2013 RREV U.K. Remuneration Guidance

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Institutional Shareholder Services Inc.

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Introduction

The continuing poor global economic outlook highlights the difficulties facing companies but also emphasizes the differences between pay generally and the pay of executives, who not only have pay that is already high but also over recent years have generally received higher pay increases than the overall workforce.

Regulatory Developments

The U.K. Financial Reporting Council's Stewardship Code (revised September 2012) aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship is believed to benefit companies, investors, and the economy as a whole.

The U.K. Government's Department for Business Innovation & Skills (BIS) published an Executive Remuneration discussion paper in September 2011 which observed that, over the last decade, executive pay in the largest listed companies has increased substantially. The paper provided the following statistics* to back this statement: (i) the median total remuneration of FTSE 100 CEOs has risen from an average of £1 million to £4.2 million for the period 1998-2010; and (ii) the median total remuneration of FTSE 100 CEOs rose annually by 13.6 percent on average between 1999 and 2010. By comparison, an average annual increase of 1.7 percent for the FTSE Index was observed across the same period. The paper suggested that this raises two possible issues: that the structure of remuneration does not necessarily incentivise directors to act in the long-term interests of a company; and that the level of remuneration may represent excessive reward for the performance observed.

The paper also highlighted that, over the same period, compared with the median pay increase of 13.6 percent per year for FTSE 100 CEOs, average employee earnings grew by only 4.7 percent per year, meaning that FTSE100 CEOs in the U.K. are earning on average over 120 times that of the average worker. The BIS paper suggested that this raises questions about the distribution of rewards within companies and whether concentration of rewards at the top end is really the most effective way of motivating staff and sustaining long-term performance.

These statistics provided the context for the U.K. Government taking its initiative on the reform of executive pay. The reasons for doing so are summarised as:

"Directors' remuneration which is well structured, clearly linked to the strategic objectives of a company, and which rewards contributions to the long-term success of that company, is important in promoting business stability and growth. However, pay policies which do not appropriately link directors' remuneration to company strategy and performance can diminish shareholder returns, weaken corporate governance and reduce public confidence in business."^

The Government has brought forward amendments to the Enterprise and Regulatory Reform Bill to introduce reforms that have been published for comment. Although the legislation had not been finalised as of end-November 2012, the changes are intended to create a more robust framework for directors' pay in order to:

- Restore a stronger, clearer link between pay and performance;
- Reduce rewards for failure;
- Promote better engagement between companies and shareholders; and
- Empower shareholders to hold companies to account through binding votes.

This remuneration guidance will be revised once the detailed legislation is enacted.

*Source: Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011.
^ Source: BIS Consultation on Revised Remuneration Reporting & Regulation, June 2012.

Early Adoption of New Pay Regulations

The proposed changes to the remuneration reporting regulations will not come into effect for the 2013 voting season, but companies are encouraged to start the transition of their reporting to reflect the expected future reporting requirements regarding remuneration policy and its application. We will analyze the disclosures and make recommendations on such 'early adopter' resolutions in accordance with our current remuneration guidance.

Context for 2013 Assessments

The Stewardship Code states that investors in a company play an important role in holding the board to account for the fulfilment of its responsibilities. In recent years, a significant part of discharging this responsibility is to monitor and then register an opinion on remuneration arrangements through voting at company meetings. Consistent with National Association of Pension Funds (NAPF) Corporate Governance Policy, this guidance paper provides an outline of the most common considerations that we will be taking into account before issuing vote recommendations to our institutional investor clients on U.K. listed companies' remuneration-related resolutions.

The U.K. Corporate Governance Code published in May 2010 applies to financial years beginning on or after 29 June 2010 and the recent updated version published in September 2012 applies to financial years beginning on or after 1 October 2012. Both versions maintain the now long established main principle that:

*Levels of remuneration should be **sufficient to attract, retain and motivate** directors of the quality required to run the company successfully, but a company should **avoid paying more than is necessary for this purpose**. A significant proportion of executive directors' remuneration should be structured so as to **link rewards to corporate and individual performance**.*

In November 2012, the Association of British Insurers (ABI) updated its paper, "Principles of Remuneration." Although the Principles do not seek to prescribe or recommend any particular remuneration structure, they provide a useful reference for many aspects of remuneration practice.

As the current global economic outlook remains uncertain, most shareholders continue to have minimal appetite for a return to the steady upward pay ratcheting that was a feature of the pre-downturn years and expect a rigorous approach to the restraint on executive pay and encourage simplified pay arrangements that offer improved line of sight to both executives and shareholders.

