

Welcome

Welcome to the latest edition of Reward Matters, the Kepler Associates newsletter covering topical issues relating to executive remuneration.



Less than a year after the FSA launched its Code on Remuneration, the European Union's Capital Requirement Directive looks set to dramatically extend regulation of pay in the financial services sector - both in terms of the number of firms covered and the more prescriptive nature of its rules. In advance of the conclusions from the FSA's consultation on its own Remuneration Code, we consider some of the likely implications.

Other regulatory developments include new regulations for Large and Medium-sized companies as well as new reporting requirements for AIM-listed companies.

For our fourth-quarter breakfast discussion programme, please see the back page. If you would like to book a place please contact us on 020 7930 7730 or email our Events Coordinator Alex Hamilton at ahamilton@kepler-associates.com.

I hope you enjoy this newsletter. If you have any questions or comments please do not hesitate to contact me or any of the team.

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FSA consults on remuneration regulations

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New regulations from the EU look set to herald a significant widening in the scope of pay regulation for financial services companies. Since late 2009, when the FSA published its Code on Remuneration, 26 UK banks and building societies have been subject to additional reporting requirements as well as limitations on pay structure for senior and higher-paid staff. For some time, the EU has been considering a Europe-wide response to the banking crisis and this will now be introduced as part of the European Capital Requirements Directive (CRD3).

Whilst the principles of CRD3 are intended to apply uniformly across EU member states, the detail of implementation is the responsibility of national financial regulators. It may be of some consolation to UK financial sector firms that the FSA is now revising its Code to comply with CRD3, rather than operating two overlapping governance structures.

In late July the FSA launched a consultation on how exactly the new remuneration governance regime should be implemented. While some of the detail will remain unclear until the FSA publishes its revised Code in November, companies can begin to plan now for many aspects that are already clear.

The most significant change is the extension of regulation to a far broader group of companies - around 2,500 financial services firms in the UK including "all banks and building societies, asset managers, hedge fund managers, UCITS investment firms, as well as some firms that engage in corporate finance, venture capital, the provision of financial advice and stockbrokers".

The number of individuals covered within each institution will also change. Whereas the existing rules applied to 'Principle 8 employees', a new definition of 'Code Staff' will be adopted. This will include (i) a person who performs a role with significant influence; (ii) a senior manager (a member of, or direct report to, the executive committee); and (iii) other staff whose remuneration is similar to that of a senior manager and who could have a material impact on a firm's risk profile. In the first instance, firms will need to identify their own Code Staff, but it is likely that this will be scrutinised closely by the FSA, particularly in the early years of implementation.

In combination, these changes will have a significant impact, especially at smaller boutique firms whose flat structures may result in a larger proportion of staff being covered.

Recognising the need for differentiation, the FSA has stated that it will apply a 'proportional approach' in applying the Code, taking into account company size, internal organisation and the nature, scope and complexity of its business activities. It envisages three levels of regulation, ranging from 'full application', through 'partial application', to a more flexible 'comply or explain' approach.

The main implication of these regulations for compensation structures of Code Staff is the requirement for significant bonus deferral. The requirement for deferral will also apply to staff whose variable remuneration is a third or more of their overall remuneration (this contrasts with the current guidelines which require deferral only where total remuneration exceeds £1 million). 40% of bonus must be deferred over a period of at least three years, rising to 60% for those with remuneration packages above £500,000. For these purposes, LTI awards count as deferred variable remuneration when calculating compliance with this rule (in the year of grant and on the basis of fair value at the date of grant). Furthermore, at least 50% of any variable remuneration should be made in shares (or other instruments which are either linked to shares or reflect credit quality) and be subject to a minimum retention policy.

In all cases, there is an expectation that deferred

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FSA consultation

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compensation should be tied to the future performance of the firm or division, with the opportunity for awards to be adjusted in the cases of employee misconduct, material error, a material downturn in business performance, or a material failure in risk management. Where an award is deferred in shares, the employer should have the ability to adjust the number of shares post award; the impact of share price movements alone will not be considered sufficient adjustment.

The question of LTIP timeframe is considered, and the suggestion made by Walker - that LTIP vesting periods could be lengthened, at least in part, to five years - is revisited. The proposal is that 50% of any LTIP payment be deferred until the end of the fifth year.

Many of the themes on risk, covering how risk should influence remuneration, remain in the new Code. Firms and their remuneration committees are encouraged to take risk into account when determining incentive outcomes, for example by linking bonus to economic profit and, in the case of long-term incentives, to include measures which capture future risk. Specific recommendations regarding the remuneration of staff in control functions (e.g. Risk, Compliance, Legal and HR) are included to strengthen their independence from the businesses they support and oversee.

