



# South African Reward Association

## What shareholders want to know

20 November 2014

# Introduction

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- Background
- Investors' views
- What do shareholders want to know?
- How should you communicate with them?

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# Background

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- Shareholders own the companies in which they invest
- As a result, Boards are accountable to their shareholders for the performance of the Company
- Basic expectations for the governance (including executive remuneration practices) of companies is set out in the various Corporate Governance Codes (which have evolved since the 1990s)
- Separate to the various Corporate Governance Codes, individual institutional investors and shareholder protection bodies retain their own best practice guidelines against which they expect companies to comply
- Through engagement, institutional shareholders and their protection bodies encourage companies to comply with their expectations since they believe that compliance with their general policies leads to improved corporate performance
- Where companies do not comply or explain non-compliance, shareholders use their voting power to encourage companies to change their behaviour – or at least this is the theory!

## Background (continued)

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- Depending on which country's governance code and national legislation applies, the key shareholder resolutions from a remuneration perspective are:
  - A binding vote on Remuneration Policy
  - An annual advisory vote on the Remuneration Report;
  - The adoption of a new long-term incentive plan or approval for shares to be used for such a plan
  - The election of the RemCo Chair, members or, in extreme cases, the Company Chair
- The combination of the credit crisis and some recent “fat cat” and “pay for failure” debates has increased the focus on how institutional investors vote their shares (shareholders were labelled ‘absentee landlords’) and this is beginning to result in changes to disclosure and voting practice of such shareholders
- Aside from individual shareholders with very significant shareholdings, shareholder protection bodies and proxy voting agencies such as ISS carry the greatest potential to influence voting actions

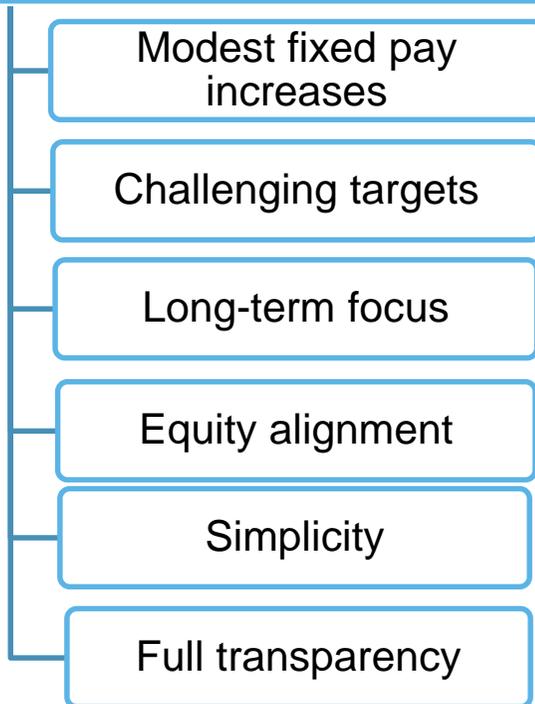
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## Investors' views

