above we favour 50% deferral, over five years, with no faster than straight line vesting.

The company already needs to have a policy statement that summarises, and explains, the policy on the duration of contracts with directors, and the notice periods, and termination payments, under such contracts. In addition to this it might be helpful to shareholders to understand, with an example, what payments will be triggered in the case of an executive leaving the company. US companies have a section in the DEF 14A filing that sets out 'potential payments on termination'. For example, IBM demonstrates the payments that would be made under 'termination' (e.g. resignation, retirement and involuntary termination not for cause) and 'for cause'.[44] BIS propose that the principles on exit payments are to be disclosed and whether the company will distinguish between types of leaver and how performance will be taken into account. So this is very similar to the US requirements and we would support such an idea.

Non Executive Director pay policy

Policy on NED fees should be set out here, including – if applicable – the structure for additional fees for committee membership, committee chairmanship and travel.

Anything else that shareholders should be made aware of

Again, this section may well help to make shareholders aware of any potential expenses ahead. For example, the tax bill that Barclays paid for Bob Diamond should have appeared in this section (were it to have been in place at the time).[45] This may encourage the committee not to take unpopular decisions that come to light later, and make shareholders aware of material future liabilities.

44 IBM 2011 DEF 14A filing, page 63

45 'Barclays' Bob Diamond tax-bill controversy just won't go away' Guardian, April 2012 http://www.guardian.co.uk/business/blog/2012/apr/16/barclays-bob-diamond-tax-bill-iss

6

Ending Rewards for Failure – Clawbacks not Caps

In this chapter we look at the issue of rewards for failure and how to prevent them. Our contention is that 'clawbacks' are the best way not only to prevent rewards for failure but also to change behaviour to make failure less likely. We think that the BIS proposals for implementing an 'exit cap' were clumsy and not particularly effective[46] and are pleased that they have been dropped. For example, these exit caps would likely not have impacted on the departing Aviva CEO because his was an agreed resignation rather than a termination of contract. As a result he departed with a severance package of £1.75m. Given that it is widely acknowledged that there had been failure at Aviva, it is likely that a good part of Mr Moss's past compensation would have been subject to clawback under our proposals. In such a circumstance it is likely that he would have received much less, possibly nothing at all. In cases such as Sir Fred Goodwin's it is entirely plausible that a well constructed clawback clause would have left him having his deferred compensation paid back to RBS shareholders.

We will outline how such a clawback clause could work and why it would be more effective than the exit cap originally proposed by BIS. We then look at four historic controversial remuneration cases – RBS, Thomas Cook, Punch Taverns, and Cable & Wireless – and examine how the proposals contained in this document would have changed the payments made to the executives in question. We would argue that had clawback been in place it may well have changed behaviour too although clearly that is hard to prove.

Clawback – How it could work

The government asked in their consultation document whether every company should have a clawback provision as part of their remuneration policy. Our answer to that is unequivocally yes. Structured correctly, we believe that it can avoid rewards for failure and act as a deterrent from risky behaviour that we see exhibited in some of the rewards for failure examples that follow. However, there are clawbacks and clawbacks. Although more companies have been introducing clawbacks (such as BAT, see page 26), in most cases they require a major failing of the executive in question, for example gross negligence or material misrepresentation. This can be hard to prove and potentially means the company and their executives ending up in court.

Clawback is already in use in the financial services industry, care of the FSA's remuneration code. This states that:

46 The BIS proposal was to cap any exit payment at one year's salary and that this would be incorporated into all directors' contracts. Any payout in excess of this would have to be approved by a vote at the AGM.

A firm should reduce unvested deferred variable remuneration when, as a minimum:

a. there is reasonable evidence of employee misbehaviour or material error; or
b. the firm or the relevant business unit suffers a material downturn in performance; or
c. the firm or the relevant business unit suffers a material failure of risk management.[47]

This clawback is meant to be applicable to deferred variable compensation. That deferral is generally a minimum of 40% of that variable compensation, which is deferred over a period of three to five years and vests no faster than a pro rata basis.

We believe this is a reasonable starting point for clawback, particularly b) and c) where (in the case of executives) the company suffered a material downturn in performance or there was a material failure in risk management. However, if the reasons for clawback were left as general as this for executive pay too much discretion would remain in the hands of the remuneration committee. As we see in the Thomas Cook example below, remuneration committees can be too generous in their interpretations of one off events and give the executives the benefit of the doubt. Equally in the event of someone resigning or being fired that could lead to lengthy legal wrangling.

Our preference is for clawback to be more automatic. Indeed, we would like to see it structured to be a partial mirror of the Long-term Incentive Plan. In a LTIP targets are generally set and then rewards paid out according to how well those targets are met. We would like to see remuneration committees setting downside conditions, which if breached would trigger clawbacks dependent on the extent of the breach. Like LTIPs we would like to see a number of downside conditions set and the clawback dependent on which ones were breached. In the event that all the downside conditions were breached to the maximum extent (which would likely represent corporate failure) we would expect 100% clawback of all deferred compensation.

The type of quantitative targets we are thinking of would be:

- underperformance in terms of total shareholder return
- a fall in the absolute share price beyond a certain level
- a fall in the EPS of more than a certain amount
- a rise in the credit spread of the company's debt beyond a certain level
- or a breach of maximum gearing ratios.

These downside conditions would be set so that, if breached, it would be clear that the company and its management had failed in some way. We are not arguing, for example, that they should be symmetric with the upside LTIP targets. These are normally set so as to be obtainable, albeit with good performance. Downside conditions should be set so that they can only really be breached in the event of failure. Let us consider two examples. First a total shareholder return target. This might be to perform above median for the peer group in an LTIP, but for clawback the downside condition might be to underperform the peer group markedly, say 25%. Second a target for the

47 http://media.fsahandbook.info section 19A.3.52

growth in earnings. For an LTIP his might be to grow EPS at an annualised rate of 10% over a number of years, but the downside condition might be a, more dramatic, 33% drop from the starting point. Similar to targets for LTIPs we would argue that the clawback conditions should not be triggered immediately when breached but only if the breach continues over a period of time. Nevertheless, given that they are meant to highlight failure we would suggest that the period of time should be shorter, for example two years rather than the five years we are suggesting for LTIPs.

Clearly these would vary by firm and would need to be set by the remuneration committee, but we would strongly recommend such quantitative targets with automatic clawback. Shareholders should be given the opportunity to overrule the automatic clawback, on the recommendation of the remuneration committee, but it would have to be via a majority vote at an AGM. That would allow for exceptional circumstances, for example in the case of a natural disaster. However, it would be the reverse of the current situation where the remuneration committee can decide to amend or waive something and shareholders can only vote down the entire remuneration report.

One of the questions that has been raised about clawback is – how can you make sure it can work? In particular, the legal issue has been raised about clawing back money already paid. There is a precedent for this in the financial services industry, where clawback has been exercised on a number of occasions over deferred pay. Lloyds, HSBC, UBS and now JP Morgan have all exercised or are exercising clawbacks. The FSA rules, referred to earlier, call for a minimum of 40% to be deferred over three to five years with vesting no faster than straight line. For executive pay we would propose a minimum 50% deferral over five years, with no faster than straight line vesting[48] and we would apply this to both bonus and LTIP payments. As a result, at any one point in time there would be 150% of the average bonus or LTIP payout at risk. That would provide a considerable pool for clawback, bearing in mind that LTIP and bonus payouts are based on percentages of salary in their payouts. Given that we are proposing that the length of time over which an LTIP is calculated is extended to five years, that would make at least part of the LTIP payment relevant over a ten year period.

