

***Does ‘Say On Pay’ Work?  
Lessons on Making CEO Compensation  
Accountable***

**Policy Briefing No. 1**

**[DRAFT]**

THE MILLSTEIN CENTER FOR CORPORATE  
GOVERNANCE AND PERFORMANCE



YALE SCHOOL OF MANAGEMENT

by

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***This draft policy briefing is being released for public comment***

**Comments:** Comments on any aspect of this draft are welcome. Please address comments to Stephen Davis, Millstein Center Fellow, and send to Michele Grammatico, Coordinator, at [michele.grammatico@yale.edu](mailto:michele.grammatico@yale.edu).

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## **Executive Summary**

*Based on a review of UK experience, advisory shareowner votes on executive compensation policies (“say on pay”) appear practical for adaptation in North America and other markets. They represent a lever that could strengthen both boards and shareholders in the quest to better align top corporate pay with performance. But they are hardly a panacea on their own. They are likely to spur dialogue between boards and shareholders. However, market parties in the UK—which pioneered the advisory vote concept—remain concerned that boards and investors are each falling short of success in tethering pay to performance. US players may be able to adjust advisory votes to avoid flaws evident in the UK. Indeed, turning advisory votes into a value-driving tool in the US could involve fitting the practice into a package of accountability reforms. Further, boards, shareholders, and service providers face the challenge of hard-wiring material changes in their operations to get ready for advisory votes.*

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## 1. Introduction

The Millstein Center's mission is to serve as a vital contributor to the growing architecture of international corporate governance. The Center sponsors research, hosts conferences, generates global databases, designs training and publishes Policy Briefings on emerging corporate governance policy issues. *Does Say on Pay Work?* is the first in a series of Policy Briefings designed to assist policymaking.

Millstein Center Policy Briefings are framed as think tank reports rather than scholarly research. They include original material and policy analysis in a concise format. Reports serve both as pointers to further detailed empirical research and as a resource for market practitioners.

Annual non-binding shareowner votes on corporate executive compensation policies—known colloquially as ‘say on pay’ rights—are now required in several jurisdictions after having debuted in the United Kingdom in the 2003 annual meeting season. Elsewhere, ongoing shareowner concerns about misalignment between executive pay and corporate performance have stoked interest in ‘say on pay’ as a possible antidote. Investors and lawmakers in the United States moved the idea to the forefront of debate in 2007, but players in France, South Africa, Switzerland and other countries are watching developments with a view to introducing advisory votes as well.

Despite fast-spreading interest in the measure, there has been surprisingly little analysis about whether advisory votes on remuneration work, in the sense of achieving greater alignment between pay and performance, or what impact they have had where implemented.<sup>1</sup> The Millstein Center sought to advance the assessment process through this paper and findings summarized in author testimony on March 8 2007 before the US House Financial Services Committee on H.R. 1257 (see text of the bill in Appendix B). The analysis concentrates on Britain as the only market with an extended track record of experience with advisory votes. The report is based largely on:

- Historical research;
- Data on compensation trends and voting outcomes;
- Roundtable workshops conducted in London by the Center in February 2007;

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<sup>1</sup> The principal early report was commissioned by the UK Department of Trade and Industry [Deloitte, *Report on the Impact of the Directors' Remuneration Report Regulations* (Nov. 2004).] PIRC, the governance advisor, published a detailed response [PIRC, *Review of the Study by Deloitte and Touche for the DTI* (2005).] Since research began on this Policy Briefing three other analyses have been released: Paul Hodgson, *Say on Pay: A Brief History of Shareholder Voting on Executive Compensation* (The Corporate Library, Jan. 16 2007); Amy Knieriem and Kelly Crean, *GRIST InDepth: 'Say on Pay' Policies—A Global Comparison* (Mercer Human Resource Consulting, May 2 2007); and Institutional Shareholder Services, *What International Markets Say on Pay: An Investor Perspective* (April 2007).

- Interviews with investors, non-executive board directors, corporate executives, company secretaries, scholars, compensation consultants, auditors and proxy service providers;
- A roundtable workshop in New York City convened by the Working Group on Advisory Votes in association with the Millstein Center.

The Millstein Center is grateful to the following bodies which provided assistance in the Policy Briefing project: AFSCME; Association of British Insurers; Financial Reporting Council; Institute of Chartered Secretaries and Administrators; Institute of Directors; International Corporate Governance Network; Manifest; PIRC; RREV (Institutional Shareholder Services); Shareholder Forum; and the Working Group on Advisory Votes, which provided special cooperation in respect of the Frequently Asked Questions section. However, the content of the Policy Briefing is solely the responsibility of the author.

## 2. Setting the Stage

Escalating CEO pay has a unique capacity to capture attention in virtually any market. Headlines dub it the “fat cat pay” issue, and spotlight cases of over-the-top excess. Think of Tyco CEO Dennis Kozlowski’s US\$2 million corporate-funded birthday party for his wife. Or Conrad Black’s US\$600,000 vacation in Bora Bora, courtesy of Hollinger International shareowners. Or Home Depot’s Robert Nardelli walking away with a US\$210 million golden parachute after presiding over relative corporate decline.<sup>2</sup>

But to many institutional investors the real controversies have little to do with executive avarice and everything to do with board accountability. Fund analysts believe that the way directors pay top management represents an x-ray into how thoroughly a board attends to shareowner value. The scale of misalignment can be daunting. To take one indicator, in the five years ending in 2004 some 60 companies at the bottom of the Russell 3000 index lost US\$769 billion in market value while their directors disbursed more than US\$12 billion to top managers, according to MVC Associates.<sup>3</sup> “Flawed compensation arrangements have been widespread, persistent, and systematic, and they have stemmed from defects in the underlying governance structure that enable executives to exert considerable influence over their boards,” wrote Lucien Bebchuk and Jesse Fried in *Pay Without Performance*.<sup>4</sup> Or more simply: “Too often, executive compensation in the US is ridiculously out of line with performance,” declared Warren Buffett in his 2005 letter to Berkshire Hathaway shareowners.<sup>5</sup>

Some investors have long clamored for transparency and accountability in the process by which boards set remuneration. In the United States, where CEO pay has risen exponentially, by almost every measure, since the early 1980s, investors, regulators and lawmakers have spent particular effort advocating different solutions.<sup>6</sup> They required more disclosure and explanation of pay details. They demanded independent remuneration committees. They imposed tax penalties on pay over a certain level that is unlinked to performance. And they asked boards to control conflicts among outside consultants. For all that, however, there is precious little evidence that such measures have produced the desired effect of binding pay tightly to shareowner value. In fact, some studies suggest that enhanced disclosure and tax changes, in particular, have ratcheted pay even further beyond historic highs, not downwards.

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<sup>2</sup> *Chicago Tribune* (Sept. 20 2005); [www.cbc.ca/news/background/black\\_conrad/trial-exhibits.html](http://www.cbc.ca/news/background/black_conrad/trial-exhibits.html); *Washington Post* (Jan. 4 2007).

<sup>3</sup> Stephen Davis, Jon Lukomnik and David Pitt-Watson, *The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda* (Harvard Business School Press, 2006), p. 105.

<sup>4</sup> Lucian Bebchuk and Jesse Fried, *Pay Without Performance* (Cambridge: Harvard University Press, 2004).

<sup>5</sup> [www.berkshirehathaway.com/letters/2005ltr.pdf](http://www.berkshirehathaway.com/letters/2005ltr.pdf).

<sup>6</sup> See, for instance, data compiled by MVC Associates at [www.mvcinternational.com/asp/cboresarch.asp](http://www.mvcinternational.com/asp/cboresarch.asp).

Activist funds turned to board election reform as an antidote. When SEC chairman William Donaldson boldly floated a proposal to grant shareowners a limited right to nominate directors, enthusiasm for such “access to the proxy” soared.<sup>7</sup> Funds saw the approach as offering a constructive outlet for expressions of frustration with boards they deemed unresponsive to investor interests. But Donaldson’s initiative foundered in 2005 when the Commission deadlocked on the issue. Stymied, vanguard investors looked for alternative means of enhancing board accountability, including on pay.

Thus was born the ‘say on pay’ campaign. In 2002 Britain’s Labour government had introduced an annual advisory vote on the directors’ remuneration report. Since then, Australia and Sweden have followed suit, while the Netherlands and Norway have instituted binding annual votes of confidence on compensation. Curiously, lawmakers in each jurisdiction acted in the absence of thorough studies on the impact of advisory votes. Then, in the US, AFSCME, the union representing civil service employees, filed trial balloon resolutions calling for UK-style ‘say on pay’ at seven companies in 2006. Results averaged 40%, an unheard-of high for an idea in its first innings.<sup>8</sup>

In 2007 the Council of Institutional Investors announced support for ‘say on pay,’ as did the Interfaith Center on Corporate Responsibility and key proxy services, including Institutional Shareholder Services and Glass Lewis. Funds filed more than 60 such resolutions. Outcomes so far in 2007 yield results averaging in the 43% zone, with three companies—Blockbuster, Motorola and Verizon—showing majorities in favor.<sup>9</sup> Aflac, the insurance company, became the first US corporation to adopt voluntarily the measure, beginning with its 2009 annual meeting.<sup>10</sup> In April 2007 the House of Representatives passed, by a lopsided bipartisan majority of 269 to 132, legislation that would require all listed companies to feature non-binding ‘say on pay’ resolutions on their ballots. An identical Senate bill is pending (see the text in Appendix B). And a rare ad hoc working group of both corporate and investor officials joined to develop common research and approaches to the issue. It has set a July 19 2007 conference hosted by Pfizer to air views.<sup>11</sup>

As markets reflect on advisory votes as the latest innovation in governance, the place to look for insights on how it works is Britain, which has a track record of experience with the measure.

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<sup>7</sup> <http://sec.gov/news/speech/spch100803whd.htm>.

<sup>8</sup> Institutional Shareholder Services, *What International Markets Say on Pay: An Investor Perspective*, (April 2007).

<sup>9</sup> Institutional Shareholder Services maintains a running online tally of ‘say on pay’ voting outcomes at [www.issproxy.com/knowledge\\_center/say\\_on\\_pay/index.html](http://www.issproxy.com/knowledge_center/say_on_pay/index.html).

<sup>10</sup> [www.aflac.com/us/en/aboutaflac/PressReleaseStory.aspx?rid=962932](http://www.aflac.com/us/en/aboutaflac/PressReleaseStory.aspx?rid=962932).

<sup>11</sup> This Millstein Policy Briefing project was produced in cooperation with the ad hoc Working Group, which was convened by Tim Smith of Walden Asset Management, Margaret Foran of Pfizer and Richard Ferlauto of AFSCME..



### **3. Testing the Track Record: Advisory Votes in Britain**

#### **From Cedric to Suffrage: Evolution of Advisory Votes on Remuneration**

Cedric, a 280-pound pig, made his mark in the history of corporate governance in 1994 when shareowners famously dragged him as a protest to the British Gas annual meeting. At issue that year was the escalating pay of Cedric Brown, then CEO of the privatized utility. The Tory government was facing ongoing criticism from investors and voters about “fat cat pay,” particularly at privatized former state-owned enterprises. Ministers found their laissez-faire disclaimer—that government was no longer in position to set compensation—widely greeted as inadequate.