Other provisions include:

- *Bonus guarantees and sign-on/buy-out payments* - firms are told they should offer guarantees only in exceptional circumstances and for no more than one year; sign-on and buy-out deals should be no more generous than existing arrangements, should mirror the vesting profile of existing awards (or longer) and should be subject to 'performance adjustment' (i.e. claw-back)
- *Retention payments* - firms should make retention awards only in exceptional circumstances
- *Severance payments* - should reflect performance over time and avoid rewarding failure
- *Pensions* - enhanced discretionary pension benefits for any employee retiring should be held for five years in the form of shares or share-like instruments
- *Hedging* - firms must request employees not to use personal hedging strategies that would reduce their net exposure to the firm's share price

A number of general provisions are also included which set the overall context for the new rules. Firms must ensure that their total variable remuneration does not "limit their ability to strengthen their capital base". They should also ensure that aggregate variable remuneration would be significantly reduced if financial performance were subdued or negative.

Reference is made to sanctions for breaches and to anti-

avoidance. In addition to penalties, breaches of the Code may result in 'non-compliant payments' being required to be repaid. A new rule will be introduced which defines instances which may render a contract void and require recovery of payments made. There is also a general statement that remuneration must not be paid through entities or vehicles that facilitate the avoidance of the Code.

Much of the FSA's consultation is concerned with the practical implementation of the revised Code. For the 26 banks already covered by existing regulation, the effective date for implementation of these changes is 1 January 2011 and little change is proposed to the process of supervision. The FSA has already been engaged for some months in a review of firms' Remuneration Policy Statements (RPSs) and the dialogue on these will continue. Discussions in Q4 are likely to focus on the changes required to comply with the new Code, and the FSA expects to evaluate compliance of 2010 remuneration against these standards.

For those firms which have not previously been regulated, it is likely that more time will be allowed for implementation. A date of 1 July 2011 has been proposed as the deadline for full compliance, although governance structures would nevertheless need to be in place by 1 January 2011. Both dates are subject to confirmation following the consultation.

The process of consultation, which was launched in July, runs to 8 October 2010, and the revised Code is expected to be published in November.

The last eighteen months have seen a rapid evolution in the regulation of pay in the financial sector. The previous Code responded largely to the *interim* findings of the Walker report. Since then, Sir David has published his final report, the Financial Services Act 2010 has included several provisions relating to remuneration, and the European Union has published its draft CRD3 (the final version will be published later this year). In addition, the industry (or at least the 26 largest banks) and the FSA have the benefit of a year's experience of implementing the original Code. Changes to the Code are therefore a reflection of all these factors and part of a dynamic process that will continue to evolve - not least of all with the changing shape of UK financial regulation once the future of the FSA is clarified.

Kepler Breakfast Seminar — 20 October 2010 Pay in Financial Services

As part of our regular series of seminars, our October breakfast meeting will focus on the upcoming changes in the FSA's Code and their implications. We will also review wider developments in pay across the sector.

See page 4 for details of how to book your place

Remuneration disclosure for AIM-listed companies to increase

by Jenny Martin

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Executives and remuneration committees at AIM-listed companies would be well-advised to prepare their stances over pay in the upcoming reporting season.

Scrutiny of executive remuneration is likely to rise following a recent rule change by the London Stock Exchange which requires AIM companies to provide full disclosure of directors' remuneration in their annual audited accounts. The rule change is effective for financial years ending 31 March 2010 or later. Previously, companies were under no obligation to report these details, although many chose to follow the reporting standards for main-market listed companies.

The new regulations will require disclosure of:

- emoluments and compensation, including any cash or non-cash benefits received
- share options and other long-term incentive plan details, including information on all outstanding options and/or awards; and
- the value of any company contributions to a pension scheme

Whilst the required disclosures are not as detailed as those for the main market, it seems likely that this change will result in greater shareholder scrutiny of remuneration at AIM companies in future.

Reward on the AIM market is often shaped by the shareholding of the founders who may continue to own a significant proportion of the share capital. This often means executive reward is implicitly linked very strongly to share price performance, e.g. via options, and following the tough markets of the past two years, many share options are underwater. Whilst some companies have considered resetting option exercise prices to today's share price, this is generally resisted very strongly by shareholders, who see it as an unwarranted transfer of value to participants.

Over 70% of AIM companies offer share options as their principal long-term incentive vehicle, although this figure has fallen from c.90% three years ago as the popularity of performance share plans has increased. This is in contrast to the main market, where option plans are now operated by only 20% of companies.

Pay mix is also very different for AIM companies. On average, fixed salary represents 80% of remuneration compared with about 50% for companies in the FTSE All-Share.

