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2010 RiskMetrics U.K. Remuneration Guidance

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Introduction

Remuneration Committees continue to have to reach decisions on executive remuneration in uncertain economic circumstances. The value of communication between companies and shareholders is becoming increasingly recognised and this guidance is published in order that remuneration committee decisions may be taken with as great an appreciation as possible of the concerns and expectations of investors.

This guidance provides an outline of the most common considerations we will be taking into account in the application of policy by our analysts in issuing vote recommendations for remuneration-related proposals by UK public companies in 2010 in our research reports. The guidance described is consistent with National Association of Pension Funds (NAPF) Policy and we have consulted extensively with our clients to ensure we are in-step with prevailing investor sentiment.

General Remuneration Policies and Practices

RMG will continue to maintain a robust approach to executive remuneration in 2010. The following are some statements of principle on general policy and practice:

• Remuneration committees should ensure that the performance measures chosen are aligned with business strategy and motivate executives appropriately, without promoting or rewarding disproportionate risk taking.

• Meaningful and timely prior consultation with shareholders is vital. Companies should avoid presenting finalised proposals without allowing shareholders a comment period and being responsive to their views, and the process should not be seen as a negotiation from base.

• UK boards must avoid rewarding for failure or for poor performance when approving executive compensation. Although some boards may face internal pressure to retrospectively revise performance targets to ensure bonus and stock plans pay out, the recession should not become an excuse to relax, revise or abandon performance targets retrospectively.

• Remuneration committees should not use their discretion to make payments which are not justified by financial results.

• Companies need to pay close attention to total remuneration, which should not be expected to increase in absolute terms. Companies are discouraged from increasing remuneration in response to a peer group comparison exercise.

• Remuneration should be clearly linked to the strategic objectives, targets and key performance indicators set out in the company's business review. A good performance target is aligned with company strategy, future direction and performance and shareholder value creation.

• Companies should closely examine the behaviour that the design of a remuneration package drives, particularly the attitude of executives to risk, which should become a factor considered and explained in disclosures with respect to a company's remuneration policy as a whole.

• Remuneration committees should take into account the pay and conditions across a company when setting the directors' pay. This is particularly appropriate in circumstances where the company has made, or is contemplating, significant redundancies within its workforce.

• Remuneration arrangements that are based on a tax-efficient mechanism that favour the participants should not lead to increased costs for the company, including the company's own tax liabilities, nor be overly complex or have performance targets that leave their alignment with the business strategy unclear.

• If a company's profitability declined in 2009, we do not generally expect to see any increases in executive directors' total remuneration for 2010, whether fixed or variable opportunities unless, in the case of the latter, it is in conjunction with a revised strategy and/or more demanding targets. We will expect a detailed and compelling explanation in the case of any exceptions to this principle.

• One-off pay awards to address concerns over the retention of an executive director are not considered to be effective and are therefore not justified.

Guidance on the Components of the Remuneration Package

1. Basic Salaries

In 2009, we supported the decision by many companies to freeze or reduce salaries. Although the economic outlook is now more encouraging, a post-freeze 'catch-up' salary increase is not justified. Where a salary increase is proposed, remuneration committees should take into account that, in most cases, this will have the effect of boosting the value of potential total remuneration for that individual by the same proportion. Any proposed increase should therefore reflect:

• Salary increases across the company to align the interests and motivation of all employees.

• Increased company performance/profits in 2009. If profits are down or performance has been adversely impacted, there would seem to be little scope for justifying anything better than salaries remaining flat. If a company has performed well financially then salary increases should not exceed inflation.

• Exceptions may be made for promotions, increases in responsibilities and new recruitments to the board. However, companies are required to justify salary levels and increases in basic salary with reference to their remuneration policy.

2. Bonuses

The Financial Services Authority (FSA) guidelines issued in 2009 illustrate firm views that remuneration arrangements, especially bonuses, have certainly contributed to general instability where they have rewarded excessive short-term risk-taking without regard for longer-term stability. Although the FSA guidance was aimed at banks, we consider that a number of the stated principles may be generally applied to all industry sectors and will likely influence the expectations of institutional shareholders when looking at their portfolio companies.

• Most measures chosen for bonus plans have been poorly disclosed due to companies arguing that they are commercially sensitive in nature. This lack of transparency has resulted in shareholders generally not being able to see/formulate a correlation between bonus awards and company performance. This has contributed to the lack of appreciation among shareholders of the risk associated with the pursuit of a company's objectives in order to meet its stated performance strategy. Companies should ensure that bonuses are primarily driven by sustainable profits and not short term revenues.

A proportion of bonuses should be deferred into shares to ensure that directors do not focus on a single year outcome. Although bonus awards should be paid based on performance in the year in question, actions taken during that year may not immediately manifest themselves in the company's financial results. If these effects are unfavourable to long term company profit and general performance, the deferral of such awards may allow the size of a bonus to be reduced (clawed back).

Bonuses should not encourage or demand the taking of excessive risks.

a. Bonuses awarded for 2009 performance

In some cases, although 2009 targets may not have been met, companies will still want to award bonuses for the year, commonly in the face of concerns regarding the retention and motivation of key executives. This decision may being made against a background, despite a recovery in the share price more recently, of a poor return for investors over the last 2-3 years caused by an earlier sharp fall in the share price, low or non-existent dividends and possibly significant fund raising activity.

We would suggest that Remuneration Committees should show restraint when determining the bonus award when targets are met, especially if the targets were set at a lower level than before. Notwithstanding that individual performance against internal targets may have been met, the overall corporate performance in 2009 may mean that the absolute amount of bonus payments will be viewed by shareholders as excessive and Remuneration Committees will need to be particularly sensitive in the exercise of their discretion to address such issues.