Soon after Labour came to power in 1997 the government sought a “third way” approach to the issue. Advisory votes of confidence, first outlined by Department of Trade and Industry minister Stephen Byers in 1999, would hand shareowners fresh power to address CEO remuneration on their own without the government renationalizing or intervening in boardrooms. In political terms, the idea was designed to get that particular monkey off the government’s back. When calls on companies voluntarily to introduce such measures failed to take hold, the government introduced legislation in parliament in August 2002. ‘Say on pay’ came into effect in 2003. The measure, now transferred to the Companies Act 2006, covers all UK corporations trading on UK exchanges except for the Alternative Investment Market (AIM) (Appendix A contains the relevant Companies Act texts). Foreign companies traded in Britain are not required to comply.

#### **The First Clash: The Case of Glaxo**

If Cedric the pig embodied the zenith of street protest over corporate pay, the May 2003 advisory vote at GlaxoSmithkline (GSK) proved the turning point in shareowner activism on the issue. In the first year of universal ‘say on pay’ in Britain, the pharmaceutical giant’s board resolution was defeated, with 50.72% against. Directors had endeavored to reward its CEO, Jean-Paul Garnier, according to US-like pay scales. The widely-reported vote result, though non-binding, proved both a repudiation of GSK’s own complacent attitude toward shareowner communication and an embarrassing hit to the reputations of the firm’s directors. Chairman Sir Christopher Hogg spent a year seeking to reconstruct relationships with investors. But the more important result of the GSK loss was the jolt it sent through corporate Britain. “Beforehand, we paid the CEOs what we wanted to and told investors who objected ‘too bad,’” recalled one former board member. But the Glaxo loss “concentrated the mind wonderfully. Now the board must base remuneration on performance and be scrupulous about it.”

## Lessons from the UK

Despite corporate fears that shareowners would resort too readily to voting against board pay policies, just eight companies—all relatively small in size, except for GSK—have seen ‘say on pay’ resolutions defeated in the last four years, according to ISS figures. Moreover, the proxy services themselves have largely exercised restraint in their advice. Glass Lewis has recommended votes against at approximately 10% of UK companies covered. ISS, which operates in Britain through RREV, a wholly owned subsidiary linked to the National Association of Pension Funds, recommended votes against remuneration reports in 13.4% of cases (158 companies out of a universe of 1,183) in 2006.<sup>12</sup>

But those tallies tell only part of the story of the UK experience with advisory votes. Following are observations derived from a series of Millstein Center roundtables and interviews conducted in London in 2007 (see participant list in Appendix E).

***Votes on compensation policy resulted in a marked rise in dialogue between corporate boards and management, on the one hand, and institutional investors on the other. This transformed the way compensation policies are constructed.***

The introduction of ‘say on pay,’ and in particular the GlaxoSmithKline board’s stunning defeat in 2003, produced a virtual overnight increase in the level of dialogue between companies and funds. Directors have shown a strong interest in avoiding the prospect of individual and collective reputational damage resulting from significant shareholder opposition. The Association of British Insurers (ABI) estimates that contacts initiated by companies before they finalize compensation plans tripled.<sup>13</sup> And RREV, which had recorded an average 20 such outreach efforts by companies each year prior to ‘say on pay,’ engaged in 150 instances of dialogue in 2005 and 130 in 2006.<sup>14</sup> These consultations ranged from a simple phone call to multiple high-level meetings. In many cases such dialogue resulted in boards changing corporate plans to strengthen performance triggers in ways that met shareholder objections. Critics have raised concerns about minority or special interest shareowners abusing a ‘say on pay’ system to enhance their sway over boards of directors. In Britain, anxiety over a tide of investor uprisings proved misplaced. Investors have come to view a vote against board pay policies as an option of near-last resort. Just 64 companies out of 596 reporting voting results between 2002 and 2007 experienced combined dissent (‘no’ votes plus abstentions) of more than 20%, according to Deloitte.<sup>15</sup>

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<sup>12</sup> Emails from Glass Lewis and ISS, provided by the ad hoc Working Group on Advisory Votes.

<sup>13</sup> Interview with Peter Montagnon, Head of Investment Affairs, January 2007.

<sup>14</sup> Interview with RREV director David Paterson, Feb. 5 2007.

<sup>15</sup> Data provided by Deloitte in email March 6 2007. See also Deloitte, *Executive Directors’ Remuneration* (London: September 2006).

***While top executive pay in the UK continues to outpace inflation and average workforce wage increases, advisory votes are widely seen as having been an important contributing factor in taming the rate of increase, curbing opportunities for ‘pay for failure’ and linking compensation dramatically closer to performance.***

As elsewhere, fuller disclosure of compensation in Britain is suspected of having been a contributing factor in rising pay levels among top executives. Advisory votes do not appear to have reversed that trend. Absolute numbers continue to climb, though at a more measured pace. The average annual increase has slowed in the last four years to between 5 and 11% for CEOs, according to studies conducted recently by Manifest, New Bridge, PIRC and RREV.<sup>16</sup> However, advisory votes are credited by virtually all parties with producing “dramatically better alignment between incentive pay and shareholder value,” as one roundtable participant put it. For instance, the latest Deloitte study concluded that the level of variable pay has increased significantly with meaningful performance conditions attached to incentive compensation. It also found stock option plans are being replaced by share grants tied to significant performance triggers advocated by shareholder bodies. Payouts for average performance have dropped significantly in response to investor pressure. New limits cap the amount of options any one executive may be granted. And golden parachute packages, swelled to three times final salary before a drive to curb them began in 1999, have steadily shrunk to the equivalent of one year’s wage. The quality of reporting on pay has improved substantially. In short, “the level of transparency and disclosure and explanation today can’t be compared to before,” contends one service provider. This, however, is an area that demands further detailed research.

***Corporate board compensation committees have retooled the way they design and communicate about executive pay plans so as to draw support from institutional shareholders.***

Before advisory votes came into force, the typical corporate compensation committee had to produce a package aimed at persuading the board. After advisory votes, the board compensation committee had to design packages capable of persuading shareholders. The difference has proven significant. Pay panels now meet more frequently; engage in design-stage consultation with key investors, investor trade organizations and/or proxy service advisors; utilize more information; and hire more independent outside advice. Directors “demonstrate more awareness that their work will be subject to broad scrutiny” and are “more diligent” about crafting policies that allow them “to defend decisions taken,” according to corporate secretaries at a Yale roundtable in London. Moreover, compensation committees “are much more constrained” in shaping generous severance terms, since UK shareholder guidelines on CEO employment contracts are prescriptive and relatively strict.

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<sup>16</sup> Manifest and MM&K, *The Executive Director Total Remuneration Survey* (London: May 2007); RREV, *Trends in Executive Remuneration 2006* (London: April 2007); New Bridge Street Consultants, *The 2006 FTSE 100 Executive Directors’ Remuneration Survey* (London: 2006); PIRC *Corporate Governance Annual Review 2006* (London: 2006).

Chairs of compensation committees, in particular, have welcomed advisory votes as they supply leverage in standing up to potential insider pressure. Directors have long wrestled with the task of balancing the interests of the CEO and management, on the one hand, and the interests of shareowners, on the other. “The advisory vote balances the scales,” contends a UK investor. “From our work in the UK we have observed that it provides the directors with the leverage (one might say motivation, tools or even backbone) they need to stand up to a strong CEO on pay.”

However, corporations are on a learning curve. Some initiate early, high-level dialogue with investors and produce fulsome disclosure documents considered best in class. Others make only token efforts at consultation and rely on boilerplate in reporting. PIRC, known for taking a critical approach, asserted that “only 41% of the FTSE All-Share companies in our 2006 sample fully explain their executive pay policy aims in terms of their long-term strategy or other factors specific to the company.”<sup>17</sup>

***Institutional investors have stepped up scrutiny of executive pay packages but continue to search for effective methods of monitoring compensation.***

“There is no question that investors changed dramatically after introduction” of advisory votes, observed one market player in Britain. Before them, institutions other than the handful of leading activists generally devoted fewer resources to systematic analysis of compensation structures except in egregious cases brought to special attention through media or other circumstances. The onset of universal voting on pay at FTSE All-Share companies generated fresh demands on both the time and skills of fund professionals as corporate boards sought input on plans, and as complex incentive policies required analysis for ballot decision-making. Funds have experienced mixed success in facing challenges posed by the introduction of advisory votes. Some funds responded by relying almost entirely on outsourced agents, the proxy advisory services, to conduct such analysis and consultation. Leading funds, however, sought to participate directly in engagement with companies over pay practices, relying on internal corporate governance staff to shoulder the task. They report having had marked success in persuading many boards to tie incentive pay directly to performance. However, institutional investors also worry that they have entered into something of an “arms race,” where they are struggling to match expertise with corporations’ remuneration consultants who produce ever more complex arrangements. Said one investor: “we risk getting lured into tweaking; of thinking we’ve achieved objectives when we might be missing the big picture.” UK funds are beginning debate about whether to ease their own prescriptive guidance on pay practices in favor of broader principles that can be adapted to individual companies. They are also assessing at what level of detail they must engage when reviewing compensation plans.

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<sup>17</sup> PIRC, *Corporate Governance Annual Review 2006* (London: 2006), p. 27.

***Providers of proxy analysis and recommendation services have found their role enhanced.***

Investment funds in Britain expect proxy service providers to vet remuneration plans with companies and to engage in dialogue with boards in search of improvements before plans are finalized. Other funds use service providers merely for guidance in voting. Either way, market concerns center on two questions: First, whether too many investors follow service provider voting advice automatically and, second, whether such providers apply a “one-size-fits-all” framework instead of evaluating compensation plans according to a company’s specific circumstances. The services themselves have confronted other challenges. They experienced intense new demands on internal resources in the wake of advisory votes on compensation. Ventures providing recommendations had to re-examine guidelines on pay as such best-practice advice now related directly to a voting item. The two most influential UK services (ABI’s IVIS and the NAPF’s RREV, owned by Institutional Shareholder Services) reported a substantial rise in outreach by corporate boards and representatives, such as compensation consultants. Services which may not have girded themselves with dedicated compensation expertise faced needs to improve the sophistication of their analysis of pay policies. Investor clients now expected them to conduct more intense probes into how corporate pay may be related to performance.

***Advisory votes have proven particularly effective in a context of measures that provide for substantial board accountability.***

Advisory ballots on compensation appear to carry particular weight in the UK because of a related power. Investors retain authority under corporate law to oust directors by majority vote. If members of a remuneration committee fail to be responsive to shareholder concerns over pay policies, investors understand that they have the real, but rarely exercised, option in an annual meeting—or by a mid-term special meeting—of supporting their ejection from a board. Therefore, directors choosing to ignore significant dissent in an advisory ballot face the risk of practical consequences.