We support such a system for three reasons:

- First, it provides a degree of symmetry in executive pay, if you succeed you get paid well, but if you subsequently fail you stand to lose money. This, we feel, is a way of addressing the principal agent problem identified by so many in the field, where the agent only benefits from the upside but the principal (in this case the shareholder) takes almost all of the downside.
- Second, because it does alter the principal agent trade off it should alter executive behaviour. It is clear in some of the high profile remuneration cases that we highlight below, that executives have taken risks with the company in order to meet EPS or other targets that have or could have subsequently triggered payouts. If they had felt that they were putting past gains at risk by doing so then it may have changed their behaviour. Some of the conditions we have suggested, such as maximum gearing levels may have actually prevented such risk taking even if the psychology had not worked.
- Third, it does address rewards for failure. Even were an executive be due to

48 Which means that if 50% of an award was deferred then the fastest it could be paid out would be in five equal payments over five years.

be paid out more than a year's salary on termination that could easily be overwhelmed by the clawbacks.

We also believe that it would incentivise senior executives to question the strategy of a CEO more often, because they would have more to lose. It is often the case that strong CEOs, like Fred Goodwin, have driven decisions through with little opposition from fellow executives. This no doubt reflects the CEOs' influence over other executives' compensation and career path. Previously therefore there would be little upside from challenging a CEO, now at least there would be downside to not challenging a CEO.

The point that clawback could overwhelm any contractual payout on exit is important because the government have proposed a cap of one year's salary on exit payments for executives. We believe such a cap is cumbersome and difficult to implement since companies and executives might agree a resignation with a higher payment rather than a termination. It is also arbitrary taking no account of the degree of underperformance of the executive in question.

A properly drawn up clawback scheme would ensure that the greater the underperformance the more the executive would have to pay back. Indeed, given that we are proposing a 50% deferral over five years, a 150% of average bonus and LTIP would be available for clawback. That is likely in most circumstances to outweigh any legally due compensation from the contract. So we would finally have a system where a future Fred Goodwin would have to pay shareholders back, rather than leave with a payoff.

High profile remuneration cases

Case 1 – Royal Bank of Scotland Group

The Royal Bank of Scotland Group and Fred Goodwin's role in it is probably the most well known of the rewards for failure cases. Although Mr Goodwin undoubtedly experienced some losses care of the collapse of RBS through his share ownership, he walked away with a significant pension and the bulk of his previous bonuses intact. The corporate governance at RBS left a lot to be desired and is an important case study to consider in detail.

According to an FSA report the failure of RBS can be explained by a combination of six factors:[49]

- significant weaknesses in RBS's capital position
- over-reliance on risky short-term wholesale funding
- concerns and uncertainties about RBS's underlying asset quality
- substantial losses in credit trading activities, which eroded market confidence
- the ABN AMRO acquisition, on which RBS proceeded without appropriate heed to the risks involved and with inadequate due diligence
- an overall systemic crisis.

The report goes on to state that *"the immediate cause of RBS's failure was a liquidity run. But concerns about the firm's capital adequacy (as well as about capital adequacy across the banking system) were crucial to its failure."*

49 The failure of the Royal Bank of Scotland - FSA Board Report

Fred Goodwin – remuneration history at RBS

Fred Goodwin was appointed to the board on 1st August 1998 on taking up his appointment as deputy group chief executive. He joined RBS from National Australia Group, where he had been chief executive of Clydesdale and Yorkshire Banks.[50] At that time his service agreement was terminable on 24 months' notice by the Bank, reducing to 12 months' notice on 1st August 1999, and on six months' notice by Fred Goodwin.[51] He received a paymentof £90,000 on the commencement of his employment on 1st August 1998.[52]

Following the acquisition of NatWest by RBS, Mr Goodwin was appointed Group Chief Executiveon 6 March 2000.[53] Special bonuses were awarded to the executive directors of the company in recognition of their contributions to this successful acquisition.[54] Mr Goodwin received £814,000 in addition to his annual bonus award.[55] This transactional bonus was worth around 140% of his salary (which for the 2000 financial year was £582,000).

Shareholders are now quite resistant to transaction bonuses. It is likely that a similar action today of this magnitude would probably mean a failure of the DRR vote. The ABI guidelines state that: "Shareholders are not supportive of the practice of paying transaction related bonuses".[56]

On 24 March 2003, RBS wrote to Fred Goodwin setting out details of his pension benefits.[57] The letter to Fred Goodwin explained that his pension benefits would be calculated according to the rules of the RBS Group Pension Fund with two key modifications:

- benefits would be calculated ignoring the effect of the "earnings cap"
- benefits would be calculated assuming a notional start date of his 20th birthday

It is quite normal for earnings caps to be ignored as they are very low compared to CEO salaries and so various instruments are used to provide pension benefits outside of this: UURBS, FURBS etc. However, the second point is very serious. This gave Mr Goodwin a huge increase in the value of his pension. To do so and then to not disclose the details represents terrible corporate governance.

In 2006, particularly large annual bonuses were paid. The payment made to Fred Goodwin was at 110% of the normal maximum and *"reflected the outstanding performance achieved by Corporate Markets and the Group overall respectively and were within the exceptional maximum level."*[58] This bonus was delivered in cash and made the total short-term incentive worth £2,760,000[59] which was equivalent to c.230% of salary.

According to the 2006 Annual Report: *"For the Group Chief Executive, the annual incentive is primarily based on specific Group financial performance measures such as operating profit, earnings per share growth and return on equity. The remainder of the Group Chief Executive's annual incentive is based on a range of non-financial measures which may include measures relating to shareholders, customers and staff."*

Again in 2007 a further significant annual bonus was awarded as *"Group operating profit targets were met in full notwithstanding the impact of challenging credit market conditions in the second half of the year, and customer and employee satisfaction scores showed improvement in line with or above expectations. Financial performance in most divisions exceeded target. As a result, the Remuneration Committee proposed and the*

50 RBS Group 1998 Annual Report

51 ibid

52 ibid

53 RBS Group 2000 Annual Report

54 ibid

55 ibid

56 page 10, ABI Principles of Remuneration; September 2011

57 House of Commons Treasury Committee, Ninth Report of Session 2008–09; Banking Crisis: reforming corporate governance and pay in the City p.39

58 RBS Group Annual Report 2006

59 ibid

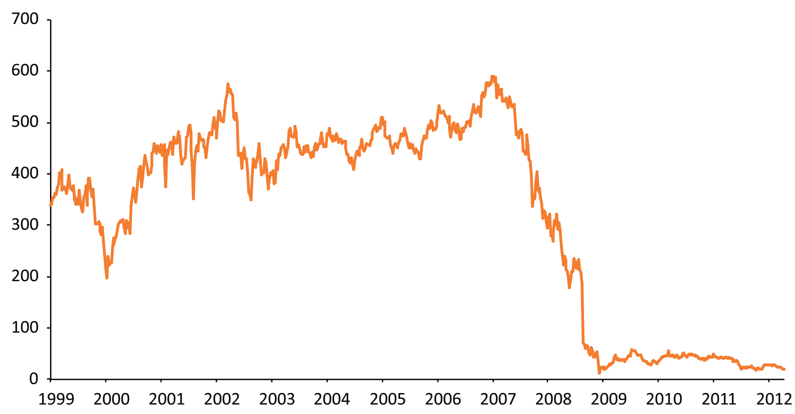
Board (excluding executive directors) agreed annual incentive payments of up to 112.5% of normal maximum levels. Levels of incentive payments to executive directors covered a wide range, reflecting variations in divisional performance."[60] Again, this bonus was delivered in cash and made the total short-term incentive worth £2,860,000 which was equivalent to c.220% of salary.[61]

So in both 2006 and 2007 Fred Goodwin was awarded significant annual bonuses which had no long-term performance link. Given that the risks were not understood, (or were ignored) these rewards were granted just before a catastrophic failure. Given the reward was granted in cash and with no deferral, there was no risk for Mr Goodwin (or Sir Fred as he was then) that he would lose that money should his decisions turn out to be bad ones, as indeed they did.