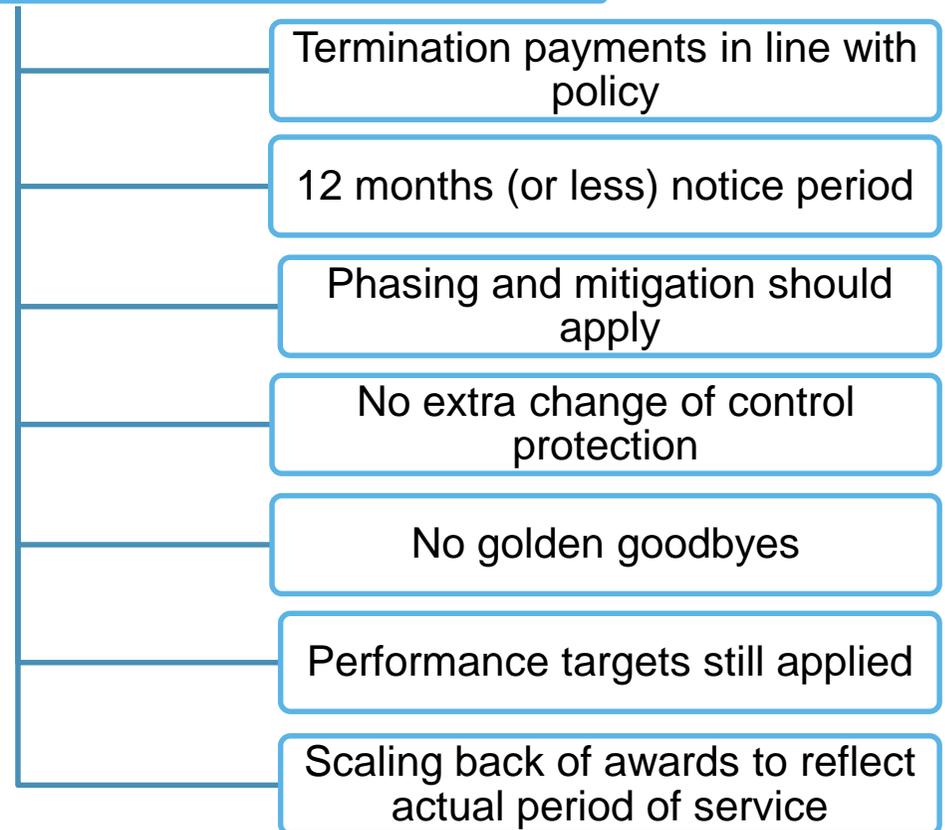
# Investor views - The key pillars

- The two key themes from an investor and governance stand point are paying for performance and not rewarding failure.

## 1. Pay for Performance



## 2. No Rewards for Failure



## Investor views – Recent Developments

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<b>Element</b>	<b>Observations</b>
<b>Pay levels</b>	<ul style="list-style-type: none"><li>▪ Continuation of encouragement for companies to show restraint</li></ul>
<b>Annual bonus</b>	<ul style="list-style-type: none"><li>▪ Wish to see greater disclosure of bonus outcomes vs. targets</li><li>▪ Renewed encouragement for greater bonus deferral</li><li>▪ Scrutiny of bonus payments in the light of performance, including compared to prior year</li></ul>
<b>Long-term Incentives</b>	<ul style="list-style-type: none"><li>▪ Desire for simplicity and reduction in number of plans, matching plans are out of favour</li><li>▪ There is some pressure to increase performance or vesting periods for LTIPs or alternatively to add a holding period post vesting, in addition to formal share ownership guidelines</li><li>▪ Fidelity to vote against any remuneration report (from 2015) without a 5 year grant to sale period</li><li>▪ One-off arrangements are generally viewed very negatively</li></ul>

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## Investor views – Recent Developments (continued)

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<b>Element</b>	<b>Observations</b>
<b>Clawback/ malus</b>	<ul style="list-style-type: none"><li>▪ Clawback and/or malus are strongly encouraged</li></ul>
<b>Contracts &amp; cessation</b>	<ul style="list-style-type: none"><li>▪ Opposition to liquidated damages, preference for mitigation and phased payments</li><li>▪ Insistence on pro-rating LTI awards for good-leavers and limiting bonus to time worked in year of departure with performance targets still to be applied</li></ul>
<b>Share Ownership</b>	<ul style="list-style-type: none"><li>▪ Greater emphasis on executive share ownership</li><li>▪ Only beneficially owned shares should count and general push for 200% ownership requirements</li></ul>
<b>Recruitment</b>	<ul style="list-style-type: none"><li>▪ Buy-out (if any) must be like-for-like</li><li>▪ Ongoing policy as per existing directors</li></ul>

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# ISS

- ISS stands for Institutional Shareholder Services (previously known as RREV or Riskmetrics)
- Subscribers are typically investment managers, pension funds and US funds (e.g. JP Morgan, Jupiter, MFS, Montanaro, Schroders and UBS)

How do they operate	What is their impact on voting	Influential?
<p>RREV was originally a joint venture between NAPF and ISS (a leading proxy voting agency in the US) before becoming wholly owned and rebranded as ISS.</p> <p>ISS guidance is based on both overall views of best practice and local market practice.</p> <p>Provides actual voting recommendations.</p>	<p>ISS is now the most influential agency in shareholder voting outcomes.</p> <p>A "vote against" is a significant issue for a Remuneration Report.</p> <p>US shareholders will typically follow ISS voting guidelines.</p> <p>There is a high correlation between ISS recommendations and votes cast for and against.</p>	<p>Yes, engagement with ISS is important.</p>

- ISS also provides a bespoke service in which it analyses company remuneration policies against rubrics developed by shareholders

## The 2014 UK AGM season – Key areas of focus

- The main areas of focus for the voting agencies in the UK in relation to reporting under the 2013 regulations were as follows:

Arising issues	Comment
<b>Flexibility and discretion</b>	<ul style="list-style-type: none"><li>▪ There was a lot of focus on the potential use of discretion</li><li>▪ Companies were expected to provide a maximum cap on variable pay levels where there was a discretion to exceed regular award amounts</li><li>▪ Concern was raised, and some companies were required to clarify their position, where it appeared discretion was reserved to exceed specified levels of variable pay in recruitment situations but with no maximum cap</li><li>▪ Companies were advised that the use of any reserved discretions would be monitored very carefully through the Annual Report on Remuneration</li></ul>
<b>Salary policy maximum</b>	<ul style="list-style-type: none"><li>▪ Although some law firms advised that an absolute maximum for salaries/ salary increases was required to comply with the regulations very few companies did this in practice and investors and voting agencies seem comfortable with this approach</li></ul>