The ‘teeth’ of majority rule may explain in a differing way why both corporations and investors in Britain have come to endorse the concept of advisory votes on pay. Boards see the measure as a way of channeling dissent away from elections so that directors can isolate and resolve a specific problem over pay rather than risk stinging levels of opposition, or outright defeat, for a board candidate. Investors, for their part, back votes of confidence on remuneration because the tool allows them to register dissent over pay without exercising their power to overthrow board members they might otherwise support.

***Advisory votes are seen by government as having succeeded not only in handing investors a voice on compensation, but in contributing to the competitiveness of the British economy and the attraction of London as an international capital market.***

British lawmakers may have initiated advisory votes “as a negative push to correct scandals on pay,” asserted a key official the UK Department of Trade and Industry (DTI), the agency which crafted and now oversees ‘say on pay’ legislation. But London now perceives them as part of strategic measures that “enhance the competitiveness of the UK economy.” The DTI has concluded that advisory votes result in “better planning by corporations, fewer surprises, better dialogue with investors.” They are “a prophylactic against poor management,” the official said in an interview, keeping UK companies in fighting trim. Advisory votes are among “appropriate steps to reduce risk...and we have had no big scandals among quoted companies” in recent years. Public authorities and the London Stock Exchange have touted the UK corporate governance regime, including ‘say on pay’ voting rights, as equipping the City with a competitive edge for attracting capital, especially in comparison to New York.<sup>18</sup> Echoing that perspective, four of the world’s largest funds recently wrote to the Securities and Exchange Commission asking for advisory votes to expand shareholder rights and, thereby, to improve the attraction of the US for foreign capital.

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<sup>18</sup> Foreign corporations listing in London need not offer a ‘say on pay’ right to shareowners unless their home market rules require it. But the DTI believes the measure contributes to London’s brand as a trusted market. The London Stock Exchange also sees corporate governance as an advantage. ““On an array of measures - from IPO costs, trading costs and perceived corporate governance standards - London offers a highly competitive environment in which to conduct business relative to its major challengers,” it said in a typical press release (June 29 2006) ([www.londonstockexchange.com/NR/exeres/E9A703D2-6818-4A60-9C23-7DA9FBD0BB4D.htm](http://www.londonstockexchange.com/NR/exeres/E9A703D2-6818-4A60-9C23-7DA9FBD0BB4D.htm)).

## 4. Adapting Advisory Votes to the US

It follows from the observations above that ‘say on pay’ in Britain is a demonstrated if flawed propellant of more robust corporate-shareholder relations. It has a meaningful record of strengthening performance links to CEO compensation. Further, insights from the UK experience illuminate variables US players should address in the course of Americanizing advisory votes on pay. Some involve legislation; others adaptation of market practices.

### Selected Policy Considerations

- Corporate resistance to advisory votes on pay tends to fuel support for legislative action mandating the policy for all listed firms. The history of UK experience before votes on pay became law makes clear that 23% of FTSE All-Share companies, many already known for responsiveness, became early voluntary adopters.<sup>19</sup> But most companies—including ones watchdogs deemed most in need of greater accountability—shunned the tool, despite significant government and investor pressure.<sup>20</sup> A credible effort to stave off a market-wide US legislative mandate would likely have to involve even controversial companies embracing ‘say on pay’ on a voluntary basis. Otherwise, lawmakers will likely face sustained grassroots pressure to adopt pay measures.
- Advisory votes appear to offer constructive outcomes in and of themselves. However, investors championing ‘say on pay’ in the US already contend that such rights can reach their full potential when operating at companies which conduct director elections according to the majority vote standard.<sup>21</sup> AFSCME, a lead advocate which favors both majority rule and shareowner rights to nominate directors, put it this way in testimony before Congress. “In the UK, which has both rights, these shareholder powers are viewed much like soccer’s yellow and red warning system. The advisory vote is the yellow card. A large shareholder vote against a pay report is the yellow card warning to the company board. If this warning is not heeded and pay practices are not reformed and better aligned with performance, then shareholders have the opportunity to use the red card by replacing failed directors.”<sup>22</sup> Ongoing efforts to install majority voting as the electoral standard at US companies can be an important parallel development in the drive to better align executive pay with performance. As of April 2007, 52% of US S&P 500 corporations had adopted some form of majority rule elections.<sup>23</sup>

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<sup>19</sup> PIRC, *Review of the Study by Deloitte and Touche for the DTI* (2005).

<sup>20</sup> *Ibid.*

<sup>21</sup> See, for instance, “Testimony of Richard Ferlauto, Director of Pension and Benefit Policy, American Federation of State, County and Municipal Employees, Before the Committee on Financial Services-US House of Representatives on H.R. 1257 The Shareholder Vote on Executive Compensation Act, March 8 2007.”

<sup>22</sup> *Ibid.*

<sup>23</sup> Statistics provided by Neal, Gerber & Eisenberg LLP.

- Corporate boards can develop effective proactive strategies to secure investor loyalty in advisory votes. New SEC disclosure rules on pay are far more comprehensive than those in Britain. Compensation committees can oversee design-stage consultation exercises with investors and/or their agents, and road shows on pay policies in advance of the annual meeting. [See Frequently Asked Questions.]
- The large US market features a more diverse and numerous shareowner base than Britain, and no investor trade associations with financial and political clout comparable to the ABI and NAPF. However, leading investors can prompt entities such as the Council of Institutional Investors to develop advanced collective guidance on best-practice compensation principles and insist that outsource services abide by them. This approach can begin to address fears, also expressed by market parties about Britain, that ‘say on pay’ in the US would inflate the influence of commercial proxy recommendation firms.
- Funds may not fully appreciate that ‘say on pay’ may require them to expand resources they tap to address corporate compensation at portfolio companies, or to rely further on analysis produced by outsource agents such as proxy or engagement services. Institutions would also have to revisit corporate governance and voting guidelines to ease the process of casting ballots on advisory votes. Funds or fund trustees may have to mount further oversight of fund managers as to how or whether they analyze executive pay at portfolio companies. One approach floated by certain funds in Britain is to have institutional investors hire, individually or collectively, their own outside compensation experts to review corporate plans in detail. Other funds contend that it is not feasible to compete with boards in what becomes an arms race of expertise on remuneration. Instead, they suggest that the best approach is for investors to focus on “asking the right questions” and making sure that the remuneration committee has “the right people” to frame compensation to advance shareowner interests.
- Funds may face pressure by corporates, their own clients or stakeholders to adopt ‘say on pay’ policies covering their own practices. Some lawmakers debating H.R. 1257 have already pressed US trade unions to do so. Mutual funds, which feature periodic board votes, might have to respond to similar calls.



## 5. Frequently Asked Questions about Advisory Votes

This Policy Briefing has had the benefit of partnership with the Working Group on Advisory Votes, an ad hoc coalition of investing institutions and corporations. The Working Group helped gather many of the following questions and members generously commented on draft answers.

### 1. *What precisely goes before investors for a vote—exact pay numbers, or big-picture policies?*

In Britain the law is simple: each listed company (other than those traded on the Alternative Investment Market) must annually put forward a resolution at the annual meeting asking shareowners to approve the report of the remuneration committee. The proposal addresses the package of policies and practices approved by directors as outlined in their compensation report. The resolution is *not* an endorsement of any specific employment contract or pay arrangement.

A typical UK resolution—this one drawn from BP's April 12 2007 annual meeting agenda—states as follows:

***Resolution 2: Directors' Remuneration Report.** To approve the directors' remuneration report for the year ended 31 December 2006.*

BP's notice booklet, equivalent to a US proxy statement, then includes a Notes section on the resolution which states as follows:

*The directors' remuneration report is included on pages 26-35. It complies with requirements of the Companies Act 1985 (as amended) for a report on the remuneration of all directors, both executive and non-executive. The report is divided into three parts. Executive directors' remuneration is set out in the first part of the report, which was prepared by the remuneration committee. Non-executive directors' remuneration is set out in the second part of the report, which was prepared by the company secretary on behalf of the board. Additional statutory information and other disclosures are contained in the third part. Relevant sections of information are subject to audit. The report has been approved by the board and signed on its behalf by the company secretary.*

A UK directors' remuneration report is roughly equivalent to the US Compensation Discussion and Analysis (CD&A). But there is a significant difference. The CD&A is a product principally of management, though it may be approved by the board Compensation Committee, whereas the UK report is authored exclusively by the board.

The Working Group on Advisory Voting has been considering options for language in a US model resolution and expects to produce its ideas for public scrutiny. A resolution, for instance, could be titled simply: “Ratification of the Board Compensation Committee Report.” This report might include the Compensation Discussion and Analysis, tabular compensation disclosures now required by the SEC, and any other commentary prepared by the compensation committee.

## **2. Did the onset of advisory votes in Britain produce a substantial increase in cases of votes against management?**

Anxiety over a tide of investor uprisings proved misplaced. Investors have come to view a vote against board pay policies as an option of near-last resort. Just 64 companies out of 596 reporting voting results between 2002 and 2007 experienced combined dissent (‘no’ votes plus abstentions) of more than 20%, according to Deloitte.<sup>24</sup>

## **3. If shareowners reject an advisory vote on compensation, won’t a company be forced to guess which components of the report proved of most concern?**

In markets where advisory votes are in effect, companies have reported few barriers to determining root causes in instances where they have been caught off guard by shareowner dissent reaching significant levels. Boards report that they identify triggers for ‘no’ votes by:

- Consulting analytical reports prepared before the meeting by proxy advisory and governance research firms;
- Arranging meetings with key investment community organizations, such as trade bodies;
- Soliciting meetings with representatives of major fund owners;
- Reviewing media reporting about the company’s compensation policies; and
- Reading any letters sent to the company by dissenting investors.

These steps can reduce guesswork. Where dissenting votes are significant, there are typically a small number of issues that appear to rise to prominence to galvanize opposition. However, it is also common that companies engaged in ongoing dialogue with investors and proxy advisors on compensation (and other matters) are made aware of criticism of pay policies in advance of the annual meeting, and indeed before the compensation committee settles on key policies. That way, directors have an opportunity of preempting opposition—and managing risks of negative media—by modifying pay practices.

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<sup>24</sup> Data provided by Deloitte in email March 6 2007. See also Deloitte, *Executive Directors’ Remuneration* (London: September 2006).

Aflac CEO Dan Amos set out his approach to a hypothetical shareowner ‘no’ vote. “We would go back to our big shareholders and ask: ‘Why did you vote against? What was it you didn’t like?’ From there, we’d make adjustments.”<sup>25</sup>

Another idea has been floated by some investors. A proxy statement could provide shareowners with the option of turning to a company website to frame comments on corporate compensation policies.

