Appointment and remuneration of board members: the key issues

April 5, 2016
Appointment of board members

• Role of shareholders
• Who propose?
  – Board
  – AGM/shareholders
  – Slatevoting/Shareholders
  – Substitution during the mandate
• Who prepare the proposal?
  – Nomination committee

Italian experience:
Overall numbers
Assogestioni slates
Minority members of the board elected by institutional investors 2013-2015

In 2013-2015
113 elected in 48 listed companies
(29 FTSE Mib, 18 MID CAP, 1 MICRO CAP)

- 66 board members
- 45 sindaci, including 38 chairmen/women
- 2 supervisory board members
- 80 men (71%)
- 33 women (29%)
- 22 in boards
- 10 in collegi sindacali (8 Chairwomen)
- 1 in supervisory board

In the previous 3 years (2010-2012) 64 elected in 24 listed companies:
- 38 board, 2 supervisory boards,
- 24 sindaci (including 19 chairs)
Remuneration of directors

• Directors remuneration designed to attract, maintain and motivate directors endowed with the professional skills necessary for managing the issuer successfully.

• Remuneration of executive directors shall be articulated in such a way as to align their interests with pursuing the priority objective of creating value for the shareholders in a medium-long term timeframe.

• Pros and cons of stock option and grants.
Remuneration of directors - 2 -

- Who design and fix remuneration?
- Remuneration Committee made up of non-executive directors (Italy: all non-executive with independent chairman)
- No director involved in fixing his remuneration
- Role of GM
- Who pays?
- Transparency of remuneration and benefits
Executive Pay: Overview

• Typical components of a Remuneration package
  – Base salary
  – Bonus
  – LT Incentive (usually Stock-based)

• The Structure of
  – Accounting-based bonus plans
  – Stock-based compensation
Remuneration Package

• Three main components
  – Base salary
    • Fringe benefits
  – Incentive Pay (tied to objectives and/or performance measures)
  – Long-term incentive Pay (typically stock-based)

• Bonus usually based
  – Either on pre-defined business objectives
  – Or on Accounting performance measures
    • EVA (Economic Value Added) = NOPAT – WACC x C
      – Where: NOPAT = Net Operating Profit after tax
      – WACC = Weighted Average Cost of Capital
      – C = Capital invested
    • Alternatively: EVA = (ROC-WACC) x C
      – Where: ROC = Return on Capital invested (in % terms)
Structure of a typical bonus plan

• Define:
  – Target EVA (based on budget/long-term plan)
  – Bonus pool (to be distributed if EVA = target)
  – Individual Participation to Pool

• Measure actual EVA
  – A number of accounting issues may arise

• What happens if actual EVA > or < target?
  – Define:
    • sensitivity of incentive plan
    • Floor/cap to incentive
Base salary and bonus

The diagram illustrates the relationship between cash remuneration and performance measure. The "Incentive Zone" represents the pay-performance relation where bonus becomes capped.

- Base Salary
- Base Salary + Target Bonus
- Base Salary + Threshold Bonus
- Base Salary + Bonus Cap

Threshold Performance and Target Performance indicate the points at which the bonus starts to increase.
LT Incentive Plans

• Often stock-based
  – Alternatives:
    • Stock Grants
      – And also Restricted Stock
        » beneficiaries are not allowed to sell stock until a certain date
    • Stock Options
    • Deferred compensation plans mimicking stock-based compensation
      – Phantom Stock
      – Phantom Stock Options
      – Stock Appreciation Rights (SAR)

Possible Reasons
  » Non listed Firms
  » Transactions costs
  » Tax/accounting reasons
CG & Executive Pay: Overview

• The Actors in Setting Executive Pay
  – The Board
  – Consulting firms
  – The General Meeting

• Stock-based Pay: a solution or a symptom of agency problems?

• Current issues and proposals
The Role of the Board

• Hiring & firing CEO/managers
  – and also setting executive pay
• Remuneration committee increasingly recommended
  – Adequate composition (independent directors)

• The role of Consulting firms
  – Basically agents monitoring other agents
    • What are their incentives?
      – Who appoints the consulting firm?
      – Is the consulting firm “independent”?
      – What is (who defines) the scope of its mandate?
      – May the consulting firm render additional business services to the company?
    • The inherent risks of market benchmarks
The Role of the GM

- The Board is accountable to the General Meeting
- **Disclosure** is central in this regard:
  - Procedure followed to define compensation packages
  - A statement on Remuneration Policy is increasingly recommended
  - Details of such packages
    - Amounts assigned to executives/directors
    - Fixed/Variable components (and parameters on which variable components depend)
    - Information is often scanty and/or scattered across a numer of documents: a comprehensive remuneration report is increasingly recommended
- The **limits** of disclosure
  - Compensation packages are often quite complex
  - Shareholders may lack the competence or the incentives to “become informed” (information is costly)
Voting at the GM

• Shareholders may vote
  – On the Remuneration Policy
  – On particular issues regarding the compensation package:
    • total remuneration of Board members
    • remuneration for particular tasks
    • And/or incentive plans (such as ESO plans)
  – The Vote may be alternatively:
    • Mandatory
    • Advisory

• Regulators are trying:
  – to lift the barriers to investor activism
  – EU Shrd rights proposal 2015
Executive Pay and CG

• Is the process of pay definition/contracting correct/acceptable from a CG viewpoint?