Throughout this time the company was making annual grants under its long-term incentive plans to executives.[62] Unlike the bonus these long-term incentives were in the form of share options and share or share equivalent awards. The executive share option scheme was approved by shareholders in January 1999. Under this scheme, each executive director was eligible for the annual grant of an option over shares at the market value at date of grant. These executive share options were subject to an EPS performance target measured over a three-year period.

The share plan was called the medium-term performance plan and it was approved by shareholders in April 2001. Each executive director was eligible for an annual award under the plan in the form of share or share equivalent awards. Awards under this plan were subject to three-year performance targets based on EPS growth and relative TSR performance. The chief executive received awards of options with a face value of around £900,000 in 2003 and then in the following years (approximately), £2.5m, £2.8m, £3m and finally £3.9m in 2007. However, none of these options were actually exercised and so no value was received from them. The options all lapsed by the end of January 2010.[63] They expired worthless because the share price collapsed to below the exercise price but the incentive effect was biased to increasing the share price. Mr Goodwin's tried and tested way of doing this (up until 2007) was to grow the business, either organically or by merger. This led to an overstretch of RBS and played a part in its subsequent demise, as noted by the FSA report.

Figure 10: RBS share price (pence)



Source: Bloomberg

60 RBS Group Annual Report 2007

61 ibid

62 RBS Group Annual Report 2004, page 125

63 RBS Group Annual Report 2008, p 165

The PSP awards yielded little in the way of value as well. An award of around 100% of salary was awarded in 2002 and then awards of around 150% of salary were granted in 2003, 2004, 2005, 2006 and 2007, and finally around 175% of salary was granted in 2008. The 2002 award partially vested (at c.76%), but the following awards all lapsed as the performance condition was not met.

Therefore, over a period of several years, the LTIP yielded a value of (only) around £600,000 for the chief executive. Furthermore, these shares may have been kept up to and through the crash in the share price, reducing the value received. The other directors that participated in the same incentive plans also received no value from the 2003 grant onwards.

Regarding his pension, Fred Goodwin elected to exchange some £186,979 a year of his pension for a lump sum of £2,781,317. Such a lump sum in his case would not be tax-free. So in 2007 RBS agreed to pay the tax due on any lump sum which Sir Fred elected to take as part of his pension. This was not disclosed to shareholders at the time.[64]

To gross-up in this way is a very bad use of shareholders' funds. Had this been disclosed, we suspect that it would have met significant opposition from shareholders. It is one of the reasons we want a disclosure clause to be introduced at the end of every Remuneration Report.

Fred Goodwin's exit package

On Sunday 12th October the RBS Remuneration Committee agreed that Fred should be given 12 months' notice and that he was to be on "garden leave" for this period. He was to be offered the option of an immediate undiscounted pension.[65]

The following day the directors agreed that Fred Goodwin should step down as Chief Executive and resign from the board. The Remuneration Committee's arrangements of the previous day were approved. Later, RBS wrote to Fred confirming that his retirement would be treated as "retirement at the request of the employer" and that therefore no reduction would be made for early retirement. This, according to RBS, was "consistent with RBS's usual practices."[66]

Fred Goodwin's employment with the company ended on 31 January 2009. According to RBS, *"under the terms of the agreement reached in October 2008, he waived any payment in lieu of notice and his rights in respect of unvested executive share options and unvested awards under the Medium-term Performance Plan lapsed. He [did] not receive a short-term incentive payment for the financial year ended 31 December 2008."*[67]

At the end of 2007 Fred Goodwin had a beneficial interest in 2.5m shares which were valued at c. £5.7m at that time. The share price dropped significantly after this time, having a corresponding impact on the value of his shareholding.

Fred Goodwin's pension transfer value increased from £8.3m to £16.6m during 2008.[68] According to the annual report he was *"contractually entitled to an immediate pension based on [his] accrued service, including any service transferred in, with no discount for early payment."*[69]

Had Mr Goodwin been dismissed by RBS, rather than asked to resign the terms of his pension entitlement would have been less generous. He would have received a deferred pension payable at age 60 or at an earlier age but subject to actuarial reduction.[70]

The value of Mr Goodwin's pension was £703,000 p.a. as at 31 January 2009. The approximate value of a deferred pension payable now would be £416,000 per annum.[71]

64 House of Commons Treasury Committee, Ninth Report of Session 2008–09; Banking Crisis: reforming corporate governance and pay in the City p.41

65 ibid, p 42

66 ibid, p 43

67 RBS Group Annual Report 2008, p 161

68 ibid, p 168

69 ibid

70 House of Commons Treasury Committee, Ninth Report of Session 2008–09; Banking Crisis: reforming corporate governance and pay in the City p.44

71 ibid

Later, under heavy political pressure, Fred Goodwin volunteered to make a reduction to his pension to the level of £342,500 a year.[72]

The lessons

There were huge corporate governance errors at RBS relating to Fred Goodwin's compensation. The addition of 20 years service to his pension and agreeing to pay the tax on a lump sum for forgoing part of his pension, both without disclosing to shareholders at the time, are two serious breaches of good corporate governance. Also paying bonuses entirely in cash with no deferral, limited the ability to clawback remuneration from any decisions that subsequently turned out to be poor ones. This, of course, was the case as decisions over strategy in many areas subsequently proved to be poor or in the case of the RBS acquisition of ABN Amro disastrous.

Our proposal that there should be a catch all clause at the end of every Remuneration Report where the board would have to declare anything else that shareholders should be aware of would have captured both of the questionable pension events. We strongly suspect that, had the board been forced, or at the very least strongly encouraged, to disclose them, they would either have been less generous or would not have happened at all. Similarly, under our proposals for clawback a portion of all bonuses would have to be paid in shares and deferred for a number of years. In so doing, much more of Fred Goodwin's bonus would have been vulnerable to clawback in the event of failure. As it was, the deferred compensation would have collapsed in value care of the fall in share price.

Case 2 – Thomas Cook

In 2007 Thomas Cook became part of Thomas Cook Group plc which was formed on June 19th 2007 by the merger of Thomas Cook AG and MyTravel Group plc.[73] Manny Fontenla-Novoa took the position of chief executive in 2003[74] and held that position until termination of his employment in November 2011.[75].

Following the merger, the chief executive was made a participant in the "Secured Synergies Bonus Plan".[76] Under this plan *"incentive arrangements [were] put in place to secure merger related synergies"* with the objective of securing significant value for shareholders. During the first six months of 2008 the original targets were met and so *"the Committee considered it appropriate to develop a new bespoke incentive arrangement to incentivise further synergies in excess of the £136m (€200m) already secured."*

These new targets were also met and *"the Committee was satisfied that the exceptional performance and personal effort of the senior executives involved warranted payment of the maximum bonus under the Plan. Accordingly, a payment of £5m was made to the Chief Executive Officer"*. The award appears to have been made in cash and without any deferral period.