#### **4. Would the 10-day discretionary broker voting rule apply to advisory votes on pay?**

Absent any special amendments, New York Stock Exchange listing Rule 452 would automatically apply to any management resolution seeking an advisory vote on pay. That means brokers would be allowed to cast ballots on behalf of clients if they have received no voting instructions 10 days before a meeting. In practice, most brokers have routinely voted in alignment with management, though some are now apportioning votes to mirror instructions by other investors.<sup>26</sup>

Many institutional shareowners—notably the Council of Institutional Investors—have long objected to the discretionary voting rule on grounds that it can distort outcomes, usually by magnifying totals cast for management. A New York Stock Exchange working group recommended abolition of broker voting in respect to director elections, and the Exchange’s board endorsed that stance in October 2006. Various corporate bodies have contended that reform of Rule 452 should properly await rule changes facilitating direct corporate communication with ultimate shareowners. At this writing the US Securities and Exchange Commission is still considering whether to ratify, modify or reject the NYSE-requested revisions in Rule 452.

Whatever the outcome, the discretionary voting rule would still apply to management resolutions proposing advisory votes on compensation. A separate reform process would have to be launched at the NYSE to remove such proposals from 452 coverage.

Note that Rule 452 does not now, and would not in the future, apply to any dissident shareowner resolution seeking an advisory vote on pay. Such proposals are by definition non-routine, and therefore not subject to discretion under the rule. Brokers may not cast uninstructed votes on those resolutions.

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<sup>25</sup> *USA Today* (Feb. 14 2007).

<sup>26</sup> “Mirror voting” itself is controversial. Critics assert that it is subject to manipulation.

## **5. How does a corporation best engage in consultation with its shareowners on compensation policy?**

Executive compensation can be a lightning rod issue for many shareowners, in part because they see it as a litmus test for determining how dedicated a board might be to aligning corporate objectives to shareowner value. So it is often essential for directors and investors to engage in an open and thoughtful dialogue. The benefit for companies is clear-cut: they can obtain feedback and guidance on compensation policies, enabling them either to revise plans, better anticipate and perhaps preempt resistance, and/or manage risks of opposition. Investors gain by having the opportunity to provide input aimed at enhancing value. Dialogue helps them better understand a board's compensation thinking in the course of refining engagement strategies.

Consultation on compensation is not cost-free, however. The exercise requires resources on the part of investors, corporate executives, board directors and, often, outside consultants. For the shareowner, it typically involves a screening process to determine which portfolio companies merit extra attention; collection and analysis of information; and informed dialogue with corporate officials. For companies, consultation involves an internal assessment of issues with potential to trigger investor disquiet; identifying and preparing outreach opportunities; and fielding directors and skilled officials for meetings with investors. One common point of debate in such sessions is the tension between a board's interest in crafting packages competitive enough to draw best executive talent against investor guidelines—some quite rigid—designed to put a framework around compensation.

Consultation has often taken a different course in the US as compared to the UK. In the US the shareowner resolution process can be used as a stimulus to productive dialogue. For instance, TIAA-CREF filed 10 dissident resolutions in 2007 calling for majority rule voting in director elections. The filings prompted every one of the targeted firms to open high-level negotiations with the fund, resulting in withdrawal of all the resolutions. In Britain, however, most investors consider the act of submitting a challenge resolution to an annual meeting as a last and hostile resort following a breakdown in relations with the company.

The advisory vote, if applied market-wide, would be a regular management resolution rather than a ballot item surfacing as a result of shareowner targeting. As a result, it would represent an invitation to annual, ongoing dialogue rather than shotgun exchanges driven by dissent or crisis. Timing, however, might have to be different for dialogue in the US as compared to the UK. The dates for filing agendas in the US are far earlier, forcing earlier consultation over policies.

UK investors surveyed for this Policy Briefing indicated that consultation over advisory votes has ranged in intensity from a simple, one-time telephone conversation to repeated in-person meetings and negotiations. Some companies conduct group consultations or individual consultations with specific investors.

Consultation should aim to build constructive, informed relationships between directors and investors in the framework of advisory votes. Lessons for corporations on consultation over pay drawn from the UK experience include the following measures:

- Prepare an outreach plan well before the annual meeting.
- Plan to consult shareowners before the compensation report is finalized so that boards receive early notice of potential material dissent. That way, directors can consider revisions or persuasion strategies.
- Identify key shareowners, trade associations, agents such as proxy voting analysis services and media who have capacity to sway investor and public opinion on compensation matters. Modulate the engagement plan to reflect intensity of potential dissent.
- Engagement tactics used by UK companies most often include the chair of the remuneration committee offering meetings with key market players. Companies also offer investors meetings with remuneration committee compensation consultants.
- For the US, companies could consider designing road shows pitched not to portfolio managers but to fund officials (who may also be the portfolio managers) responsible for corporate governance. The presentation could include a ‘say on pay’ section in which the company’s compensation is explained in the context of shareowner value. Other methods of outreach could include holding a series of webcasts/conference calls for interested investors during which concerns and critical comments are encouraged; responding to investor letters and calls; and arranging that company officials speak at conferences and forums on executive pay philosophy and metrics. In addition, the board compensation committee could design channels for investor feedback, such as dedicated webcasts or conference calls. In cases of potential controversy, it may be particularly prudent to make the chair of the compensation committee, and not just management representatives, available for dialogue with investors.

**6. If an advisory vote on pay is rejected at the annual meeting, would it force a company to renegotiate contracts or renege on pay arrangements?**

It would have no legal impact. The vote is advisory. It acts as a barometer of shareowner confidence in the compensation policies of a company. There are no obligatory actions that would flow from a rejection just as precatory shareowner resolutions, even if achieving a majority, cannot force boards to respond. This allows boards sufficient flexibility to meet agreed contracts with executives while striving to address investor concern in the following year.

However, in practice, there are serious practical consequences. Companies in Britain have found that significant levels of opposition (commonly thought to be 20% or more) to compensation policies can be deeply injurious to the reputation of the company and its directors if left untended. Media, investors, trade associations and proxy advisory services tend to ramp up pressure on companies experiencing a defeat. Moreover, all UK companies operate in a context of majority rule in director elections. As one investor noted, “boards are aware that if they do not appear to be taking note of the signals that are being sent by shareholders, the next step could be to vote against members of the remuneration committee—which of course is a binding vote.” For that reason, UK boards facing such circumstances have tended to react by consulting with investors to identify offending features, and then modifying them in advance of the next annual meeting.

**7. Are there any legal impediments to advisory votes on pay in Delaware or other state laws?**

None. Experts have found no laws in major US states of incorporation that act as barriers to corporate boards electing to introduce annual advisory votes on compensation policy.

**8. Would the introduction of an advisory vote on pay change the Compensation Committee’s report?**

Advisory votes *require* no change in the report (such as the US CD&A) that the board compensation committee produces. However, as more UK companies are beginning to appreciate, the compensation committee report has a different role in the context of an advisory vote than it does without one. Companies may be inclined to make cosmetic or material changes to reflect this new situation.

Without an advisory vote, the compensation report is seen primarily as a disclosure document, designed to inform investors and meet regulatory information requirements. It might well contribute to shaping market attitudes about the company. But it has no need to persuade anyone but the full board.

By contrast, the compensation report is the subject of a shareowner referendum when an advisory vote is in place. Its function is not merely one of compliance, but of persuasion. Moreover, if it is to have the best chance of winning ‘yes’ votes, it must squarely address investor concerns. The compensation committee must make a case in its report that pay policies are in alignment with solid performance. Advocates of advisory votes contend that it is precisely this element of accountability which compels directors to materially change compensation policies so that they more closely meet investor expectations.

One UK company secretary put it this way: Advisory votes have “caused Remuneration Committees and boards to consider even more carefully their approach to executive remuneration....The nature of disclosures made in the remuneration report is now subject to even greater scrutiny to ensure full transparency...The risk of an adverse vote has caused a refocusing of attitudes—no RemCo or board chairman would want to have their name linked what would be seen to be a ‘failure’ in this respect.”

UK observers believe that many companies there have experienced a steep learning curve in appreciating the subtle difference in the purpose of the remuneration committee report. Directors may feel compelled to make substantive changes in policy. But they find it helpful to make other less material changes. For instance, a document fashioned to persuade must be written and formatted in a language and style that is accessible. A compensation committee may require additional internal or external resources to write a report best capable of communicating.

***9. If a company already maintains regular channels for their investors to express opinions on compensation and other matters, why is an advisory vote necessary?***

When asked this question, UK corporate and investor representatives responded similarly. They observed that many corporations maintain relations through their IR departments and via road shows with portfolio managers at investing institutions. This is natural, as such individuals are responsible for buying and selling stock. However, growing numbers of institutional investors assign stewardship duties such as voting and corporate governance monitoring to specialized staff. These may be located in a compliance, general counsel, or portfolio management wing. Fewer corporations are consistently good at maintaining regular outreach to such investment staff and, as a result, may find themselves caught off guard when a fund the board thinks it knows is found to have opposed management in annual meeting resolutions.

UK market players, therefore, agree that the advisory vote there has prompted healthier and routine dialogue between boards and investor agents responsible for governance. In particular, it has strengthened the role of the compensation committee chair in these discussions. The advisory vote places more of a reputational spotlight on him or her, motivating them to oversee a more vigorous and effective outreach.

One example: GlaxoSmithKline now arranges an annual consultation process on remuneration and governance. The chair of the firm’s remuneration committee conducts two roundtables with about a dozen investor representatives each in two UK cities. Glaxo holds a similar exercise in the US.

**10. The Compensation Committee oversees detailed and complex work on pay. Do shareowners have sufficient expertise, time and resources to, in effect, second guess directors on such matters through an advisory vote?**

UK bodies appear to have reached consensus that investors, particularly institutional investors, are capable of taking up responsibilities granted under the advisory vote practice. “You don’t need to be an Einstein, at least not if you’ve got enough knowledge to buy shares in the company and watch it,” said one former company chairman. “Investors are competent to do it, no question.” Institutional investors themselves assert that if they shoulder the fiduciary responsibility of picking, choosing and holding equities, they can handle the task of making judgments as to whether compensation policies are structured in ways that address their interests. It is the role of the investors to evaluate the compensation report from their own point of view, not to construct it. Nonetheless, UK investors express disquiet that they have not as yet settled on best ways of exercising their advisory vote rights (see next question).

Some investors would skirt the investor expertise argument, contending instead that advisory votes place a burden on the company to explain and justify a compensation plan clearly to its shareowners. A board must present policies in ways that convince shareowners that plans are fully understood—both by shareowners and by the board compensation committee itself. If the case is not persuasive, it may not be up to the shareowners to ramp up expertise, but up to directors to revisit their policies and explanations. A board might discover the need to provide more comparative data with relevant peer groups.

**11. Do investors have to change their engagement practices to handle the responsibilities of an advisory vote on corporate pay policies?**

Institutional investors in Britain strongly support the advisory vote. But they continue to debate means of addressing their advisory vote rights amid concerns that even the best-resourced funds remain less than confident in their compensation oversight strategies. Several consequences, however, are clear from the UK experience.