## The 2014 UK AGM season – Key areas of focus (continued)

Arising issues	Comment
<b>Disclosure of performance targets</b>	<ul style="list-style-type: none"><li>▪ Level of disclosure of annual bonus targets and performance against them in the year under review has increased. However shareholders are commenting that it does not go far enough and we are expecting this to increase and become an even greater focus</li><li>▪ Most companies have either adopted full retrospective disclosure or disclose the majority of annual bonus targets</li><li>▪ Less detailed disclosure of personal/strategic targets</li><li>▪ The level of disclosure of performance targets for long-term incentives has historically been greater than for annual bonus and less change has therefore been seen in this area</li></ul>
<b>Share ownership guidelines</b>	<ul style="list-style-type: none"><li>▪ ISS are focusing on any company that has a share ownership requirement below 200% of salary</li></ul>

## Significant shareholder dissent in the UK in 2014

- The table below sets out voting outcomes for the AGMs held in 2014 to the end of July with significant shareholder dissent.

Company	Report	ABI	ISS	Votes Against	S'holder Dissent	Summary of Objections
Kentz Corporation	Annual	Red	Against	54%	58%	Large CEO salary increase; large transaction bonus paid to CEO
	Policy	Red	Against	51%	58%	Recruitment awards can be made outside policy
Burberry	Annual	Amber	Against	53%	53%	Substantial fixed allowance in addition to base salary for CEO; Large one-off share award for CEO with limited disclosure of performance targets
Easyjet	Annual	Blue	Blue	45%	45%	Founder shareholder opposition
	Policy	Blue	Blue	44%	45%	Founder shareholder opposition
Reckitt Benckiser	Annual	Amber	Abstain	31%	43%	Large salary increase; no retrospective disclosure of bonus targets
Catlin Group	Annual	Amber	Abstain	10%	43%	Large salary increases; large bonus awards; additional PSP awards

## Significant shareholder dissent in the UK in 2014 (continued)

Company	Report	ABI	ISS	Votes Against	S'holder Dissent	Summary of Objections
Hiscox Limited	Policy	Amber	Abstain	42%	43%	Recruitment awards can be made outside policy; uncapped annual bonus
Carnival	Annual	Red	Against	41%	42%	Poor disclosure of bonus targets; large bonus and share awards on CEO's recruitment; exit payments; high bonus payout despite poor results
	Policy	Red	Against	38%	38%	Scope for significant recruitment awards and exit payments outside of policy; significant quantum of the annual bonus and TSB awards
Standard Chartered	Policy	Amber	Against	41%	41%	Move towards annual rather than long-term targets; guaranteed awards can be made on recruitment
Centamin	Annual	Amber	Against	26%	41%	Poor bonus disclosure; uncapped recruitment awards

## Significant shareholder dissent in the UK in 2014 (continued)

Company	Report	ABI	ISS	Votes Against	S'holder Dissent	Summary of Objections
AstraZeneca	Annual	Amber	Against	39%	39%	Poor LTI target disclosure; discretion used to accelerate vesting on CFO's departure; high bonus payout despite poor results
	Policy	Amber	Abstain	15%	31%	Recruitment awards can be made outside policy; annual bonus policy allows awards above normal maximum
IP Finance	Annual	Amber	Against	37%	39%	Large CEO salary increase; LTI award made at exceptional limit
Crest Nicholson	Annual	Amber	Against	35%	39%	Enhanced awards granted under the LTIP at the same time as vesting of IPO awards; Low ROCE targets
National Express	Annual	Blue	Against	36%	37%	Lower EPS targets for LTI after large increase in CEO's total remuneration in prior year
Tullett Prebon	Annual	Amber	Against	36%	36%	CFO received a 27% salary increase
Pearson	Annual	Amber	Against	34%	36%	Large salary increases; exit payments

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What do shareholders want to know?

## Shareholders (to varying degrees) are interested in ....

Issue	Interested in:
Quantum	Absolute amounts and relative amounts (to both internal and external comparators)
Processes	How does RemCo/company manage pay from a governance perspective?
Overall policy	What are the key drivers behind the remuneration policy?
Link between pay and performance	How is pay linked to performance? What areas of performance is the company paying for? How do performance conditions link in to stated KPIs?
Discretion	How much discretion does the RemCo have and how is it exercised?
Risk	Is management encouraged to take undue risk?
Alignment	Are the interests of management aligned with the interests of shareholders?
Cost and dilution	Is the cost and/or dilution excessive (in absolute terms or relative to company performance or to other companies)?

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## Shareholder communication

## Effective shareholder communication

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- Improved communication is a recurring theme throughout recent investor guidance
- From a remuneration perspective, there are three basic forms:
  - Direct shareholder consultation in respect of proposed changes to policy
  - Indirect shareholder consultation (via proxy agencies such as ISS) in respect of proposed changes to policy
  - The Directors' Remuneration Report

# Approach to investor consultation

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## Why consult?