A short while later, signs of trouble became apparent. In August 2010, the Chief Executive, Manny Fontenla-Novoa told investors,[77] *"As we enter the final quarter, it is apparent that trading in the UK business is softer than expected… As a result, we now anticipate underlying operating profits for the full year (excluding the impact of the volcanic ash cloud) to be at the lower end of market expectations."*

In the following month the company issued a profit warning.[78] The troubles of the volcanic ash cloud emanating from Iceland and the civil unrest in northern Africa had

72 RBS Group Annual Report 2009, p 227

73 http://www.thomascook.com/about-us/thomas-cook-history/key-dates/

74 http://www.independent.co.uk/news/people/profiles/manny-fontenlanovoa-the-bloke-from-spain-who-wants-you-to-take-two-weeks-in-torremolinos-469500.html

75 Thomas Cook annual report 2011, page 60

76 Thomas Cook annual report 2011, page 61

77 Thomas Cook Group plcInterim Management Statement (http://www.thomascookgroup.com/news-item?item=471817189859685)

78 The Guardian (http://www.guardian.co.uk/business/2010/sep/28/thomas-cook-viewpoint)

urther affected profitability.[79] These problems continued through 2011, with a series of profit warnings, eventually resulting in the resignation of Mr Fontenla-Novoa in early August of 2011[80] and the company had to enter talks with its banks in November 2011 to enable it to continue trading. At that point the share price collapsed by 50% in just one day.[81]

While the problems at Thomas Cook were exacerbated by a number of one off factors the company, and hence its executives, made a number of strategic errors which created problems. In particular it underestimated the threat from budget airlines to its charter flight model. It also was slow to understand the impact of the internet in changing the type of holidays that people wanted to book. The fact that a number of its key competitors continued to perform satisfactorily during this period tends to support the view that poor strategy rather than industry wide issues caused the problems at Thomas Cook.[82]

Remuneration details

According to the merger prospectus, Manny Fontenla-Novoa earned a salary of £630,000 at the time of listing.[83] According to the same document "Mr Fontenla-Novoa's salary will be reviewed by the Management Development and Remuneration Committee in January 2009 and, thereafter, on an annual basis".[84]

In December 2008 the committee stated that a *"review was undertaken throughout the year with the Committee determining at its September 2008 meeting that his base salary should be increased in recognition of his operational and strategic achievements"*.[85] The reasons for the increased salary included *"organising a Group-wide flexible action plan to address the uncertainties and challenges that may arise from the developing economic climate"*.[86] The new salary level from 30th September 2008 was £850,000, representing a 35% increase. The salary remained at this level until his departure.[8788]

The annual bonus plan was structured such that the chief executive was eligible for an annual bonus payment of 175% of salary.[89] From 2008, the part of any bonus that was above 100% of salary had to be deferred in company shares, but each share was then eligible for a matching award of a further 3.5 shares depending on the EPS growth and strength in the ROIC over a three year period.[90]

For the financial year ending in 2008, *"the Committee considered that the financial stretch targets and the individual and other non-financial criteria had been met in full"*.[91] The following year *"the Committee took into account financial and overall business and personal performance and awarded [the] Group Chief Executive Officer, a total bonus of 96% of the maximum"*.[92]

In August 2010, the chief executive issued a profit warning stating that: *"we now anticipate underlying operating profits for the full year (excluding the impact of the volcanic ash cloud) to be at the lower end of market expectations."*[93]

Although the 2010 annual bonus was linked to *"the attainment of Group financial targets, quarterly Group cumulative free cash flow targets and individual and other non-financial criteria"*,[94] the committee awarded all the executive directors 80% of the maximum bonus.

Two further profit warnings were made in 2011[95] citing political unrest in certain destinations and a weaker UK economy as influences on the company's operations.[96] In response, the chief executive announced a strategic review of the UK division.[97]

79 Thomas Cook Group plc Interim Management Statement, February 2011

80 Guardian, 3rd August 2011, "Thomas Cook chief executive resigns" (http://www.guardian.co.uk/business/2011/aug/03/thomas-cook-chief-executive-resigns)

81 http://www.guardian.co.uk/business/2011/nov/22/thomas-cook-shares-halve-bank-talks

82 http://www.globalholidays.co.uk/blog/?p=4898

83 Thomas Cook Merger Prospectus, page 468

84 ibid

85 Thomas Cook annual report 2008, page 60

86 Thomas Cook annual report 2008, page 60

87 Thomas Cook annual report 2009, page 55

88 Thomas Cook annual report 2010, page 61

89 Thomas Cook annual report 2007, page 58

90 Thomas Cook annual report 2008, page 61

91 Thomas Cook annual report 2008, page 60

92 Thomas Cook annual report 2009, page 55

93 Thomas Cook Group plc, Interim Management Statement, 11th August 2010 (http://www.thomascookgroup.com/news-item?item=471817189859685)

94 Thomas Cook annual report 2010, page 61

95 Independent, 12th July 2011, "Thomas Cook in third profit warning", (http://www.independent.co.uk/travel/news-and-advice/thomas-cook-in-third-profit-warning-2312348.html)

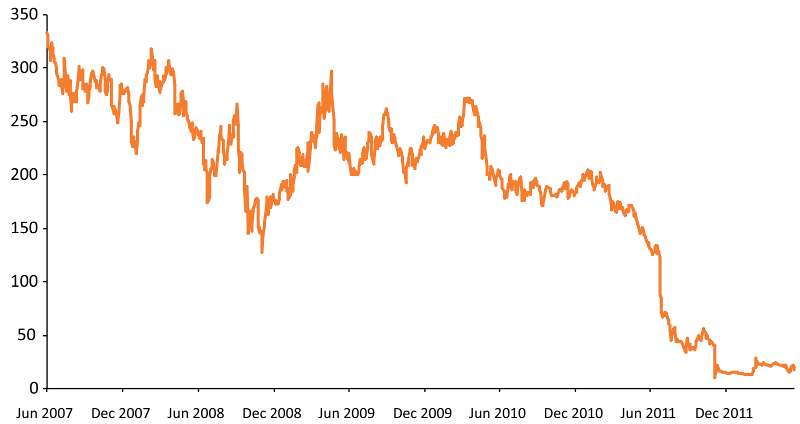
96 http://www.guardian.co.uk/business/2011/jul/12/thomas-cook-profit-warning-middle-east-unrest

97 Guardian, 12th July 2011, "Thomas Cook blames profit warning on Middle East unrest and weak UK economy" (http://www.guardian.co.uk/business/2011/jul/12/thomas-cook-profit-warning-middle-east-unrest)

No bonus was paid to any of the executive directors for performance in 2011.[98]

The chief executive resigned in early August of 2011.[99] In summary, during 2011, Thomas Cook's share price dropped 91 per cent, whilst making a pre-tax loss of £398m, and writing down £430m.[100]

Figure 11: Thomas Cook share price (pence)



Source: Bloomberg

The long-term incentives plans partially vested despite the declining company performance in 2010. According to disclosures made in the 2010 remuneration report, the remuneration committee used its discretion to adjust the level of award that would otherwise have vested regarding the grants made in 2007.

The plan, approved by the board prior to listing, involved the annual granting of awards of "*shares having a face value at the date of grant of up to 200 per cent of the individual's base salary. Awards will vest after three years providing the participant is still employed by a company in the Group and to the extent that the performance conditions have been met.*"[101] However, the 2007 merger prospectus also states that *"if an event occurs which causes the Management Development and Remuneration Committee to consider that an amended target would be a fairer measure of performance and not materially less difficult to satisfy, the performance targets may be amended."*[102]

The performance conditions were based on EPS growth and relative TSR performance targets.