“There is no question that investors changed dramatically after introduction” of advisory votes, observed one former company chairman. “They were asleep until they had to do something by law.” For one, funds have either had to raise their in-house capacity to analyze compensation, or rely further on analysis produced by outsource agents such as proxy or engagement services. [US funds had to take a similar course in 2007 as companies complying with CD&A requirements tripled the amount of compensation data released to the market.] UK Institutions have also had to revisit corporate governance and voting guidelines to ease the process of casting ballots on advisory votes. This has meant one-time internal reviews by individual funds but, equally, work by collective investor bodies to update joint guidance on compensation. Finally, funds have often found it necessary to allocate additional staff time for consultation exercises with companies.



Presumably, US funds would have to consider following a similar path in the context of advisory votes.

At a deeper level, UK funds are unsettled about how to approach participation in a vote of confidence on pay policies. “Investors are not HR people and should not be involved in setting absolute strategies,” commented one Yale roundtable participant in London. “But things have evolved into a game in which paid consultants come up with more and more complex schemes. Because there is more dialogue, funds get welcomed into the fold. We tweak. We think we’ve won, and we become implicated. There is a danger that investors are sleepwalking into complicity.” The risk, noted another investor, is that “funds get sucked into micromanagement of just one aspect” of a company.

One approach floated by certain funds is to have institutional investors hire, individually or collectively, their own outside compensation experts to review corporate plans in detail. Other funds contend that it is not feasible to compete with boards in what becomes an arms race of expertise on remuneration. Instead, they suggest that the best approach is for investors to focus on “asking the right questions” and making sure that the remuneration committee has “the right people” to frame compensation to advance shareowner interests.

Another route might be for a key investor group—such as, in the US, the Council of Institutional Investors—setting up what are referred to as ‘case committees’ in Britain. Engagement teams would collaborate on following one or a select group of companies intensively over a two to three year period so that all the players get to know one another and that the dialogue is sustained and substantive. This could involve a more efficient approach to engagement on pay.

***12. Does the practice of having advisory votes on pay hand new influence to proxy advisors? And if so, isn’t there a risk that boards will design plans to pass advisor specifications rather than do what is best suited to the company?***

This is a concern raised by all parties in the UK, including some proxy advisors themselves. “There is a real risk that an unthinking investor can adopt a proxy service recommendation as if it is cast in stone,” commented one CEO of a UK recommendation provider. “Chairmen of remuneration committees are worried about creeping box ticking,” said a former corporate director.

Having said that, each of the recommendation providers claims to have adapted to advisory votes by reviewing corporate plans in detail with a view to advising on what best suits the company rather than against a one-size-fits-all standard. Indeed, once advisory votes became routine in Britain, the services faced the challenge of ramping up internal expertise and budgeting significantly more time to compensation analysis and consultation exercises with companies. One firm calculated that it had to staff up for a 30% increase in workload. Another counted a fourfold rise in consultation exercises. As

one consequence of advisory votes, qualitative analysis of compensation has emerged as an important feature investors now use to differentiate commercial proxy service competitors.

Some corporations reported in the Yale roundtables that the advisory vote process had compelled a dialogue between companies and some proxy recommendation firms that had not existed at any depth beforehand. Such corporate representatives credit advisory votes with prompting the services to raise their skill levels, producing more fruitful discussions with companies before they finalize recommendations.

Nonetheless, some fund users and companies argue that proxy services that make voting recommendations too often take a cookie-cutter approach based on rigid prescriptions set either by their own procedures or by collective bodies. That, in turn, prompts remuneration committees to “fear rejection unless they take the boilerplate approach,” said one investor. Some funds suggest that standard setting bodies replace rigid compensation standards with more flexible principles, and use their convening power to become facilitators of collective dialogue between companies and investors.

***13. How will proxy advisors frame voting analyses and recommendations in the context of an advisory vote? Will their conclusions rest on quantitative scoring or company-specific assessments of the quality of a plan and its disclosure?***

This is tough to answer since the proxy firms covering the US have yet to set internal policies and metrics covering advisory votes. Moreover, they each feature different procedures for updating the guidelines they use to determine voting advice. Some reach out to market players for their views; others are equipped with oversight by an advisory body that may include outsiders. Each so far reserves final decisions to itself.

However, the UK experience offers some insight into what may occur in the event that advisory votes on compensation policy spread in North America.

Glass Lewis has recommended votes against at approximately 10% of UK companies covered. Reasons cited are generally poor design, inadequate information or weak links between performance and incentive pay triggers.

ISS operates in Britain through RREV, which is now a wholly owned subsidiary. RREV produces proxy reports on UK listed companies and routinely adds voting analysis and recommendations for each report on advisory votes. In 2006 RREV recommended votes against remuneration reports in 13.4% of cases (158 companies out of a universe of 1,183). The comparable figure in Australia was 12.3%.

Once advisory votes were required in Britain, RREV had to accommodate need for more skilled analysis and increased dialogue with companies. Before advisory votes, except in rare circumstances, RREV prepared sections on compensation on its own, without

consulting corporate officials for clarification or issue engagement. After, however, the firm found its consultation demands tripling. RREV does use a template of guidelines with varying degrees of specificity. But it also

- regularly offers senior analysts for dialogue with companies in advance of final publication of voting advice;
- “looks at individual circumstances and the quality of individual schemes;” and
- consults in controversial cases with client funds and other investment bodies.

This intensity of dialogue between RREV and companies reflects the fact that the firm is a creature both of ISS and the National Association of Pension Funds. The NAPF withdrew as a co-owner. But it continues to exercise key engagement policies through RREV and shares staff with the firm. Either way, RREV’s approach appears to diverge from its US-based sister firm, which does not typically initiate regular dialogue with companies and which relies to a greater extent on templates for voting advice. As one corporate official wrote to the Working Group about a US proxy advisor: “It sets company-wide policy on voting either per issue or via its compensation plan algorithms, and tells you that with 7,000 companies to review it cannot make exceptions.” Investors and companies pressed RREV for more qualitative advice when advisory votes began in Britain. Funds may seek similar assurances from US proxy firms in the context of advisory votes.

#### ***14. Wouldn’t it be better to have investors express dissatisfaction with pay policies by simply voting against members of the Compensation Committee who appear on the ballot?***

In Britain, investors see advisory votes as having two advantages over the option of expressing dissent through ballots against directors. First, there are many cases where funds will take issue with compensation policies but otherwise consider the company well governed. Voting against a board member is seen, in this context, as too draconian a remedy for the problem at hand. “It would be like throwing the baby out with the bathwater,” said one. Or as one proxy advisor put it: “it is possible to have crap remuneration policy without having a crap board.” Advisory votes represent a targeted, light touch (because they are non-binding) alternative. “It’s a way to signal that change is needed without removing large chunks of the board,” commented one proxy advisor.

Second, investors view advisory votes—in soccer terms—as an opportunity to show a cautionary ‘yellow card’ to the board. If directors decline to show responsiveness, investors can choose “the nuclear option” of escalating dissent to a ‘red card’ through a vote against relevant directors at the next annual meeting. The majority rule election standard, universal in Britain, means that such ballots contain real risks of director losses.

UK companies, for much the same reasons, appear to favor advisory votes as well. They view votes against a director as “a blunt instrument,” as one corporate executive put it. Before advisory votes, investors tended to express dissatisfaction with compensation policies by turning against the chair of the remuneration committee at the annual meeting. Today, advisory votes “achieve the aim of drawing dissent away from directors.

Having an advisory vote on compensation as a line item on the proxy has allowed for more nuanced voting on the election of directors. For example, US companies, at present, are unable to unpack different withhold votes from an individual director unless investors take the step of contacting the company about a vote. Did Director Smith, who chairs the compensation committee, receive a high level of opposition because investors were unhappy with pay or is it because he missed more than 25% of meetings or sits on five other boards?”

***15. Do companies with experience in advisory votes feel that they gain any benefits or suffer any material downsides from the process?***

A striking finding from the Millstein Center roundtables in London was the apparent strong view among UK corporate representatives that advisory votes have generally proven a fillip to boards. The principal downside is the modest additional cost involved for most companies—unless they trigger widespread shareowner opposition—in annual consultation and document preparation. There have been few or no instances of special interests appearing to succeed in hijacking advisory votes. Advantages often cited include:

- Dialogue with investors has improved in quality and quantity with “knock-on effects on other [non-compensation] issues.”
- Remuneration committee chairs are often grateful for opportunities to learn early of investor criticism on pay, as it provides them with leverage in fashioning performance-oriented packages.
- The “level of transparency and disclosure and explanation can’t be compared to the time before” advisory votes.
- Consultation has proven a “proactive, reputation building exercise” that can “draw the sting” from investor dissent.
- Compensation committees in general now meet more frequently, use more information, demonstrate more awareness that their work will be scrutinized; seek more independent outside advice; and show enhanced abilities to defend their decisions; and focus more on overall strategy.
- Boards have been able to continue to raise pay, including incentive pay, so long as it can be explained to shareowners as linked to performance.

## 6. Appendix A

### UK Company Law Text on Advisory Votes

The requirement on corporate boards to produce an annual report on compensation may be found in the Companies Act 2006, chapter 46, part 15, ch.6, sections 420-422. The requirement that the report be put to a shareholder advisory vote may be found in the Companies Act 2006 Chapter 46, Part 15, ch. 9, section 439.

#### CHAPTER 6

##### QUOTED COMPANIES: DIRECTORS' REMUNERATION REPORT

#### 420 Duty to prepare directors' remuneration report

- (1) The directors of a quoted company must prepare a directors' remuneration report for each financial year of the company.
- (2) In the case of failure to comply with the requirement to prepare a directors' remuneration report, every person who-
  - (a) was a director of the company immediately before the end of the period for filing accounts and reports for the financial year in question, and
  - (b) failed to take all reasonable steps for securing compliance with that requirement,commits an offence.
- (3) A person guilty of an offence under this section is liable-
  - (a) on conviction on indictment, to a fine;
  - (b) on summary conviction, to a fine not exceeding the statutory maximum.

#### 421 Contents of directors' remuneration report

- (1) The Secretary of State may make provision by regulations as to-
  - (a) the information that must be contained in a directors' remuneration report,

- (b) how information is to be set out in the report, and
  - (c) what is to be the auditable part of the report.
- (2) Without prejudice to the generality of this power, the regulations may make any such provision as was made, immediately before the commencement of this Part, by Schedule 7A to the Companies Act 1985 (c. 6).
- (3) It is the duty of-
- (a) any director of a company, and
  - (b) any person who is or has at any time in the preceding five years been a director of the company,
- to give notice to the company of such matters relating to himself as may be necessary for the purposes of regulations under this section.
- (4) A person who makes default in complying with subsection (3) commits an offence and is liable on summary conviction to a fine not exceeding level 3 on the standard scale.