- Good governance, investor expectation
- Essential to gauge investor support for a proposed change in remuneration that they will be asked to vote on
- Enables RemCo to determine whether any adjustment to proposed changes to policy is advisable in light of feedback from investors
- Assists with clarification and justification of potentially more difficult disclosures in the Remuneration Report, e.g. high bonus in year of low profit
- Provides opportunity for earlier communication and discussion if appropriate of changes *within an approved policy*, e.g. change of performance measures
- Policy may specify that RemCo will consult regarding certain matters within an approved policy prior to making changes, e.g. higher LTI awards within a specified maximum

# Investor Consultation Process

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## How to consult

- Determining the most appropriate channel of communication is important in shaping a positive outcome
- Where consultations are undertaken, the general rule of thumb is to consult investors with over 2% to 3% of the shareholder register (targeting a minimum of 40% of the shareholder register) plus ISS (and any other local proxy agencies that are prepared to consult)

## Supplementary Disclosure

- Depending on the nature of the information, this could take the form of a letter to accompany the Annual Report (e.g. greater explanation on the bonus earned in the year under review or justification of a salary increase awarded during the year) to personal calls by the RemCo Chair if the issues being disclosed are highly sensitive (e.g. high bonus awards in a year of low profit)

## Investor Consultation Process (continued)

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### **Minor amendment to policy (e.g. renewal of an LTIP, move from EPS to relative TSR etc.)**

1. Letter detailing the change and summarising broader remuneration policy
2. Allow two/three weeks for a response (longer may be required in busy times)
3. Follow up the letter with a call around the two week deadline
4. Summarise feedback and provide update to the Remuneration Committee
5. Courtesy follow-up letter detailing any revisions to the original proposal and thanking investors for their feedback

## Investor Consultation Process (continued)

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**Higher quantum (material increases in fixed or variable pay), change of approach to incentives (e.g. one off valuing sharing plan) or substantial change of remuneration policy**

1. Letter detailing the change and summarising broader remuneration policy
2. Meeting briefing note or formal slide presentation
3. Coaching e.g. mock meetings prior to the main event
4. Arranging the meetings
5. Assisting the RemCo Chair with interpreting feedback
6. Formulating a revised proposal taking account of the feedback received during the meetings (if appropriate)
7. Follow up letter
8. Final feedback

## Approach to investor consultation (continued)

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### Timing

- If consulting, then need to be early enough in cycle to ensure that changes can be made
- If very substantial changes are being considered then sometimes a very early consultation where outline proposals are aired can be effective
- If trying to win support for decisions already taken, then can be post publication of remuneration report

### Format

- Face to face meeting with fund manager and corporate governance manager (if they have one) probably most effective rather than just letter and/or call
- Group meetings with more than one shareholder can be effective as allow you to consult with more shareholders BUT run the risk of one critical shareholder swaying views of others

## Investor Consultation Process – who should attend?

Advisor	Reward director & Advisor	RemCo Chair, Reward director & Advisor	RemCo Chair & Reward director	RemCo Chair
Historically not uncommon	Historically not uncommon	Relatively common	Increasingly common	Not too common
Investors no longer keen as want to see Company not advisors	Investors no longer keen as want to see RemCo Chair is behind policy not just management	Reward director and advisor there to deal with technical questions	Investors often prefer not to see advisors	Whilst shareholders might like fact that management not represented, many RemCo Chair uncomfortable with detail

Might be appropriate to take Corporate Affairs Director  
 In some instances (possibly as follow-up) there can be a role for the Company Chair

# Effective shareholder communication – the remuneration report

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Best Practice has evolved beyond compliance with the basic regulations to now include:

- An introductory letter from the RemCo Chair
- Clear linkage between the front end of the Annual Report and the Remuneration Report
- Tabular summary of policy
- Charts illustrating the balance between fixed and variable pay
- Explanation of performance targets and justification of incentive payouts
- Performance to date for outstanding long-term incentive awards
- Individual total remuneration analysis;
- Links between directors' pay and that of other employees
- Details as to how risk is taken into account

## Lessons to learn

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- ISS's influence on voting should not be underestimated
  - Increasing prevalence of overseas investors; and
  - Outsourcing of voting activities
- Substantive changes to remuneration policy may require shareholder meetings - particularly where quantum is being increased
- Increasing quantum and special remuneration arrangements (on appointment, contractual terms, one-off incentive plans) remain potentially contentious.
- Consult early
- De-clutter the Remuneration Report which should, as far as possible, be forward looking and concise
- Beware of 'unintended consequences'
- No going back – once you have disclosed something, difficult to revert to previous approach!

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