In relation to the 2007 award, the committee decided to *"adjust the EPS figure for the year ended 30 September 2009 in so far as it applied to the 2007 PSP award vesting as the earnings had been adversely affected by:*

- *the decision (approved by the Board) to fully draw the financing facility in October 2008 to avoid the risks from the market interruption caused by the Lehman Brothers insolvency and the subsequent banking crisis;*
- *the decision (approved by the Board) to only invest liquidity overnight to avoid bank insolvencies; and*

98 Thomas Cook annual report 2011, page 61

99 Guardian, 3rd August 2011, "Thomas Cook chief executive resigns" (http://www.guardian.co.uk/business/2011/aug/03/thomas-cook-chief-executive-resigns)

100 FT, 22 January 2012 "Thomas Cook bookings down by a third" By Roger Blitz and Christopher Thompson (http://www.ft.com/cms/s/0/ca6be8a6-44e5-11e1-a719-00144feabdc0.html#axzz1plzcLtXm)

101 Thomas Cook annual report 2007, page 58

102 Thomas Cook Merger Prospectus, page 479 (http://www.thomascookgroup.com/downloads/pdf/travel-merger/Merger_Prospectus.pdf)

103 Thomas Cook annual report 2010, page 64

- *a net interest charge arising from the mismatch of assumed interest received on pension asset and interest paid on pension liabilities. This item is non-cash and beyond management control in the short-term."*[103]

The result was that the EPS element of the performance target "vested at 98%".[104]

In relation to the TSR element of the award, "the Committee agreed that the volcanic ash cloud was an exceptional event and had a distorting effect on the share price. Therefore, having received advice from external advisers, the Committee agreed that it was appropriate to end the TSR measurement period on 15 April 2010 (the first date when UK and European airspace was closed). Accordingly, the TSR element of the 2007 award vested at 37%. This meant that the total level of vesting for the 2007 PSP award was 67.5%."

Many shareholders were not comfortable with this approach and the ABI issued a red top alert[105] on the report.[106] Although the resolution on the remuneration report was passed, the report saw 39.1% of votes cast against.[107]

Regarding the long-term incentive programmes, the chief executive received a grant of 283,784 shares[108] under the PSP in 2007 and, as described above, the committee used its discretion to determine the overall level of vesting of 67.5%.

The awards under the PSP and COIP made in 2008 lapsed.[109] Also, the committee determined "in respect of PSP and COIP awards granted in 2009…[the] targets would similarly not be met. Under the terms of Manny Fontenla-Novoa's departure, none of his Matching Shares, awarded under the COIP, vested."[110]

The exit package

When he left office, the size of his exit payments hit the headlines. However, according to the 2011 annual report[111] *"the terms of the settlement were agreed by the Committee and by the Board and provided for no remuneration beyond that which was contractually or legally due to him. Manny Fontenla-Novoa's service contract contained a 12-month notice period. In accordance with its terms he received a payment in lieu of notice in respect of base salary, pension allowance and contractual benefits. No payment was made in respect of annual bonus and all subsisting share awards have lapsed with no vesting. Total payments made to Manny Fontenla-Novoa after his resignation amount to £1,166,639, which is made up as follows:*

- *he continued to receive his salary, pension and certain benefits (private medical, life cover, personal accident, income protection, death in service pension and access to car and pool driver) in accordance with contractual terms for the period between his resignation and 4 November 2011. Payments made and benefits received during this period amounted to £315,525; and*
- *on termination of his employment on 4 November 2011 it was agreed that a payment of £851,114 would be made to Manny Fontenla-Novoa, in full and final settlement of all amounts due. Due to deterioration of the Company's forecast year-end headroom position after agreement was reached, Mr Fontenla-Novoa agreed to a deferral of the due date for payment of this sum until after the seasonal cash low point at the end of December.*

With the exception of medical cover, which is being continued until 1 April 2012, all other insured benefits ceased on termination of employment."

104 ibid

105 A red topped report "indicates a matter of serious concern" (http://www.abi.org.uk/Media/Releases/2010/04/IVIS_Review_2009_.aspx)

106 Guardian, 8th February 2011, "Thomas Cook braced for shareholder revolt over bonuses" (http://www.guardian.co.uk/business/2011/feb/08/thomas-cook-bonuses-shareholder-revolt)

107 Guardian, 11th February 2011, "Thomas Cook shareholders revolt over executive bonus awards" (http://www.guardian.co.uk/business/2011/feb/11/thomas-cook-bonuses-shareholders-vote)

108 Thomas Cook annual report 2007, page 63. These may have been structured as nil-cost, or nominal-cost options rather than actually shares

109 Thomas Cook annual report 2010, page 65

110 Thomas Cook annual report 2011, page 62

111 Thomas Cook annual report 2011, pages 59 and 60

The report also details that *"Manny Fontenla-Novoa exercised options over 52,500 ordinary shares on 10 January 2011. On the same day, he sold 26,830 shares at a price of 194.8p, to cover income tax liability and NICs and commission costs. The total pre-tax gain on exercise was £102,270. He retained the remaining 25,670 shares after exercise."*

During 2010 and 2011, the chief executive did not sell any shares (other than to cover a tax liability) and so his holding declined in value along with the share price.

The lessons

This case highlighted a number of flaws in the corporate governance process surrounding executive compensation. First, a success bonus was, in effect, paid for seeing the merger through with no deferral and no scope for reassessment if the merged company hit difficulties later on. The success or otherwise of mergers cannot be judged on one year's performance. At the very least part of this bonus should have been deferred and paid in shares, thereby exposing the CEO to the subsequent performance of the company. Under our proposals for clawback half of that £5m bonus would have been deferred and invested in shares.

Adjusting EPS targets for 2009 to reflect changes in interest charges because of decisions taken by the management, even if they were prudent moves, was also dubious, since shareholders had to bear the impact of profitability. The adjustment of the TSR for special factors, which the company did in 2010, was equally poor. They were one off events but the shareholders, again, had to suffer the impact of the one off events, so why should executives be excused? At a minimum, in the latter case, judgement should have been deferred to see how much recovery in the share price and profitability there was after the effect of the disruption had passed. The exit payments themselves were not a governance issue, other than to underline the fact that without clawback contractual payments of some kind have to be made.

Case 3 – Punch taverns

Punch is a classic example of executives building a business on leverage, seeing EPS rise in an economic upswing and then the whole thing falling apart in a downturn. The executives were paid out on earnings progression, with no caveats in the remuneration policy that would have forced them to focus on the long-term sustainability of the business as opposed to running it for shorter term EPS growth.

Punch is a pub operator of 5,000 leased and tenanted pubs[112] and Giles Thorley was appointed as chief executive in January 2003, having joined as executive chairman in December 2001.[113] The financial year ending in 2004, was Giles Thorley's first full year as chief executive. In the 12 months to August 2004, he earned £328,500 as basic salary[114] and an annual bonus of £279,000 (25% of which was used to buy shares as part of the deferred bonus plan).[115] This deferral plan allows for the shares to be matched 1:1 assuming that the company's earnings per share was equal to or exceeds RPI+5% p.a. over a three year holding period and also that he had maintained that shareholding and had not left the employer.[116]

His salary increased significantly over the next few years rising from £328,500 to £525,000 for the 2007/08 year.[117] His annual bonus payments were 55%,[118] 75%,[119] and 75%[120] for the three financial years to August 2007. Shareholders approved changes to the long-term incentives at the AGM in January 2004.[121] For 2004, the chief executive received a grant of shares with a face value of 200% of salary and a grant of options with a

112 Punch Taverns annual report 2011, introduction

113 Punch Taverns annual report 2008, page 22

114 Punch Taverns annual report 2004, page 29

115 Punch Taverns annual report 2004, page 35

116 Punch Taverns annual report 2004, page 29

117 Punch Taverns annual report 2008, page 36

118 Punch Taverns annual report 2005, page 24

119 Punch Taverns annual report 2006, page 34

120 Punch Taverns annual report 2007, page 35

121 Punch Taverns annual report 2004, page 31

face value of 100% of salary. This was an unusually high grant and for both 2005 and 2006 shares of 133% of salary was awarded along with a face value of 67% of salary in options.