General Remuneration Policies and Practices

We will continue to maintain a robust approach to executive remuneration in 2013. The following are some statements of principle on general policy and practice:

- Remuneration should motivate executives to achieve the company's 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, performance, and shareholder value creation, without promoting or rewarding disproportionate risk taking. Changes in pay levels should take into account the pay and conditions across the company.
- Remuneration policies should be clearly disclosed, including how they promote achievement of the company's strategic objectives. Any divergence from the application of the stated policy when payments are made require an

explanation of the circumstances that warranted the exceptional arrangement so that an assessment can be made as to whether it was justified.

- Sufficient detail should be disclosed about the performance targets adopted in order to allow shareholders to make their own assessment of whether they are appropriate. For example, EPS is a commonly used metric but the ways of measuring it may vary widely and so the variant adopted should be disclosed.
- Many investors are concerned that remuneration has become too complex and question its effectiveness in motivating management. Therefore, companies are encouraged to adopt simpler remuneration structures and require executives to hold greater numbers of shares for long periods.
- Any increases in total remuneration for executives should not be out of line with general increases at the company. Companies are discouraged from market benchmarking for pay reviews, unless it is applied infrequently (3 – 5 year intervals) and then only as one part of an assessment of remuneration policy.
- Boards must avoid rewarding for failure or for poor performance and the current economic environment should not become a justification to relax, revise, or abandon performance targets retrospectively. In addition, the members of the Remuneration Committee must also have a clear understanding of their responsibility to negotiate suitable service contracts when appointing an executive to the board and be able to justify severance payments to shareholders, ensuring that the full benefit of mitigation is obtained.
- It is considered good practice for companies to make variable pay elements subject to clawback provisions. Clawbacks should require the return of payments if the performance levels that determined payments made are shown, for whatever reason, not to be a true representation of the performance achieved.
- Companies should provide a statement of their policy for making on-appointment awards to new recruits from outside the company. Where such arrangements are necessary, the cost is expected to be kept to a minimum and not exceed the realistic value of rewards forfeited by changing employer. In principle, the vesting schedule of the on-appointment package should mirror that of the awards forgone and is expected to include a significant proportion that is subject to performance and liable to forfeiture on early departure. A full explanation and breakdown of the arrangements and quantum should be disclosed to shareholders.
- Engagement initiated by remuneration committees is expected to be in the form of a meaningful, timely, and responsive consultation with shareholders prior to the finalisation of changes to the remuneration package, whether or not they require a separate shareholder vote, and not simply a statement of changes already agreed to by the remuneration committee.
- In cases where a remuneration committee uses its discretion to determine payments, it should provide a clear explanation of its reasons, which are expected to be clearly justified by the financial results and the underlying performance of the company.
- Remuneration committees should closely examine the behaviour that the design of a remuneration package will create and ensure that it reflects the board's appetite for risk.

* Targets should be set to achieve long-term growth and any high growth targets should be accompanied by a justification and information on risk management to ensure company stability.
* 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. The company should demonstrate why this step is positive for the company and for shareholders, not merely that the impact is cost neutral or cost negligible.
* One-off pay awards to address concerns over the retention of an executive director have been shown to be ineffective and are therefore not justified.
* For shareholder alignment, the development of a meaningful shareholding by executive directors is expected, with 100 percent of basic salary now considered to be a minimum, with much higher shareholding requirements expected at larger companies or where the total remuneration package offers high multiples of basic salary.

Guidance on the Components of the Remuneration Package

1. Basic Salaries

Companies should include a meaningful explanation that explains the policy for setting and reviewing salary levels.

Any increase in salary is expected to be low and be in line with general increases in the company; post-freeze 'catch-up' salary increases or benchmarking related increases are not generally supported. In order to restrain an increase in total remuneration, a significant salary increase should generally be offset by a reduction in variable pay.

Exceptions may be made for promotions, increases in responsibilities, and new recruits to the board. Companies are required to justify salary levels and increases in basic salary with reference to their remuneration policy. Where an executive is appointed at an 'entry-level' salary-point which the company expects to increase to a higher level once the individual has proved him/herself in the role, the road map for increases should be disclosed at the time of appointment.

2. Annual Incentives

There should be transparency over the annual bonus targets for the year in which the annual report is published. For bonuses paid, there is increasing shareholder pressure for companies to provide informative retrospective disclosure of targets set at the start of the year and the extent to which they were achieved. Any use of discretion and its impact on the award made should be clearly explained. Bonus payment levels should be justified by the company's profits.