#### **422 Approval and signing of directors' remuneration report**

- (1) The directors' remuneration report must be approved by the board of directors and signed on behalf of the board by a director or the secretary of the company.
- (2) If a directors' remuneration report is approved that does not comply with the requirements of this Act, every director of the company who-
- (a) knew that it did not comply, or was reckless as to whether it complied, and
  - (b) failed to take reasonable steps to secure compliance with those requirements or, as the case may be, to prevent the report from being approved,
- commits an offence.
- (3) A person guilty of an offence under this section is liable-
- (a) on conviction on indictment, to a fine;
  - (b) on summary conviction, to a fine not exceeding the statutory maximum.

**CHAPTER 9****QUOTED COMPANIES: MEMBERS' APPROVAL OF DIRECTORS'  
REMUNERATION REPORT****439 Quoted companies: members' approval of directors' remuneration report**

(1) A quoted company must, prior to the accounts meeting, give to the members of the company entitled to be sent notice of the meeting notice of the intention to move at the meeting, as an ordinary resolution, a resolution approving the directors' remuneration report for the financial year.

(2) The notice may be given in any manner permitted for the service on the member of notice of the meeting.

(3) The business that may be dealt with at the accounts meeting includes the resolution.

This is so notwithstanding any default in complying with subsection (1) or (2).

(4) The existing directors must ensure that the resolution is put to the vote of the meeting.

(5) No entitlement of a person to remuneration is made conditional on the resolution being passed by reason only of the provision made by this section.

(6) In this section-

"the accounts meeting" means the general meeting of the company before which the company's annual accounts for the financial year are to be laid; and

"existing director" means a person who is a director of the company immediately before that meeting.

## **7. Appendix B**

### **S. 1181 and H.R. 1257: “Shareholder Vote on Executive Compensation Act”**

110th CONGRESS  
1st Session  
**S. 1181**

To amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation.

**IN THE SENATE OF THE UNITED STATES**

**April 20, 2007**

Mr. OBAMA introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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**A BILL**

To amend the Securities Exchange Act of 1934 to provide shareholders with an advisory vote on executive compensation.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

#### **SECTION 1. SHORT TITLE.**

This Act may be cited as the ‘Shareholder Vote on Executive Compensation Act’.

#### **SEC. 2. SHAREHOLDER VOTE ON EXECUTIVE COMPENSATION DISCLOSURES.**

- (a) Amendment- Section 16 of the Securities Exchange Act of 1934 (15 U.S.C. 78n) is amended by adding at the end the following new subsection:
- “(h) Annual Shareholder Approval of Executive Compensation-
- “(1) IN GENERAL- Any proxy or consent or authorization for an annual or other meeting of the shareholders occurring on or after January 1, 2009, shall permit a separate shareholder vote to approve the compensation of executives as disclosed pursuant to the Commission's compensation disclosure rules (which disclosure shall include the compensation



discussion and analysis, the compensation tables, and any related material). The shareholder vote shall not be binding on the board of directors and shall not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board, nor shall such vote be construed to restrict or limit the ability of shareholders to make proposals for inclusion in such proxy materials related to executive compensation.

**^(2) SHAREHOLDER APPROVAL OF GOLDEN PARACHUTE COMPENSATION-**

**^(A) DISCLOSURE-** In any proxy solicitation material for an annual or other meeting of the shareholders occurring on or after January 1, 2009, that concerns an acquisition, merger, consolidation, or proposed sale or other disposition of substantially all the assets of an issuer, the person making such solicitation shall disclose in the proxy solicitation material, in a clear and simple form in accordance with regulations of the Commission, any agreements or understandings that such person has with any principal executive officers of such issuer (or of the acquiring issuer, if such issuer is not the acquiring issuer) concerning any type of compensation (whether present, deferred, or contingent) that are based on or otherwise relate to the acquisition, merger, consolidation, sale, or other disposition, and that have not been subject to a shareholder vote under paragraph (1).

**^(B) SHAREHOLDER APPROVAL-** The proxy solicitation material containing the disclosure required by subparagraph (A) shall require a separate shareholder vote to approve such agreements or understandings. A vote by the shareholders shall not be binding on the board of directors and shall not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board, nor shall such vote be construed to restrict or limit the ability of shareholders to make proposals for inclusion in such proxy materials related to executive compensation.'

(b) Deadline for Rulemaking- Not later than 1 year after the date of the enactment of this Act, the Securities and Exchange Commission shall issue any final rules and regulations required by the amendments made by subsection (a).

## **8. Appendix C**

### **Association of British Insurers Guidelines on Executive Remuneration (Dec. 2006)**

#### **PRINCIPLES**

Boards are responsible for adopting remuneration policies and practices that promote the success of companies in creating value for shareholders over the longer term. The policies and practices should be demonstrably aligned with the corporate objectives and business strategy and reviewed regularly.

Remuneration Committees should be established in accordance with the provisions of the Combined Code. They should comprise independent directors who bring independent thought and scrutiny to all aspects of remuneration. It is important to maintain a constructive and timely dialogue between boards and shareholders regarding remuneration policies and practices.

Executive remuneration should be set at levels that retain and motivate, based on selection and interpretation of appropriate benchmarks. Such benchmarks should be used with caution, in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.

Executive remuneration should be linked to individual and corporate performance through graduated targets, that align the interests of executives with those of shareholders. The resulting arrangements should be clear and readily understandable. Shareholders will not support arrangements which entitle executives to reward when this is not justified by performance. Remuneration Committees should ensure that service contracts contain provisions that are consistent with this principle.

#### **Section I**

#### **REMUNERATION COMMITTEES AND THEIR RESPONSIBILITIES**

##### **Main Provisions**

Remuneration Committees are responsible for ensuring that the mix of incentives reflects the company's needs, establishes an appropriate balance between fixed and variable remuneration, and is based on targets that are stretching, verifiable and relevant. They should satisfy themselves as to the accuracy of recorded performance measures that govern vesting of variable and share-based remuneration.

They should establish effective procedures for disclosure and communication of strategic objectives, which enable shareholders to take an informed and considered view of remuneration policy and its implementation.

They should ensure that remuneration levels properly reflect the contribution of executives and be rigorous in selecting an appropriate comparator group. They should guard against unjustified windfalls and inappropriate gains arising from the operation of share incentive schemes and other associated incentives.

They should consider legal redress where performance achievements are subsequently found to have been significantly misstated so that bonuses and other incentives should not have been paid.

They should also pay particular attention to arrangements for senior executives who are not board members but have a significant influence over the company's ability to meet its strategic objectives.

## **Section II**

### **GUIDANCE FOR BASE PAY, BONUSES, PENSIONS AND CONTRACTS AND SEVERANCE Section II**

#### **1. BASE PAY AND BONUSES**

##### **Main Provisions**

Remuneration Committees should ensure that base pay reflects the contribution of the executives concerned and be robust in setting and monitoring targets for bonuses. They should ensure that bonuses reflect actual achievements against these targets.

Any material payments that may be viewed as being ex-gratia in nature should be fully explained, justified and subject to shareholder approval prior to payment. Shareholders are not supportive of transaction bonuses that reward directors and other executives for effecting transactions irrespective of their future financial consequences.

Remuneration Committees should scrutinise all other benefits, including benefits in kind and other financial arrangements to ensure they are justified, appropriately valued and suitably disclosed.

## **Guidance**

### Base Pay

1.1 Remuneration Committees should ensure their policy on base pay is fully communicated to shareholders. Where a company seeks to pay salaries at median or above, justification is required.

### Bonuses

1.2 Annual bonuses should be demonstrably related to performance. Both individual and corporate performance targets are relevant and should be tailored to the requirements of the business and reviewed regularly to ensure they remain appropriate.

1.3 Any share matching arrangements should be treated in accordance with relevant provisions under the Guidance for Share-Based Incentive Schemes. (see Paragraph 4.6)

1.4 Where consideration of commercial confidentiality may prevent a fuller disclosure of specific short-term targets at the start of the performance period, shareholders expect to be informed of the main performance parameters, both corporate and personal, for the financial year being reported on.

1.5 Following payment of the bonus, shareholders will expect to see a full analysis in the Remuneration Report of the extent to which the relevant targets were actually met.

1.6 Maximum participation levels should be disclosed and any increases in the maximum from one year to the next should be explicitly justified. Shareholders will expect increases to be subject to correspondingly more stretching performance.

1.7 Annual bonuses should not be pensionable.

1.8 Remuneration Committees should retain discretion to reduce or reclaim payments if the performance achievements are subsequently found to have been significantly misstated. Where there is doubt Remuneration Committees should work with the Audit Committee to ensure the basis of their decision is correct.

## **2. PENSIONS**

### **Main Provisions**

Remuneration Committees should recognise the impact that pension arrangements can have on the mix between fixed and variable pay. In setting an appropriate balance, they should bear in mind that pension entitlements may represent a significant and potentially costly item of remuneration that is not directly linked to performance.

## **Guidance**

2.1 Shareholders expect there to be full disclosure of the extent to which actual and potential liabilities, such as pension promises or early retirements, are funded together with any aggregate outstanding unfunded liabilities.

2.2 There should be informative disclosure identifying incremental value accruing to pension scheme participation and any other superannuation arrangements. Pensions paid on early retirement should be subject to abatement.

2.3 Changes to transfer values, discretionary increases in pension entitlement, and significant changes in actuarial and other relevant assumptions, should be fully explained and justified.

2.4 Companies should recognise the risks of changes to future mortality rates and investment returns and consider how to limit the potential liability created by pension commitments.

2.5 Companies should not compensate individuals for changes in personal tax liabilities arising from changes to pensions taxation. Companies may wish to consider whether there may be ways of delivering remuneration that are more cost-effective than a pension fund and more aligned with shareholder value creation.

## **CONTRACTS AND SEVERANCE**

### **Main Provisions**

Remuneration Committees should ensure that contracts protect the company from being exposed to the risk of payment in the event of failure.

The treatment of bonuses should be clear and a contractual link established between variable pay and performance. In the event of early termination there should be no automatic entitlement to bonuses or share-based payments.

### **Guidance**

3.1 Remuneration Committees should ensure that the policy and objectives on directors' contracts are clearly stated in the Remuneration Report.

3.2 When drawing up contracts, Remuneration Committees should calculate the likely cost of any severance and determine whether this is acceptable. All payments made should be based upon performance in relation to objectives and take account of the overall financial circumstances of the company.

3.3 Companies should justify their policies on contractual protection. Contracts should commit companies not to pay for failure.

3.4 Phased payments are generally appropriate for fulfilling compensation on early termination.

3.5 Shareholders are less supportive of the liquidated damages approach which involves agreement at the outset on the amount that will be paid in the event of severance.

3.6 Remuneration Committees should ensure that full benefit of mitigation is obtained. This includes the legal obligation on the part of the outgoing director to mitigate the loss incurred through severance by seeking other employment and reducing the need for compensation.

3.7 Contracts should make clear that if a director is dismissed as a result of a disciplinary procedure, a shorter notice period than that given in the contract would apply.

3.8 Contracts should not provide additional protection in the form of compensation for severance as a result of change of control.