The grants of options only vested if EPS growth was satisfactory. 40% of the award vested for threshold performance and at a higher growth rate the award vested in full. The vesting was calculated on a straight-line basis between these two points. For the 2004 grant the threshold and higher growth rates were RPI+12% p.a. and RPI+15% p.a.[122] For the 2005 and 2006 grants these were lowered to RPI+8%p.a. and RPI+10%p.a.[123] The share awards were to vest according to the company's comparative TSR performance. Performance at or above median was required for any award to vest.[124]

All of these share and option awards vested in full.[125] However, little value was realised from these grants. None of the option grants awarded from 2002 onwards were ever exercised. Some of the options that were awarded in 2001 did vest. According to the 2002 remuneration report Mr Thornley held 5,901,230 options at a strike piece of £1.98 and 344,780 at £2.05. These options have a combined face value of c.£12m and had no performance conditions attached.[126] On exercise the CEO made a total gain in exercise of nearly £25 million. In the 12 months to August 2004 Mr Thornley exercised[127] 1,150,000 options with a share price of £5.08 realising a gain of £3,568,000. The following year he exercised[128] a further £2,000,000 options at a share price of £7.02 leading to a gain of £10,080,000. 2006 saw a similar story with 1,500,000 exercised[129] at £9.00 to give a gain of £10,530,000.

The fortune of the business changed in 2007 and 2008 as the global credit crisis took hold and investors began to question the sustainability of the business model, given the high leverage. The share price started to collapse. In response the salary level was frozen and *"no annual bonus awards were paid to Executive Directors for the 2007 / 2008 year"*.[130] Towards the end of 2008 the company stopped its dividend,[131] and in 2009 was required to raise new equity from shareholders.[132]

Not surprisingly shareholder dissatisfaction grew and the remuneration report was voted down in 2009 with only 45% of votes being cast in favour.[133]

The chief executive stepped down in March 2010.[134]

Figure 12 – Punch Taverns share price (pence)

Source: Bloomberg

122 Punch Taverns annual report 2004, page 31

123 2005 grant: Punch Taverns annual report 2005, page 29; 2006 grant: Punch Taverns annual report 2006, page 35

124 Punch Taverns annual report 2004, page 32

125 Option vesting details: Punch Taverns annual report 2008, page 46 and 2009 page 49; Share vesting details: Punch Taverns annual report 2007 page 42, 2008 page 44, 2009 page 47

126 Punch Taverns annual report 2003, page 26

127 Punch Taverns annual report 2004, page 36

128 Punch Taverns annual report 2005, page 33

129 Punch Taverns annual report 2006, page 44

130 Punch Taverns annual report 2008, page 37

131 Guardian, 3rd September 2008, "Britain's largest pub landlord scraps its dividend" (http://www.guardian.co.uk/business/2008/sep/03/punchtaverns)

132 Guardian, 15th June 2009, "Battered Punch falls 30% after £375m emergency cash call" (http://www.guardian.co.uk/business/2009/jun/15/punch-taverns-share-placing)

133 RNS, 16th December 2009 (http://www.investegate.co.uk/Article.aspx?id=200912161657172535E)

134 RNS, 30th March 2010 (http://www.investegate.co.uk/Article.aspx?id=201003300700113824J)

The lessons

The CEO gained most from the option grant of 2001, which had a face value of over 1000% of salary and no performance conditions attached. Increasing the share price was the most effective way of getting this to pay out. The incentive plan was also based on EPS growth, and all of the targets were hit. In doing so though the executives drove gearing up at the company to the extent that when the economy turned down the company struggled to service the debt that had been taken on. In the end Punch had a massive £4.5bn of debt. The share price collapsed, from a peak of £13 to just 31p in 2009 now (the figure above shows the share price adjusted for the rights issue and company split in 2011). This wiped out the value of the options and shares awarded after 2002, which meant that the executives themselves suffered significant losses, although obviously the options realised from the 2001 plan still paid out handsomely.

That plan would almost certainly fail a shareholder vote today, both due to the size, 1000% of salary and the fact that it had no performance element. Nevertheless, we would also argue that it shows the need for deferral and clawback. If a sizeable part of these gains had been deferred and subject to clawback, it may well have made the executives think twice about pushing the company ever harder for EPS growth. A gearing clause as part of the clawback process would likely have been triggered by the expansion of the business. The fact that a number of the executives did lose a large amount of the gains they made through their incentive plans, shows that merely exposing executives to the share price does not necessarily alter behaviour. This is behind our suggestion that other non share price constraints should be incorporated into a clawback agreement.

Case 4 – Cable & Wireless

Cable & Wireless was a telecoms operator with operations in the UK, the Caribbean, Panama, Macau and Monaco. It provided various communication services to business and residential customers.[135]

In March 2010 the company demerged into two companies. Cable & Wireless Worldwide and Cable and Wireless Communications.[136]

The company's chief executive was Francesco Caio until he retired in April 2006, after the takeover of Energis. John Pluthero, who ran Energis, then took over as chief executive. This organisational structure was put in place as part of "separating Cable & Wireless into two discrete and self-contained businesses, International and UK."[137] The idea was to cut back from servicing 30,000 business customers to focus on the 300 most profitable. It worked for a while but then started to unravel after the demerger.

As part of this re-organisation, the remuneration design was changed and a long-term framework established.

Remuneration for John Pluthero

John Pluthero was to receive an annual salary of £600,000, effective April 2006 and fixed for three years. He was to be eligible for an annual bonus maximum of 100% of salary, with 60% of salary paid at target performance. Individual awards under the annual bonus scheme were to be based *"solely on financial performance and paid only in cash"* and with *"no compulsory or voluntary deferral of bonus into shares"*.[138]

For the first full year of the annual bonus plan (12 months to March 2007), Mr Pluthero received a maximum award of £600,000.[139] The following year he received,

135 C&W annual report 2005, page 5

136 RNS announcements, 26 March 2010 (http://www.investegate.co.uk/Article.aspx?id=201003260700132245J) and 22 March (http://www.investegate.co.uk/Article.aspx?id=201003220700099022I)

137 C&W annual report 2006, page 3

138 C&W annual report 2006, page 56

139 C&W annual report 2007, page 44

£447,000[140] and in 2009 his bonus was £509,400.[141] This represents an average bonus level of over 85% of the maximum.

Early in 2006, Mr Pluthero participated in various long-term incentive plans. One was the 'restricted stock plan' and under this plan he invested in 1,000,000 company shares, which were then eligible to be matched with a further 1,000,000 shares. The receipt of these shares was only *"subject to John Pluthero remaining an employee of the Company and retaining beneficial ownership until 3 March 2009 of the 1,000,000 Ordinary Shares he acquired on 3rd March 2006"*.[142] The value of a share on the date of grant was 107.5p making the face value of the award worth over £1m. These shares fully vested in May 2009.[143]

He also participated in the share option plan and was granted 1,163,873 options with an exercise price of 107.4p in March 2006.[144] On the same day he was awarded a further 232,774 shares under the "Performance Share Awards" scheme.[145] The options[146] and the shares[147] would vest after three years depending on the strength of the company's TSR performance relative to sector comparators.

