



LONG TERM REMUNERATION FOR SENIOR EXECUTIVES

This paper considers the concerns in current years about cases of very substantial remuneration packages that have evolved with insufficient regard to sustained performance by the individuals concerned. It suggests ways of addressing those concerns and the problems of substantial payments which have been made when a service contract is terminated for non-performance. The concepts outlined are intended to apply to the most senior executives of a company, for example, the executive directors.

INTRODUCTION

- 1 The Association has held discussions with a significant number of industrialists with a view to giving some guidance to remuneration committees on long-term remuneration packages for senior executive directors. It is clear that a general outline would be considered helpful in this area but that it would be difficult to set any quantitative limits and unhelpful to be prescriptive.
- 2 There is growing agreement that current share option arrangements with options exercisable after three years, may not provide the long-term motivation to high performance that was intended when they were introduced. Options tend to be exercised at the first opportunity and the resultant shares sold. The intention is, therefore, to suggest a framework of guidance or principles relating to performance and reward for executive directors around which the design of schemes for long-term remuneration could be undertaken by the remuneration committee of individual companies.

REMUNERATION COMMITTEES

- 3 It is for remuneration committees to establish clear remuneration strategies for executive directors which are appropriate to the needs of their companies. They must have discretion and flexibility to act according to their judgement.
- 4 With the emphasis now being placed on performance based structures, remuneration committees have a central role and responsibility in requiring that demanding targets be set in such schemes and that the rewards relate realistically and responsibly to performance in the context of such targets.
- 5 If the remuneration committee appears to fail to measure up to their responsibilities, shareholders should quite properly ask for comment or explanation.

GLOBAL COMPETITION

- 6 For a number of major companies, an important development is the growth of global operations and competition. This has a direct effect on the overall remuneration packages required for the executive directors of these companies as they must be competitive in international terms and well designed to reinforce performance in global operations. Remuneration packages need to be competitive and realistic.

PERFORMANCE AND ITS MEASUREMENT

- 7 It is recognised that there is a need to move to a greater proportion of total remuneration based on performance: but reward should be for high performance and not for mediocrity. In particular, directors who are dismissed for inadequate performance should not receive significant payment by way of compensation.
- 8 Performance-based schemes fall broadly into two categories and there are different measurement requirements generally considered appropriate for each. It is for remuneration committees to decide which schemes, and in what combination and balance, are appropriate for their executive directors.

- (a) Short term 'annual bonus schemes'.

The measurement criteria should be related to corporate targets and these will normally be quantifiable, (though an element of subjective assessment of individual personal performance may also be appropriate).

- (b) Long-term: 3 years plus.

(i) *Long term performance schemes* - measurement criteria should increasingly be related to competitive performance in the industry/industries in which the company operates, or more generally for UK comparisons to the performance of companies in the FTSE 100. Whatever criteria is chosen, however, this should clearly be evidenced by or supported by sustained and significant underlying financial performance.

(ii) *Share option and phantom option schemes* - benefit related to share price underpinned by underlying financial performance over the life of the option.

The planning processes of a company should aim at an upward trend against competitive performance. The targets set in the schemes in (a) and (b) by the Remuneration Committee should be in line with that concept and process.

NATURE OF REWARD

- 9 The broad objectives of these proposals is to encourage continuing and long-term ownership by executive directors of significant amounts of shares in their companies.

- 10 In long-term schemes, the end reward should be in company shares which have to be retained over a period of say between of three and five years. It is recognised, however, that in some circumstances it may well be in a company's best interest for rewards to be in cash. In the latter case, consideration should be given to encouraging directors to invest a significant part of their cash reward in company shares directly or indirectly to be held for at least three years or more.
- 11 In short term schemes, it is recognised that cash rewards may be regarded by many companies as part of the annual cash remuneration of directors. There have been instances of very high annual bonuses or profit-related payments which can be destabilising. Remuneration committees will need to consider the arrangements carefully in order to avoid such a problem and should, in any event, consider if some incentive should be given for part of the annual bonus payment to be invested in company shares to be held for three years or more.