The time may well be right for more AIM companies to consider moving from the "one size fits all" use of share options to an approach that places greater emphasis on alignment with company strategy.

Changes to RiskMetrics guidelines

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Earlier this year RiskMetrics issued a number of changes to its guidelines to reflect the latest prevailing investor sentiment. In a signal of a further hardening of investor attitudes to executive pay, it also stated it may recommend shareholders vote against the remuneration report (and, in a few cases, the re-election of the chairman of the remuneration committee) for breaches of its new guidelines.

Changes to RiskMetrics guidelines in 2010 included:

- *Salary increases* - 'catch-up' salary increases following a previous freeze are not supported
- *Bonus measures and targets* - should be clearly aligned with the business strategy
- *Bonus payments* - Remuneration Committees are urged to show restraint in awarding bonuses, particularly if targets are below prior year. RiskMetrics is also seeking increased disclosure of bonus targets, and urging that a proportion of bonus be deferred into shares, with provision for claw-back to mitigate over-reliance on the performance outcome in any single year
- *Changes to improve tax-efficiency* - should not lead to increased costs for the company (after taking the company's tax liabilities into account) nor be overly complex
- *One-off retention awards* - are generally considered to be ineffective and unjustified
- *Service contracts* - new service contracts should limit severance payments to one year's basic salary and benefits, with no specific agreement on the amount to be paid on termination; and payments should be subject to mitigation
- *Termination payments* - should be limited solely to an individual's contractual provisions; Risk Metrics intends to seek justification for any payments made in excess of basic salary and benefits, and will make enquiries as to the degree of mitigation applied. Vesting of outstanding LTI awards is expected to be pro-rated for time and performance, and any application of discretion should be explained.

Government updates DRR regulations

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Government regulations relating to reporting of directors remuneration have recently changed, as the Directors' Remuneration Report Regulations (introduced in 2002) have been updated.

Small companies, for which disclosure is less onerous, are now defined as those that meet at least two of the following criteria:

- turnover of less than £6.5m (previously £5.6m)
- assets of less than £3.26m (previously £2.8m)
- fewer than 50 employees

There is little change for these companies, which are required to disclose, amongst other things, their policy on remuneration; remuneration paid to directors during the financial year including: salary, bonuses, long-term incentive awards, fees, retirement and other benefits; details of performance criteria for incentive schemes; directors' service contracts; and any compensation to third parties in exchange for the services of any director or person connected with management.

For large and medium-sized companies, the primary change to the regulations is the requirement for a statement detailing "how pay and employment conditions of employees of the company... were taken into account when determining directors' remuneration for the relevant financial year". The application of this requirement relates to reports for financial years ending on or after 5 April 2010.

Identifying how pay at the top of an organisation relates to pay throughout the firm has been under discussion for some time, with various attempts to define a single measure or ratio that captures this relationship. By including a rather less prescriptive reporting requirement and by stating that the requirement should be 'proportionate and not overly burdensome', the government has sought to adopt a more flexible approach.

Kepler survey published in September

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Kepler's Survey of FTSE-350 Incentive Practice 2010 is launched this month. The survey, drawn from Kepler's database of pay levels and incentive structures, details incentive practice for various index groupings from the FTSE-30 through to the entire FTSE-350.

Although last year saw a lull in the number of incentive proposals being put to shareholders for approval, there were nevertheless some significant changes to incentive practice as a response to the downturn and consequent hardening of shareholder views. Some of these will, no doubt, be a temporary response to the economic climate; as companies position themselves for recovery, their incentives will once again be geared towards growth. But other trends are likely to endure: increased deferral, the use of claw-back, and an increasing trend towards multiple long-term incentive measures all look set to become part of the remuneration landscape. As companies review their incentives for the coming year, this report provides a snapshot of current market practice.

We will be reviewing the findings of the survey at our breakfast meeting on 21 September.

Kepler breakfast discussions

You are welcome to join us at one or more of our forthcoming breakfast discussions. The breakfasts are an opportunity for Remuneration Committee members, HR professionals and company secretaries to meet in an informal atmosphere to share experiences and exchange views on current topics and trends. They are held in central London, begin at 8.30am and finish by 10.00am. To book a place, please contact us on 020 7930 7730 or email ahamilton@kepler-associates.com.

21 September	Trends in FTSE-350 Incentive Practices – review of Kepler's survey findings
20 October	Pay in financial services



About Kepler Associates

Kepler Associates is a leading independent reward consultancy focussed on helping companies develop executive remuneration programmes. We help companies identify the drivers of value and align performance measures and reward programmes with the business strategy that maximises value. Our clients are companies that see incentive compensation as a source of competitive advantage. Remuneration Committees value our independence, our ability to bring new thinking to old problems, and the responsiveness of our service.