3.9 Pension entitlement on severance can represent a large element of cost to shareholders. Remuneration Committees should identify, review and disclose in their report any arrangements that guarantee pensions with limited or no abatement on severance or early retirement. These would not be regarded as acceptable if included in new contracts. Remuneration Committees should demonstrate that the route taken on severance represents the lowest overall cost to the company.

### **Section III**

#### **GUIDANCE FOR SHARE-BASED INCENTIVE SCHEMES**

##### **Main Provisions**

Share-based incentives should align the interests of executive directors with that of shareholders and link reward to performance over the longer term. Vesting should therefore be based on performance conditions measured over a period appropriate to the strategic objectives of the company. This will not be less than, and may exceed, three years.

All new share-based incentives or any substantive changes to existing schemes should be subject to prior approval by shareholders by means of a separate and binding resolution. Their operation, rationale and cost should be fully explained so that shareholders can make an informed judgment.

The operation of share incentive schemes should not lead to dilution in excess of the limits acceptable to shareholders.

Executive share options should not be granted at a discount to the prevailing market price.

It is desirable to align the interests of chairmen and independent directors with those of shareholders, for example through payment in shares bought at market prices. However, shareholders consider it inappropriate for chairmen and independent directors to receive incentive awards geared to the share price or corporate performance that would impair their ability to provide impartial oversight and advice.

Shareholders encourage companies to require executive directors and senior executives to build up meaningful shareholdings in the companies for which they work.

## **Guidance**

### **1. SCOPE**

1.1 This Guidance applies to all share-based schemes whether option-based or involving conditional awards of shares, and including any arrangements whereby the value of an option gain will be paid either in the form of cash or shares (cash or share-settled share appreciation rights respectively).

## **REVIEW AND DISCLOSURE**

2.1 Remuneration Committees should:

- \* regularly review share incentive schemes to ensure their continued effectiveness, compliance with the current Guidance and contribution to shareholder value;
- \* provide a statement in the Remuneration Report as to whether a review of the current share incentive schemes has been undertaken both as regards their operation, including how discretion has been exercised, and whether grant levels, performance criteria and vesting schedules which have been previously approved by shareholders remain appropriate to the company's current circumstances and prospects; and
- \* obtain prior shareholder authorisation for any substantive or exceptional amendments to scheme rules and practice including changes to limits and changes which make it easier to achieve performance targets, and where significant exercise of discretion is proposed by the Remuneration Committee.

2.2 Scheme and individual participation limits must be fully disclosed in share incentive schemes. Disclosure should, inter alia, cover performance conditions and related costs and dilution limits as set out in the relevant sections below. The reasons for selecting the performance conditions and target levels, together with the overall policy for granting conditional share or option awards, should be fully explained to shareholders.

### **3. GRANT POLICY**

#### Phasing of Awards and Grants

3.1 The regular phasing of share incentive awards and option grants, generally on an annual basis, is strongly encouraged because:

- \* it reduces the risk of unanticipated outcomes that arise out of share price volatility and cyclical factors;
- \* it eliminates the perceived problem that a limit on subsisting options encourages early exercise;
- \* it allows the adoption of a single performance measurement period; and
- \* it lessens the possible incidence of ‘underwater’ options, where the share price falls below the exercise price.

The phased vesting of awards in specific tranches following the minimum three year performance measurement period is not an alternative to phased grants. However, it can help to enhance the linking of vesting of awards to sustained performance and maintain incentivisation.

### **4. PERFORMANCE**

4.1 The desired alignment of interests is best achieved through the vesting of awards under share incentive schemes being conditional on satisfaction of performance conditions. Performance measures should be fully explained and be clearly linked to the achievement of challenging and stretching financial performance which will lead to enhancement of shareholder value.

Remuneration Committees should satisfy themselves that vesting of awards accord with these objectives.

4.2 Challenging performance conditions should:

- \* relate to overall corporate performance;
- \* demonstrate the achievement of a level of financial performance which is demanding and stretching in the context of the prospects for the company and the prevailing economic environment in which it operates;
- \* be measured relative to an appropriate defined peer group or other relevant benchmark; and
- \* be disclosed and transparent.

4.3 Threshold vesting amounts should not be significant by comparison to annual base salary. Furthermore, award structures with a marked ‘cliff-edge’ vesting profile are considered inappropriate, particularly where there may be clustering of performance outcomes around the average.



4.4 The vesting of awards with high potential value should be linked to commensurately higher levels of performance. Full vesting should be dependent upon achievement of significantly greater value creation than that applicable to threshold vesting. Companies should explain clearly how this is achieved, especially when annual grants of options in excess of one times salary, or equivalent long term share incentive awards, are made.

4.5 Sliding scales are a useful way of ensuring that performance conditions are genuinely stretching. They generally provide a better motivator for improving corporate performance than a 'single hurdle'.

4.6 Awards of matching shares arising from annual bonuses payable in the form of shares where these are held for a qualifying period, should be subject to the satisfaction of performance criteria prior to the vesting of the matching element. (see Paragraph 1.3 – Guidance for Base Pay, Bonuses, Pensions and Contracts and Severance)

4.7 Comparator groups used for performance purposes should be both relevant and representative. Where only a small number of companies are used for a comparator group, Remuneration Committees should satisfy themselves that the comparative performance will not result in arbitrary outcomes which are inconsistent with this Guidance. Awards should not vest for less than median performance.

#### Performance Criteria

4.8 Total Shareholder Return (TSR) relative to a relevant index or peer group is one of a number of generally acceptable performance criteria. However, Remuneration Committees should satisfy themselves prior to vesting that the recorded TSR or other criterion is a genuine reflection of the company's underlying financial performance, and explain their reasoning.

4.9 Where TSR is used as a performance criterion and the chosen comparator group includes companies listed in overseas markets, it is essential that TSR be measured on a consistent basis. The standard approach should be for a common currency to be used. Where there are compelling grounds for the calculation to be based on local currency TSR of comparator group companies, then the reasons for choosing this approach should be fully explained.

4.10 The definition of Earnings Per Share (EPS) or any other financial measure should fully reflect the performance of the business on a consistent basis in respect of the measurement period.

4.11 Shareholders need to have sufficient data to judge the appropriate size of the award for any given performance level. They also expect a maximum level of grant to be disclosed.

4.12 The setting of a premium exercise price is not of itself a substitute for the adoption of relative performance conditions in accordance with this Guidance.

## Retesting

4.13 It is recognised that any retesting of performance conditions for all share-based incentive schemes is unnecessary and unjustified.

## **5. COST AND BASIS OF PARTICIPATION**

### Cost

5.1 The following information should be disclosed in order that shareholders can make a judgment about total cost:

- \* The potential value of awards (see Appendix) due to individual scheme participants on full vesting. This should be expressed by reference to the face value of shares or shares under option at point of grant, and expressed as a multiple of base salary.
- \* The expected value (see Appendix) of the award at the outset, bearing in mind the probability of achieving the stipulated performance criteria.
- \* The maximum dilution which may arise through the issue of shares to satisfy entitlements.

5.2 There should be prudent and appropriate arrangements governing acquisition of shares, and financing thereof, to meet contingent obligations under share-based incentive schemes.

5.3 The use of phased grants of share options and restricted shares, and utilisation of both new and purchased shares to satisfy the vesting of awards, requires a comprehensive approach to valuation. Assessment should focus on expected value, which should be disclosed, and it should take account of the performance vesting schedule which is adopted as well as the existence of any 'retesting' and 'replacement option' facilities such as have been prevalent under traditional schemes. Shareholders are helped in this task by disclosure of face value of any share award or option grant as well as of expected value.

### Vesting of Awards

5.4 Remuneration Committees should consider the use of performance measurement periods of more than 3 years and deferred vesting schedules, in order to motivate the achievement of sustained improvements in financial performance.

5.5 Where LTIP awards are made over whole shares<sup>1</sup>, a better alignment of interest with shareholders will be achieved if, in respect of those shares that do vest, equivalent value to that which has accrued to shareholders by way of dividends during the period from date of grant also vests in the hands of LTIP recipients. To the extent that the shares conditionally awarded do not vest then nor should any scrip or cash amounts representing the rolled-up dividends.

5.6 Remuneration Committees should ensure that the size of grants made on this basis takes into account reasonable expectations as to the value of the dividend stream on the company's shares over the period to vesting. Where the facility for rolled-up dividends is introduced a smaller initial grant size is required in order to target a similar level of value in the conditional share award.

#### Performance on Grant

5.7 Shareholders expect that future performance should govern the vesting of options or share awards. Performancing at point of grant is generally not considered a suitable alternative.

#### Change of Control Provisions

5.8 Scheme rules should state that there will be no automatic waiving of performance conditions either in the event of a change of control or where subsisting options and awards are 'rolled over' in the event of a capital reconstruction, and/or the early termination of the participant's employment. Remuneration Committees should use best endeavours to provide meaningful disclosure that quantifies the aggregate payments arising on a change of control.

5.9 Shareholders expect that the underlying financial performance of a company that is subject to a change of control should be a key determinant of what share-based awards, if any, should vest for participants. Remuneration Committees should satisfy themselves that the performance criterion genuinely reflects a robust measure of underlying financial achievement over any shorter time period. They should explain their reasoning in the Remuneration Report or other relevant documentation sent to shareholders.

5.10 Where share incentive awards vest early as a consequence of a change of control, awards should vest on a time pro-rata basis i.e. taking into account the vesting period that has elapsed at the time of change of control.

#### Participation

5.11 Participation in share incentive schemes should be restricted to bona-fide employees and executive directors, and be subject to appropriate limits for individual participation which should be disclosed.

5.12 There should be no absolute right of participation in share incentive schemes. Grant policy should be disclosed and consistently applied and, within the limits approved by shareholders, reflect changing commercial and competitive conditions. In the event of declining share price levels it is particularly important to avoid unjustified increases in the actual number of shares or options awarded.

5.13 Participation in more than one share incentive scheme must form part of a well-considered remuneration policy, and should not be part of a multiple arrangement designed to raise the prospects of payout.

## **6. PRICING AND TIMING**

### Pricing of Options and Shares

6.1 The price at which shares are issued under a scheme should not be less than the mid-market price (or similar formula) immediately preceding grant of the shares under the scheme.

6.2 Options granted under executive (discretionary) schemes should not be granted at a discount to the prevailing mid-market price.

6.3 Repricing or surrender and regrant of awards or ‘underwater’ share options is not appropriate.

### Timing of Grant

6.4 The rules of a scheme should provide that share or option awards normally be granted only within a 42 day period following the publication of the company’s results.

## **7. LIFE OF SCHEMES AND INCENTIVE AWARDS**

7.1 No awards should be made beyond the life of the scheme approved on adoption by shareholders, which should not exceed 10 years.

7.2 Shares and options should not vest or be exercisable within three years from the date of grant. In addition, options should not be exercisable more than 10 years from the date of grant.

7.3 Options or other conditional share awards are normally granted in respect of the year in question and in expectation of service over the performance measurement period of not less than 3 years.