SHARE OPTION AND PHANTOM OPTION SCHEMES

- 12 It is reasonable to require directors to perform to a high standard in order to obtain the rewards under such schemes. The Association of British Insurers and National Association of Pension Funds have issued a Joint Statement emphasising that schemes which do not include performance criteria are likely to be opposed, and it would be hoped that boards generally would support the introduction of performance criteria as a condition of exercise. It is assumed that options would not, in any event, be granted to executives who were not already satisfying performance criteria.
- 13 As a matter of principle, an award of options should be considered on an annual basis for individual directors under these schemes rather than the whole value up to the limit being granted in only one or two tranches. Any such award would clearly depend on the individual's as well as the company's performance. This would enable a steady flow of options to be held by individual directors and encourage continuing interest and motivation.
- 14 In a global environment and for certain companies, it may be felt to be desirable to increase the limits of an individual's potential to achieve share options beyond 4 times annual remuneration in order that the remuneration package is competitive. Where such circumstances do not exist, however, the pressure for options in excess of four times salary would lessen if the participants were encouraged to hold the interest in the shares for a longer period.
- 15 The Association of British Insurers introduced in 1984 the concept of "super-options" whereby an option is not exercisable for five years, and exercise is in any event conditional upon the underlying financial performance of the company being equal to, or exceeding, that of the top quartile of the FTSE 100 companies.
- 16 Remuneration committees should emphasise, by their policies and actions, the strong desirability of directors retaining their options for a longer period than the minimum three years. The phased grant of options would encourage, overall, a longer involvement period. This suggests that, in future, the minimum period should in any event be between three and five years, and that directors should be encouraged to continue to hold as many shares as practicable after the exercise of

options. An amendment to current fiscal legislation removing the limitation on exercise of options more frequently than at three yearly intervals would encourage the phased grant of options.

SERVICE CONTRACTS

- 17 The purpose of service contracts is generally held to be as follows:-
- (a) from the company's point of view to tie an employee to a minimum period of service if it so wishes and to avoid his moving to a competitor company with valuable information and knowledge;
 - (b) for the employee, to provide some protection in the event of premature cessation of employment, to continue to be paid for a reasonable period while finding alternative employment;
- 18 The Cadbury Committee has recommended that service contracts should not exceed three years unless prior approval of shareholders is obtained and this seems generally to be supported. Remuneration Committees are encouraged to include a provision restricting the employee from competing with a company for a defined period following cessation of employment or termination of his contract, although each company will need to take advice on the question of the extent of duration and range of activities prohibited by any such provision.
- 19 The role of the Remuneration Committee becomes particularly significant when a service contract is terminated prematurely. There continue to be instances of substantial payment being awarded in such circumstances and this is clearly a matter of concern to shareholders generally. Remuneration Committees are urged rigorously to apply the normal principles relating to mitigation both by the employee whose contract is terminated particularly where this is on grounds of poor performance, and by the company. Consideration could well be given to the inclusion in service contracts of provisions which would limit in advance the amount which would be paid.
- 20 It is suggested that the Remuneration Committee should review each year, in conjunction with the Chairman and the Chief Executive as appropriate, whether or not the service contract of each individual executive director is to be continued in the existing form. It would be the non-executive directors who would consider the Chairman/Chief Executive contracts.
- 21 The objective in each of the foregoing recommendations is to enable remuneration committees to have sufficient flexibility to negotiate contracts which will attract, in an international environment, executives of the calibre to produce long term underlying improvement in the financial performance of the companies they serve. Such arrangements, when adequately disclosed, will help to convince long term investors, of the desirability of the remuneration packages that have been established while ensuring that where an executive director fails to produce long term improved performance, his service contract will no longer provide guaranteed and substantial payment.

COMMUNICATION OF INFORMATION ON DIRECTORS' REMUNERATION

- 22 It is anticipated that companies will find no difficulty in complying with the recommendation that there should be a full display in the company's Annual Report of information on the policies and schemes for the remuneration of directors and on their remuneration and holdings. This disclosure will ensure that while above average performance will produce above average reward, there should be neither excessive reward nor indeed substantial payment for failure.

CONCLUSION

- 23 The foregoing recommendations are designed to relate to those key persons who would normally be executive directors within a group. They are put forward in response to requests and to provide constructive but non-prescriptive guidance for remuneration committees who are charged with devising remuneration packages for senior executives.