For 2009 awards, companies should use discretion to align awards with shareholder value creation during the past year.

There may be cases when targets have been met for 2009 even though the position of the company at the end of the year and looking forward into 2010 is severely compromised, for example where the chosen targets:

• Do not take account of financial performance (e.g. large percentage of individual qualitative targets or targets are not linked to company profit such as subscription target/ R&D).

• Performance has been sufficient in part of the year for targets to have been met for the full year notwithstanding poor performance for the remainder of the year.

b. Bonuses for 2010

Against a backdrop of ongoing uncertainty about the economic outlook, many companies will be in the process of setting their 2010 bonus targets. Therefore, companies should allow themselves a certain amount of flexibility, whilst taking into account current economic conditions. For 2010, bonus potential should be reduced in line with any reduction in company profits as bonus awards should be viewed as a cost that is financed from a 'pool' that is funded from profits. If company profits are down, then this should be reflected in a reduced pool.

Most companies do not operate a bonus pool per se but rather define bonus awards based on individual award limits. Conceptually if these award limits are not reduced, then a participant (director) would get a larger percentage of any 'pool' and in turn this may impact on the amount outstanding available to pay bonuses to other participants and dividends.

Targets should be challenging but realistic and consequently targets for 2010 should closely reflect a company's ongoing business expectations.

However, the lowering of targets should generally be reflected in a reduction of the bonus potential. This can occur either as described above or by reducing the amount of award earned for the base target hurdle, whilst ensuring that the stretch target remains robustly challenging.

If targets remain unchanged, companies may consider reducing the on-target hurdle i.e. 95% of target may be reduced to 90% of target for a lower award to vest.

We continue to expect a greater amount of disclosure surrounding bonus plans and bonus awards than has customarily been provided in the past. This should include:

- Award limits.
- How bonus awards are divided between pre-defined financial targets and pre-defined individual targets.
- The types of financial targets chosen and how it links to the company's strategy.
- Awards paid for the last award cycle with information about the extent to which each pre-defined target was achieved.
- The risk factors that have been applied.

3. Long Term Incentive Plans

a. Existing Awards

In line with long-established market practice, investors do not expect the terms of any existing awards to be changed to the advantage of the participants. Companies should avoid:

- *Retrospectively changing targets set for previous awards.*
- *Repricing options. The repricing of options that may be underwater is considered inappropriate and contrary to long-standing best practice.*

b. Awards granted in 2010

For current year awards, companies continue to be encouraged not to lower targets under their long term incentive plans. Long-term targets should be clearly linked to a company's pre-stated long-term strategy. In any long-term cycle, it should be expected that there will be periods of decline as well as buoyancy and so there may not be a justification for changing conditions if the long term goals of the company remain the same. However, in a circumstance where a company has fundamentally amended its strategy, the targets should be appropriately adjusted to align them with the objectives.

It is acknowledged that companies need to be responsive to changing market conditions and that targets need to be realistic so that participants view them as reasonably achievable. Therefore, although discouraged, any reduction in targets should be accompanied by:

- *A reduction in individual award limits/ award potential, and*
- *A reduction in award levels for the lower level of performance.*

Companies are encouraged to give emphasis on performance periods beyond 3 years in order to create an alignment to long-term strategy. Such awards should not increase a directors' total remuneration package.

Consideration also needs to be given to total remuneration in absolute terms, which should not be expected to increase. Proposals to increase the maximum award limits under new or amended plans in order to provide 'flexibility' is discouraged.

Companies are encouraged not to change the balance of its variable pay from long term to short term.

Many companies argue they do not have clear visibility of the long-term and may be unable to set appropriate targets beyond one year. Should companies decide to realign the balance of long-term incentive pay towards short-term and a compelling justification is provided, we strongly recommend that performance targets remain unchanged. In the event of a shift in the distribution of the overall remuneration package from the long-term (where disclosure is typically higher) towards the short-term, then companies should ensure there is no reduction in disclosure or transparency by increasing the disclosure of performance criteria for short term incentives and the extent to which they are achieved.

Dilution – where significant share price depreciation would lead to a vastly increased number of shares being awarded based on a percentage of basic salary, consideration should be given to lowering award levels to address the management of dilution.

4. Service Contracts

Guidance on the terms of termination arrangements included in service contracts has been reinforced for 2010 as described below:

a. Company policy on service contracts

For 2010, we expect companies to have a policy for new service contracts that limits the termination provisions to one year's basic pay and benefits, with no specific agreement on the amount to be paid on termination. All payments should be subject to mitigation. Where the policy is not in place for future contracts, we may recommend that shareholders vote against the resolution to approve the remuneration report.

b. New contracts

During 2010, where a company enters into a new service contract, we expect the new contract to include the provisions relating to termination described in 4.1. Where this approach has not been applied to any new contract agreed in 2010, we may recommend that shareholders vote against the resolution to approve the remuneration report.

c. Assessment of termination payments made

We continue to encourage companies to take steps to limit termination payments solely to meet contractual obligations applicable to that individual's service contract. We will seek explanations for any payments made in excess of basic pay and benefits, including what steps have been taken to mitigate the cost to the company. We also expect the vesting of outstanding long-term awards to be prorated for time and performance and for companies to explain any use of discretion. Where the termination arrangements do not appear to be justified we may recommend that shareholders vote against the resolution to approve the remuneration report and, in cases considered to be extreme, the chairman of the remuneration committee.