7.4 Where individuals choose to terminate their employment before the end of the service period, or in the event that employment is terminated for cause, any unvested options or conditional share-based award should normally lapse.

7.5 In other circumstances of cessation of employment, it is to be expected that some portion of the award will vest, to the extent of the service period that has been completed but subject to the achievement of relevant performance criteria. In general the originally stipulated performance measurement period should continue to apply. However, where in the opinion of the Remuneration Committee, early vesting is appropriate, or where it is otherwise necessary, awards should vest by reference to performance criteria achieved over the period to date.

7.6 Where options vest, in the event of death or cessation of employment of the option holder or where a company is taken over (except where arrangements are made for a switch to options of the offeror company), or where they have already vested at the time of such event, they must be exercised (or lapse) within 12 months. Where the performance measurement period applicable to an option extends beyond the point of cessation of employment as provided for by Paragraph 7.5 above, options must be exercised within 12 months of vesting following the end of the performance measurement period.

7.7 Any shares or options that a company may grant in exchange for those released under the schemes of acquired companies should normally be taken into account for the purposes of dilution and individual participation limits determined in accordance with this Guidance.

## **8. DILUTION**

8.1 The rules of a scheme must provide that commitments to issue new shares or re-issue treasury shares, when aggregated with awards under all of the company's other schemes, must not exceed 10% of the issued ordinary share capital (adjusted for share issuance and cancellation) in any rolling 10 year period. Remuneration Committees should ensure that appropriate policies regarding flow-rates exist in order to spread the potential issue of new shares over the life of relevant schemes in order to ensure the limit is not breached.

8.2 Commitments to issue new shares or re-issue treasury shares under executive (discretionary) schemes should not exceed 5% of the issued ordinary share capital of the company (adjusted for share issuance and cancellation) in any rolling 10 year period. This may be exceeded where vesting is dependent on the achievement of significantly more stretching performance criteria.

8.3 The implicit dilution commitment should always be provided for at point of grant even where, as in the case of share-settled share appreciation rights, it is recognised that only a proportion of shares may in practice be used.

8.4 For small companies, up to 10% of the ordinary share capital may be utilised for executive (discretionary) schemes, provided that the total market value of the capital utilised for the scheme at the time of grant does not exceed £1,000,000.

## **9. JOINT VENTURE COMPANIES AND SUBSIDIARY COMPANIES**

9.1 Shareholders generally consider it undesirable for options and other share-based incentives to be granted over the share capital of a joint venture company.

9.2 Discretionary grants over shares of a subsidiary company should only be made in exceptional circumstances. Where companies can justify doing so in terms of

contribution to overall value creation, shareholders may consider exceptions subject to the following:

- \* Participation in subsidiary company schemes is restricted to those whose time is fully allocated to that subsidiary. Parent company directors should not participate in such schemes.
- \* There is full disclosure of the accounting treatment used when recognising the cost of option or share awards.
- \* Grants of options or share awards are subject to appropriately challenging performance criteria.
- \* Dilution limits relating to the subsidiary company should be disclosed in the context of parent company dilution limits.
- \* The methodology for valuing the subsidiary company shares and in the case of option awards the measurement of volatility of those shares should be disclosed. The party responsible for the valuation process should also be disclosed.
- \* Any entitlement or obligation to convert subsidiary company shares to parent company shares should be disclosed.

9.3 Shareholders may consider further exceptions where the condition of exercise is subject to flotation or sale of the subsidiary company. In such circumstances, grants should be conditional so that vesting is dependent on a return on investment that exceeds the cost of capital and that the market value of the shares at date of grant is subject to external validation.

9.4 Exceptions will apply in the case of an overseas subsidiary company where required by local legislation, or in circumstances where at least 25% of the ordinary share capital of the subsidiary company is listed and held outside the group.

## **10. ESOTs AND ALL-EMPLOYEE SCHEMES**

### Employee Share Ownership Trusts - ESOTs

10.1 ESOTs should not hold more shares at any one time than would be required in practice to match their outstanding liabilities, nor should they be used as an anti-takeover or similar device. Furthermore an ESOT's deed should provide that any unvested shares held in the ESOT shall not be voted at shareholder meetings. The prior approval of shareholders should be obtained before 5% or more of a company's share capital at any one time may be held within ESOTs.

10.2 Where companies have provided for an ESOT to be used to meet scheme requirements, they should disclose the number of shares held by the ESOT in order to assist shareholders with their evaluation of the overall use of shares for remuneration purposes. The company should explain its strategy in this regard.

## All-Employee Schemes

10.3 All-Employee schemes, such as SAYE schemes and Share Incentive Plans (SIPs) - (formerly known as AESOPs), should operate within an appropriate best practice framework. If newly issued shares are utilised, the overall dilution limits for share schemes should be complied with. The Guidance relating to timing of grants (except for pre-determined regular appropriation of shares under SIPs) applies.

## **APPENDIX**

### Potential Value of the Award

Shareholders are likely to have regard to the potential value of the award assuming full vesting. This should be expressed on the basis that a conditional award is made of shares, or options over shares, with a face value, at current prices, equal to a given percentage of base salary. However the potential value will also be a function of share price at the time of vesting and of illustrative disclosures of potential outcomes may also be helpful. Full vesting of awards of higher potential value should require the achievement of commensurately greater performance.

### Expected Value

The concept of Expected Value (EV) should be central to assessment of share incentive schemes. Essentially, EV will be the present value of the sum of all the various possible outcomes at vesting or exercise of awards. This will reflect the probabilities of achieving these outcomes and also the future value implicit in these outcomes. The calculation of the EV of share schemes relies on a range of assumptions, and reliance on this concept by Remuneration Committees will require a sufficient measure of disclosure to enable shareholders to make informed judgments about such arrangements.

The nature of performance hurdles governing exercise is also crucial to calculations of EV and it must also be recognised that any facility for 'retesting' will also increase the EV of the award whereas in contrast if the exercise price is set at a premium to the share price at the outset, this will reduce the value of the EV of the instrument.

Shareholders welcome efforts towards ensuring that accounting for share options and other share-based payment awarded under incentive schemes fully reflects the true cost to shareholders.

## 9. Appendix D

### Example of UK Voting Guidelines on Advisory Votes:— Universities Superannuation Scheme



#### 9. Remuneration

##### 9.1. Background

The remuneration system is a critically important strategic control mechanism at all levels of the corporation as a well-planned system is essential in attracting, focusing, motivating and retaining the right people. The current system of executive remuneration prevalent in the UK is, in general, considered to be better than that in some other countries (notably USA and France). However, there are on-going weaknesses including the continuing focus on options, a strategy which has been widely criticized for fostering a culture of short termism with little or no link to individual performance and for aligning executive and investor interests on managing share price. There is growing awareness that the systems and relationships between corporate management and analysts/fund managers now make it almost inevitable that executives will feel under some pressure to generate short-term gains even if they put long-term performance at risk. The current remuneration debate, however, has tended to avoid addressing these systemic issues directly and has instead focused on curbing high-profile symptoms (ie excessive rewards for underperformance or failure). USS's remuneration policy is based on the premise that companies should introduce remuneration systems that genuinely incentivise directors to deliver durable shareholder value by deconstructing that metric into component parts related to the corporation's long-term strategy and value growth which, in turn, is used as a basis to reward executive directors.

##### 9.2. Policy statement

*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. (Combined Code Principle B.1.)*

USS will support companies whose remuneration policies and payments are compatible with the long-term interests of shareholders. USS will not support policies and payments which merely reflect short-term market trends and/or an upward ratchet of remuneration levels with no corresponding improvement in performance. Corporations should also be sensitive to pay and employment conditions elsewhere in the group, especially when determining annual salary increases.



The chairman of the board and/or chairman of the remuneration committee should ensure that the company maintains contact as required with its principal shareholders about remuneration in the same way as for other matters.

USS requires that the Remuneration Committee has the responsibility for appointing external remuneration consultants who should be accountable to the Committee.

### ***9.3. Performance related remuneration***

USS will only support remuneration policies that contain incentive and performance based schemes which are clearly aligned with business strategy and objectives and linked to progress in long-term value creation. Executives should be compensated appropriately for their contribution to this process and not for market or industry wide rises in stock prices. USS encourages companies to focus on specific responsibilities by linking individual rewards more materially to their performance in advancing the corporation's strategy with a particular focus on their specific responsibilities and personal targets. The Remuneration Committee should consider whether the directors should be eligible for annual bonuses and long term incentive schemes. If so, performance conditions should be relevant, stretching and designed to enhance long-term shareholder value and reflect the company's objectives and value creators. Performance criteria should govern both the granting and exercise of such awards.

As required by the Directors' Remuneration Report Regulations 2002, USS expects corporations to disclose what is being incentivised and requires companies to put the Remuneration Report to the vote of shareholders on an annual basis as a separate resolution.

Upper limits for all schemes should be set and disclosed. The total rewards potentially available should not be excessive and no scheme should exceed 100% of base salary. The performance targets should also generally be disclosed in the Remuneration Report. USS will not support transaction bonuses which reward directors and other executives for effecting transactions irrespective of their future financial consequences.

USS encourages corporations to significantly decrease their emphasis on stock options for the reasons outlined above. Restricted shares granted under conditions relating to executive tenure and performance should make up a significant proportion of performance related remuneration. USS would expect that directors be encouraged to hold their shares for a further period after vesting or exercise.

Where there is any type of matching arrangement or performance-linked enhancement in respect of shares awarded under deferred bonus arrangements, there should be a separate shareholder vote. USS will not support arrangements whereby shares or options may, in effect, be granted at a discount and would expect that satisfaction of further performance criteria will be required in order for the matching element to vest.

#### **9.4. Process and evaluation**

USS supports the recommendation of the Combined Code that the Remuneration Committee comprises a minimum of three directors all of whom are independent NEDs. (*See board composition section for definition of independence*).

USS considers it is the role of the Remuneration Committee to:

- set the policies, pay levels and performance criteria by which the executive directors and senior management at the level below board level are rewarded;
- fully disclose these to shareholders in the Remuneration Report;
- be fully transparent in disclosure of remuneration policies and payments to enable shareholders to evaluate the fairness of the decisions of the Remuneration Committee;
- put the remuneration report to the vote of shareholders annually as a separate resolution.

#### **9.5. Voting policy**

*USS will:*

- *vote against a resolution to adopt the report and accounts, or take other appropriate actions, if the company does not put the remuneration report to the vote.*
- *vote against a resolution to approve the report of the Remuneration Committee and to appoint or re-elect a director who is also a member of the Remuneration Committee where USS considers the board's management of remuneration issues is unacceptable in the context of USS's policy.*
- *vote against or abstain from voting on a resolution to appoint or re-elect an executive director or NED who is also a member of a committee where the presence of that director is considered by USS to have an undue adverse influence on the committee, or to diminish its independence.*
- *vote against a resolution to approve the report of the Remuneration Committee if the composition of the Committee does not conform to the Combined Code guidelines.*
- *vote against a resolution to approve the remuneration report if there is insufficient disclosure on performance related pay.*