- 24 They are supplemental, therefore, to existing guidelines which relate to the generality of share option schemes and which are designed to contain dilution within a reasonable amount while permitting companies to operate schemes as widely as they consider appropriate to their circumstances. Performance has been promoted by ABI in the context of such schemes since 1984. There has been much debate about the criteria for measurement of performance and it is emphasised that whatever measurement is chosen by a remuneration committee, it should be evidenced by, or at very least supported by, sustained and significant improvement in the financial performance of the group in question.

Disclosure of the details of long-term incentive schemes will demonstrate the community of interest such arrangements generate between participating executives and shareholders.

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ADDENDUM

Following publication of the paper on Long Term Remuneration for Senior Executives and the subsequent recommendations of the Greenbury Study Group which require shareholders to approve such schemes, there have been requests from advisers and companies for an indication of the performance criteria etc, felt to be appropriate in such schemes. Guidance has already been given in the long term paper that there should be demanding performance criteria incorporated in such schemes as a condition of reward.

It is for remuneration committees to decide which schemes and in what combination and balance as part of the total remuneration package, are appropriate for the particular company. Whatever performance measurement is chosen by a remuneration committee, it should be evidenced by, or at very least supported by sustained and significant improvement in the financial performance of the group in question.

It is not felt to be appropriate, therefore, to attempt to devise further formal guidelines, as individual schemes will differ and it is important to consider each scheme in the context of the overall remuneration package and the particular circumstances of the company concerned. The following pages set

out a note of emerging good practice as it is felt that it may be helpful for practitioners and companies to be aware of the criteria and formulae which have been adopted by companies and which have, in the circumstances of those particular companies, been approved by shareholders.

It is emphasised that these are not guidelines and do not purport to be any more than an outline of the broad principles that institutional shareholders have applied in looking at such arrangements together with a very broad summary of the criteria used.

LONG TERM INCENTIVE SCHEMES - NOTE OF EMERGING GOOD PRACTICE

INTRODUCTION

- 1 The Investment Committee is of the view that remuneration arrangements, including share option and long term incentive schemes, are the responsibility of boards of directors. It is expected that remuneration committees will observe the recommendations of the Cadbury and Greenbury Committees when implementing such schemes and this will be evident from the statements by the remuneration committee which should in future be available annually to shareholders. It may be helpful to remuneration committees to have an outline of the broad principles that institutional shareholders will apply in looking at such arrangements.
- 2 Long term incentive schemes are normally based either on a restricted share ownership plan or a share option scheme (or arrangements providing for the equivalent economic effect) and it is expected that individual participation would be in one or other of such arrangements but not generally in both. ABI has already issued guidelines on share option arrangements and a paper on long term remuneration for senior executives and the principles enunciated in those two papers continue to be relevant.
- 3 A long term incentive scheme (LTIS) may also take the form of a scheme which involves the award of part or all of an annual bonus in the form of shares (or the eventual equivalent cash value) to be held for a minimum vesting period of, say, 3 years. Where the awards under such schemes are themselves demonstrated to be properly performed it is not a requirement that vesting of awards should also be governed by a prospective performance condition. However, all other LTISs should, in compliance with the Greenbury Code, incorporate appropriate performance criteria governing exercise, over a minimum of 3 years from date of grant. Where, under any type of LTIS, options are granted these should have a minimum life to exercise of no less than 3 years. **Whatever precise form LTISs take it is important that they should be transparent and readily understandable and form a coherent part of overall remuneration strategy** and this should be addressed in the remuneration committee's report.

PERFORMANCE

- 4 Long term incentive schemes depend for their success, in securing their objectives of incentivising and suitably rewarding participants, on

the adoption of appropriately demanding performance criteria. For conventional share option schemes, a performance condition requiring real growth in earnings per share of **at least** 2 per cent per annum over at least 3 years has generally proved acceptable to institutional investors although this is increasingly being regarded as the minimum acceptable threshold. **Remuneration committees may well be justified in concluding that for their company a more demanding performance benchmark should be specified.**