Although the introduction of deferral and/or clawbacks of annual bonus is encouraged, this does not merit on its own an increase in the maximum size of award. The annual report should set out the percentage deferred and whether deferral was or will be in cash or shares, with the share price used to determine the number of shares awarded also disclosed.

Dividends may be credited on deferred bonus shares held during the deferral period, but no further dividends should be paid on undelivered shares or options after the end of the designated deferral period.

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

Targets should be challenging but realistic and 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.

In cases where a company increases the maximum bonus opportunity, the performance targets should be made sufficiently more challenging to justify the additional reward that can be earned. It is also important that the company provides in the annual report informative retrospective disclosure of the targets set and the extent to which they were achieved, in order to support the level of bonus paid.

3. Long-Term Incentives

Targets should reflect the board's appetite for risk and be set to achieve long-term growth. High growth targets should be justified and accompanied by information on controls to manage the risk created to ensure the business remains stable. The lowering of targets should generally be reflected in a reduction of the amount that can vest and, similarly, any increase in award size should be linked to more challenging targets. The forecast level of performance at the time of award should be located well within the lower end of the target range.

Companies are encouraged to provide more informative disclosure on the extent to which performance targets have been met and the link with the amounts that vested.

Performance periods longer than three years and compulsory post-vesting holding periods are encouraged.

Dividends relating to the duration of the performance period may be paid retrospectively on shares that the executive retains after the performance targets have been measured, but no dividends should be paid on any part of the award that lapses. The practice of crediting dividend payments on undelivered shares or options after the end of the performance period or beyond a compulsory post-vesting holding period is generally opposed because, until after delivery, the participant is not a registered shareholder and, for example, cannot vote the shares at a company meeting and so therefore should not benefit from the rewards available to registered shareholders.

An objective of long-term incentives is to achieve a strong alignment of the interests of executive directors with the long-term interests of shareholders. Some investors including many long-term investors such as pension funds and index trackers believe that this can be best achieved if executive directors receive shares that they are required to hold for a very long period. This is a relatively new approach, which diverges from the recent conventional approach to share awards in the U.K. market because awards may be based on meeting pre-grant performance criteria and vest without further reference to the achievement of performance targets. When considering whether to introduce such a scheme, companies should carefully assess whether it is appropriate for their business and strategy, provide clarity over the pre-grant award criteria, and ensure that the maximum award face value is significantly reduced to take into account the high expected value of such an award compared with one subject to conventional post-grant performance. In addition, for this approach to be meaningful, the recipient must be required to hold all the vested shares for an extended period in order to build up a very significant shareholding; the sale of shares awarded under such schemes is therefore not expected, hence they are often described as 'career shares.'

4. Service Contracts

Companies should have a policy for new service contracts that limits executive termination provisions to no more than one year's basic pay and benefits, generally with no specific agreement on the amount to be paid on termination. All payments should be subject to phased payment and mitigation. We continue to encourage companies to take steps to limit termination payments solely to meet contractual obligations applicable to that individual's service contract.

The U.K. Government's draft proposals require a company to provide disclosure of contractual arrangements relating to exit payments. This is in line with our current guidance and is welcomed, as many companies currently only provide general disclosure on this important area. Therefore early adoption of this more detailed approach is encouraged for all companies.

We will seek explanations for any payments made in excess of one year's basic pay and benefits, including what steps have been taken to mitigate the cost to the company. The vesting of outstanding long-term awards should be prorated for time and performance, and companies should 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 reelection of the chairman of the remuneration committee or other directors as we consider appropriate.

5. Pensions

Pension contribution payments and contributions for executives should be clearly disclosed and companies are expected to outline their pension policy. Any compensation to executives for changes in tax relief or pension contribution is not considered to be acceptable.

6. Total Pay

A rigorous approach to restraint over any increase in overall pay quantum is expected.

7. Payments on Appointment

Companies should provide a statement of their policy for making on-appointment awards to new recruits from outside the company, as they are non-routine exceptions to normal pay arrangements. A full explanation of the process by which any on-appointment awards made were determined should be disclosed accompanied by a breakdown of the arrangements and quantum.

Where such arrangements are necessary, the cost is expected to be kept to a minimum and not exceed the realistic value of rewards forfeited by changing employer. In principle, the vesting schedule of the on-appointment package should mirror that of the awards forgone and is expected to include a significant proportion that is subject to performance and liable to forfeiture on departure within a minimum two years of joining the company. Where the on-appointment 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 reelection of the chairman of the remuneration committee or other directors as we consider appropriate.

DISCLOSURE/DISCLAIMER