According to the 2010 remuneration report all of these options vested and became exercisable from 21st May 2009. The options vested over Cable and Wireless plc shares prior to the demerger.[148] The 'Performance Share Awards' also vested in full.[149]

Later on in 2006, the company received shareholder approval for the introduction of a 'Cash Long-Term Incentive Plan' (with 86% of vote cast 'for'[150]). According the 2006 Annual Report, *"the plan will create a reward pool for each of the two businesses over a four-year period. If a business grows by less than the hurdle rate (of at least 8% per annum compounded), there will be no reward pool for that business. If a business grows by more than the hurdle rate, then 10% of the growth in value in excess of the hurdle rate goes into the reward pool…John Pluthero and Harris Jones will each receive a 20% share of their business' reward pool. 75% of the reward pool will be payable to participants at the end of year three, and 100% payable (less payments made at end of year three) to all participants at the end of year four (2010)."*[151]

This represented an unusual structure of incentive at a 'plc', and was more like some of the incentives used in private equity takeovers. The three and four year lengths of the incentive artificially simulated the 'exit' events. The plan originally had a cap of £20m that any individual could receive, however, the company announced, not much more than 12 months after the introduction of the plan that it was going to recommend, at the 2007 AGM the *"removal of the £20 million cap on the amount that can be received by an individual"*. In conjunction with lifting the cap, some awards over £20m might be deferred for a further year and paid in shares, rather than cash.[152]

Mr Pluthero, received the potential for a greater payment later on in 2007 as *"following his additional appointment as Executive Chairman of International, John Pluthero was awarded 50% of the units in the International LTIP held by the former Chief Executive, International."*[153]

The 2009 remuneration report indicates the possible value of these awards with a total LTIP pool of £70m. However, the final valuation point is extended until March 2011 and John Pluthero *"agreed to delay his payment schedule from 75% in 2009 and the balance in 2010 to one of 67% in 2009; 85%, less payments made in 2009, in 2010; and the balance in 2011"*.[154]

140 C&W annual report 2008, page 60

141 C&W annual report 2009, page 56

142 C&W annual report 2006, page 65, footnote 5

143 C&W Worldwide annual report 2010, page 54

144 C&W annual report 2006, page 62

145 C&W annual report 2006, page 63

146 C&W annual report 2006, page 57

147 C&W annual report 2006, page 65, footnote 9

148 C&W Worldwide annual report 2010, page 53

149 C&W Worldwide annual report 2010, page 54

150 RNS, 21 July 2006 (http://www.investegate.co.uk/Article.aspx?id=20060721132342PB92E)

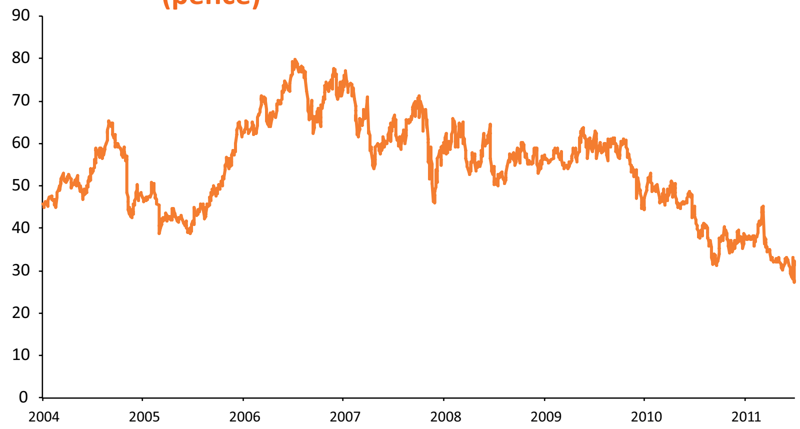
151 C&W annual report 2006, page 56

152 RNS 6 June 2007 (http://www.investegate.co.uk/article.aspx?id=200706060700348418X)

153 C&W annual report 2008, page 56

154 C&W annual report 2009, page 52

Figure 13 – Cable & Wireless communications share price (pence)



Source: Bloomberg

On 26th March 2010, Cable & Wireless demerged to form two companies: Cable & Wireless Worldwide and Cable & Wireless Communications.[155] Mr Pluthero became the Chairman of the newly formed Cable & Wireless Worldwide and retained his LTIP units.

The 2009 remuneration report states that John Pluthero received a payment of £8.3 million[156] for the first stage of vesting. The 2010 report suggests that the second stage of the award was £1.9m.[157] The remaining 15% of the award was determined towards the end of June 2011. He was replaced by Gavin Darby as CEO of Cable & Wireless Worldwide in November 2011.

Other senior executives such as Richard Lapthorne, Chairman, Anthony Rice, Finance Directo, Harris Jones, Group Managing Director International and George Battersby, Executive Director Human Resources were also given access to the incentive schemes. They also received sizeable payouts, with Harris Jones even being paid £4,289,980 on leaving the company in 2007 from an LTIP scheme that had only been running for 20 months.

The LTIP was approved by shareholders in July 2006 and from the 2006 report, the closing mid-market price of an ordinary share on 31 March 2006 was 109.25p. Then according to the 2009 report, the closing mid market price of an ordinary share on 31 March 2009 was 139.5p. So over the LTIP period the shareholders did see some returns. The problem was that the share price began to crack shortly afterwards. The figure above (for Cable & Wireless Communications) is rebased for the company split in 2010, but from a peak 80p in 2007 and even 60p in 2009 (when the LTIPs vested) it has fallen to stand below 30p. The drop for Cable & Wireless Worldwide was even more dramatic from 90p at the time of the split in 2010 to just 14p at one stage, although it has subsequently bounced back to around 34p at the time of writing. The executives were well remunerated for the sharp rise in the share price. Indeed, it is estimated that senior managers took some £88m of cash out of the business in just five years,[158] but the shareholders were again left carrying the can when it all fell apart. The awards were largely paid out when they vested with only limited deferral of those awards and no scope for clawback after the share price collapsed.

155 BBC website, "Cable & Wireless demerger takes the FTSE 100 to 101", 26th March 2010 (http://news.bbc.co.uk/1/hi/business/8589055.stm)

156 C&W annual report 2009, page 57

157 C&W Worldwide annual report 2010, page 52

158 http://www.guardian.co.uk/business/2011/dec/13/cable-wireless-worldwide-break-up

The lessons

Would clawback have changed the strategy? Probably not, but it would have at least prevented the executives from walking away with a large sum of money while shareholders had to tend their wounds. So here it would have been a clear case of not rewarding failure. This case does show, in our view, the need for such a clawback mechanism and also for increased transparency. In particular detailing the possible payouts from the LTIP under different circumstances might have triggered more concern from shareholders than was actually the case.

Appendix: Responses to BIS Consultation Questions

Role of shareholders

1. Would a binding vote on remuneration improve shareholders' ability to hold companies to account on pay and performance? If so, how could this work in practice?
2. Are there further measures that could be taken to prevent payments for failure?
3. What would be the advantages and disadvantages of requiring companies to include shareholder representatives on nominations committees?

Our proposal on shareholder votes on remuneration is for a two strikes policy, with the vote to still be advisory but with a 65% threshold. If the votes cast in favour were above 50% but below 65%, the company would have a year to amend its compensation policy in consultation with shareholders. If the vote was lost a second time it would become binding and the board would have to submit a new remuneration policy within 90 days. Should, at any point, the vote fail to gain at least 50% support the vote would become binding with the same result. This proposal allows shareholders to warn companies and then the companies have time to respond. (see Chapter 3 for further details). As we argue in Chapter 3 we think the government's proposals of binding votes, possibly only every three years, together with advisory votes on pay implementation and company responses to significant no votes is a bit convoluted. Our proposal is much simpler and more user friendly for shareholders.