- 5 There has been a trend towards performance criteria which compare corporate performance over a sustained period with that of a general market index or, where appropriate, a peer group. It has been suggested that certain sectors should use a sector comparison and privatised utility companies whose financial performance depends on the operation of a specific regulatory regime would be one such example. Where, for other companies, the approach of comparison to the overall market is adopted this is most appropriately achieved by reference to the FT-A All Share Index.
- 6 It is for remuneration committees to devise performance criteria appropriate to the circumstances of the particular company and it would seem desirable for them to reconsider periodically, ideally annually, whether these remain appropriate. **Institutional shareholders will continue to expect that the performance criteria adopted will demonstrate a sustained and challenging level of underlying financial performance.** A share price or total shareholder return based criterion alone will not necessarily provide the necessary degree of assurance. This problem may be satisfactorily resolved either through the adoption of an additional objective financial criterion or by the remuneration committee being required to satisfy itself that the movement in share price is a genuine reflection of the company's underlying financial performance.
- 7 Where comparative performance criteria are used remuneration committees may well consider that adoption of a sliding scale rather than a single performance threshold will most effectively provide appropriate incentivisation to perform at the highest level. The relative proportion of basic pay to remuneration under an incentive-based scheme will be just one factor to consider when determining how demanding the performance criterion or sliding scale should be. Shareholders would, however, expect special explanation where more than a small proportion of shares or options would vest for below-median performance.

PHASING OF GRANTS

- 8 One of the main areas of concern in the past has been the very large amounts received in a considerable number of instances because the maximum participation was granted at the outset and the performance criteria, if any, were not demanding. In the case of conventional option schemes one consequence of the long, typically 10 year, maximum lives of options from date of grant has been that significant reward has accrued to holders where underlying corporate performance has not been creditable even in cases where the 3 year performance criteria governing option exercise appeared demanding at the outset.
- 9 The Greenbury recommendations advocate strongly that any participation should be phased rather than entailing grants in one large

block, pointing out that this is particularly relevant in the circumstances of privatisation. It is anticipated that in future the adoption by remuneration committees of this approach in spreading the grant of participation over a number of years should allow minimum and maximum vesting periods for shares or options granted under long term incentive plans to be much more closely aligned and that, together with the use of demanding performance criteria, this will address the problem of windfall gains while also creating an environment in which sustained improvement in performance is encouraged and is seen to result.

LIMITS ON PARTICIPATION

- 10 The Greenbury Report makes clear that remuneration committees need to consider what division of total remuneration as between the fixed element of basic salary and variable performance-related elements is appropriate. This may vary significantly between companies in different sectors of the market but there will always exist practical constraints on the proportion of the latter to the former.
- 11 The Report also suggests that it could be appropriate for a significant proportion of a performance bonus to be invested in shares to be held for a minimum period. In these circumstances some remuneration committees may decide to make provision for additional matching shares to vest. However, they need to assess carefully what size of additional award is justifiable bearing in mind what further performance criteria need to be satisfied for the additional shares to vest and also, of course, the need to ensure appropriate limits for the proportion of variable and non-cash elements in the total remuneration package.
- 12 Guidelines for conventional share options already provide for individual limits for options outstanding at one time and for all grants over the life of option schemes. For long term incentive schemes shareholders would generally expect there to be a limit on the maximum permitted individual participation in respect of any one year and for this limit to be disclosed to shareholders. Where remuneration in the form of participation in long term incentive schemes could be judged to be disproportionate to that payable as basic salary the rationale for this should be explained to shareholders in sufficient detail to enable them to form an opinion as to its justification.

SHAREHOLDER APPROVAL

- 13 All long term incentive schemes involve potential commitments of shareholders' money at some future date or dilution of the company's equity. For this reason the Greenbury Code requires that shareholders should be invited specifically to approve all such schemes, whether payable in cash or shares, which potentially commit shareholders' funds over more than one year.
- 14 Conventional share option schemes are normally adopted for a ten year period after which shareholders have the opportunity to renew the arrangements if appropriate. Incentive plans should be reviewed in principle at more frequent intervals, within five years, to take account of developing practice and experience of the operation of the scheme.

FINANCING

- 15 Institutional shareholders would expect sponsoring companies to adopt prudent and appropriate arrangements for any acquisition and/or financing of shareholdings by ESOPs to meet contingent obligations to provide shares or pay deferred remuneration under a long term incentive scheme in order to minimise financial risk to continuing shareholders resulting from price movements in the company's shares. ESOPs should not, however, hold more shares at any one time than would be required in practice to match their outstanding liabilities. The prior approval of shareholders should be sought where 5% or more of a company's outstanding equity share capital at any one time, may be held within ESOPs.

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