The main measure that we propose to prevent payments for failure is clawback. We propose that 50% of all variable compensation is deferred for a minimum of five years, with no vesting to be no faster than straight line. As a result 150% of average variable compensation would be available for clawback in the case of underperformance. We propose that a series of downside conditions are set that if breached would constitute failure and trigger clawback, in much the same way as upside targets trigger payouts under long-term incentive schemes. Such clawbacks would likely ensure that any failing executive would not walk away with a significant payoff (see Chapter 6 for further details).

Following discussions with investors our feeling is that not many would like to have representatives on boards because of the risk of becoming insiders when buying or selling shares. Our belief is that a further professionalization of Non-Executive Directors, so that they cover less boards but become more experienced in the companies on whose boards they sit, would be more effective.

In particular they would be more able to challenge the executives on the boards on key points of policy (see Chapter 3).

Role of remuneration committees

4. Would there be benefits of having independent remuneration committee members with a more diverse range of professional backgrounds and what would be the risks and practical implications of such measures?
5. Is there a need for stronger guidance on membership of remuneration committees, to prevent conflict of interest issues from arising?
6. Would there be benefits of requiring companies to include employee representatives on remunerations committees and what would be the risks and practical implications of any such measures?
7. What would be the costs and benefits of an employee vote on remuneration proposals?
8. Will an increase in transparency over the use of remuneration consultants help to prevent conflict of interest or is there a need for stronger guidance or regulation in this area?

With reference to membership of remuneration committees we see this as less of an issue than the structure of pay itself which we deal with in more detail in this paper. Is more diversity a benefit? Yes, but only subject to those representatives having the necessary experience and skill set, rather than imposing diversity for the sake of it. We would emphasise again that our preference is for an increased professionalisation of the Non-Executive Director community so that they have more experience and devote more time to the boards on which they sit.

We do not believe employee representatives should sit on remunerations committees nor do we believe that there should be employee votes on remuneration proposals. Apart from the obvious conflicts of interest, shareholders are the owners of the companies it is they who should decide on compensation (see Chapter 3). As we note in the document BIS has decided that companies should only detail how they have considered employee views in the setting of pay.

We do believe there should be more transparency over the use of remuneration consultants and have recommended increased disclosure in the remuneration report (see Chapter 5).

Structure of remuneration

9. Could the link between pay and performance be strengthened by companies choosing more appropriate measures of performance?
10. Should companies be encouraged to defer a larger proportion of pay over more than three years?
11. Should companies be encouraged to reduce the frequency with which long-term incentive plans are reviewed? What would be the benefits and challenges of doing this?
12. Would radically simpler models of remuneration which rely on a director's level of share ownership to incentivise them to boost share value, more effectively align directors with the interests of shareholders?

13. Are there other ways in which remuneration – including bonuses, LTIPs, share options and pensions – could be simplified?
14. Should all UK quoted companies be required to put in place clawback mechanisms?

The structure of remuneration is key to the recommendations of our report. We believe that remuneration models should be simpler, that a larger proportion of pay should be deferred over a period of longer than three years and that all UK quoted companies should be required to put clawback mechanisms in place. We set out our recommendations on remuneration models in Chapter 5. We believe that remuneration plans can be made easier for shareholders to understand and the key to this is transparency. The plans should be clearly explained and examples given of how a remuneration might pay out under certain assumptions. The more shareholders can understand about the remuneration policy the more able they are to decide if it is fair and that includes measures of performance for determining pay. The government's recommendations in this area are very similar to our own and we fully support them.

We argue that LTIPs should largely pay out in shares, and that options should only be an option for small fast growing firms. Under our proposals 50% of all variable compensation would be deferred for a minimum of five years, with vesting no faster than straight line. Since, as we noted above, that at any one point in time an average of 150% of variable compensation will be held in deferral, that represents the minimum shareholding for an executive. Furthermore, as we argue LTIPs should be extended to five years then the exposure of an executive to the performance of a company stretches over as long as ten years. We believe this is more important than reducing the frequency with which LTIPs are reviewed.

We also strongly favour introducing clawback mechanisms into remuneration packages. This is the best mechanism to protect against rewards for failure and it arguably will make executives more aware of the downside risks to any strategy. Until now remuneration packages have focused too much on what should be paid out if upside targets are met. Our proposals are for downside conditions that would represent failure if hit and would automatically trigger clawback. In the worst case an executive could lose their entire deferred pool. Our proposals are outlined in detail in Chapter 6. Merely increasing executives' exposure to the share price via increased ownership is unlikely to be sufficient to align shareholders and executives interests. Lehmans is a very good example of how high levels of equity ownership did not prevent management from making poor decisions.

In terms of simplification of pay the publication of one figure for executive compensation each year has been mooted. We believe that is appropriate for salary and bonus but not for LTIPs. These should continue to be published separately because they relate to multi-year performance. (see Chapter 6). We believe the government's proposals here of one figure for the amount paid out over the last year could prompt misleading analysis because it will mix LTIP payments relating to several years performance, with salary and bonus related to the previous year's performance.

Promoting good practice

15. What is the best way of coordinating research on executive pay, highlighting emerging practice and maintaining a focus on the provision of accurate information on these issues?

The best way to ensure good practice in our view is for executive compensation to be as transparent as possible. We have recommended a template for remuneration reporting which if implemented would enable shareholders and other interested parties to keep more easily remuneration under review (see Chapter 5).

The issue of executive pay has grown in prominence over the last few years culminating in the government's proposed legislation and the "Shareholder Spring". Our report *Executive Compensation: Rewards for success not failure* attempts to come up with solutions to end rewards for failure but at the same time ensure that the UK remains an attractive place for top executives to work.

Executive pay has become over-complex and opaque, making it difficult for shareholders (and others) to understand how executives are paid. We set out a template which would help increase the transparency of remuneration reports. We believe that there should be an analysis of possible payouts under bonus and long-term incentive programmes. We also argue that there should be more disclosure on pay, with one figure disclosed for current pay, bonus and benefits and another figure for long-term incentive payments. We also propose an additional disclosure for any other relevant information to shareholders to ensure all forms of remuneration are disclosed.

We believe shareholders should have more power to vote down remuneration policies if they are inappropriate. We think the government's proposals are too convoluted. We favour a more flexible approach and recommend a two strikes policy. Under this the vote would remain advisory but with a higher threshold of 65%, but should a company lose the vote it would have a year to change the policy in consultation with shareholders. Should it lose a second vote the following year it would become binding and a new remuneration policy would have to be presented within 90 days. If at any point in time the company failed to receive 50% of the vote it would automatically become binding.

Compensation and performance have to be tied more closely together. We think current arrangements are too short-term. We propose that long-term incentive schemes should be over a five year period instead of the current three year period. We also propose that 50% of all variable compensation is deferred over a minimum of five years. The vesting of those deferred awards is to be no faster than straight line, i.e. equal payments over the five year period. Those payments should also be in shares of the company. By doing so an average of 150% of variable pay will be deferred in shares at any one point in time. With a five year long-term incentive plan and five year deferral executives will be linked into the performance of a company for up to ten years.

Finally we recommend that clawbacks be introduced for all quoted companies. At the moment incentives are set so as to pay out when upside targets are met and the payout increases the more the targets are met. The downside if they do not meet the targets is that they are not paid or worst case that they lose their post, with whatever exit payment they can negotiate. We propose that there are downside conditions, which if breached, would trigger a clawback of deferred pay. Those conditions would be set so that their breach would represent failure by the executive or company. In extremis an executive could lose all of their deferred pay. This tackles rewards for failure but also allows those who succeed can to be paid.

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