• Board accountability to shareholders
  – Ownership structure and the proxy machinery
  – The effects of compensation disclosure
  – The incentive to camouflage and stealth compensation

• Is disclosure sufficient?
  – Transparency Issues:
    • SO do not imply cash outlays (may be advantageous for cash-constrained firms; but directors/shareholders may not fully take into account their dilutive effects)
    • Do shareholders understand the cost of SO?
The situation in the EU

EU Commission Recommendation 2004/913/EC

– Each listed company should disclose a statement of its remuneration policy (Remuneration Statement).
  • It should be part of an independent remuneration report and/or be included in the annual accounts of the company.
  • It should also be posted on the listed company's website.

New Shareholder Rights Directive proposal

http://eur-lex.europa.eu/resource.html?uri=cellar:59fccf6c-c094-11e3-86f9-01aa75ed71a1.0003.01/DOC_1&format=PDF

4 column text:

The Remuneration Statement

• Should set out at least:
  – Explanation of variable and non-variable components of directors' remuneration;
  – details of performance criteria on which share-based or variable remuneration is based;
  – information on the linkage between remuneration and performance;
  – main parameters and rationale for annual bonus and non-cash benefits;
  – a description of the main characteristics of supplementary pension schemes for directors
  – terms of contracts of executives (including termination payments)
  – information on decision making process including:
    • the remuneration committee
    • the names of external consultants
    • the role of the general meeting
The Remuneration Statement (2)

- Remuneration policy (and any significant change to it) should be on the agenda of the annual general meeting
  - Remuneration statement should be submitted to GM for a vote (either mandatory or advisory)
- Total remuneration granted to individual directors should be disclosed in the annual accounts
  - total amount of salary, including attendance fees
  - remuneration from subsidiaries
  - profit sharing and/or bonus payments and their reasons
  - any significant additional remuneration for special services
  - compensation connected with termination of executives’ activities
  - estimated value of non-cash benefits
  - Information about share-based incentive schemes
  - Supplementary pension schemes
  - Any loans, advance payments and guarantees
Policy on directors’ remuneration

• Companies should **set limits on variable component** of remuneration
  – Fixed components should be sufficient to allow the company to withhold variable components when performance criteria are not met

• **Variable components should be subject to predetermined and measurable performance criteria**
  – Which should promote the long-term sustainability of the company

• **A major part of the variable component should be deferred**
  – The part subject to deferment should be determined in relation to the relative weight of the variable component compared to the non-variable component of remuneration
Policy on directors’ remuneration (2)

• The company should be able to reclaim variable components of remuneration awarded on the basis of data subsequently proved to be manifestly misstated

• **Termination payments**
  – should not exceed a fixed amount or fixed number of years of annual remuneration
    • Which should, in general, not be higher than 2 years of the non-variable component of remuneration
  – should not be paid if termination is due to inadequate performance.

• At least one of the members of the **remuneration committee** should have knowledge of and experience in the field of remuneration policy
Article 9 Right to vote on the remuneration policy

1. Member States shall ensure that companies establish a remuneration policy as regards directors and submit it to a binding vote of the general meeting of shareholders. Companies shall only pay remuneration to their directors in accordance with a remuneration policy that has been voted on at the general meeting of shareholders. Any change to the policy shall be voted on at the general meeting of shareholders and the policy shall be submitted in any case for approval by the general meeting at least every three years. However, Member States may provide that the votes by the general meeting on the remuneration policy are advisory.
NEW SHRD (EU Parliament compromise)

Article 9 Right to vote on the remuneration policy

Member States shall ensure that the value of shares does not play a dominant role in the financial performance criteria. Member States shall ensure that share-based remuneration does not represent the most significant part of directors' variable remuneration. Member States may provide for exceptions to the provisions of this subparagraph under the condition that the remuneration policy includes a clear and reasoned explanation as to how such an exception contributes to the long-term interests and sustainability of the company.
NEW SHRD (EU Parliament compromise)

Article 9b Information to be provided in the remuneration report and right to vote on the remuneration report

1. Member States shall ensure that the company draws up a clear and understandable remuneration report, providing a comprehensive overview of the remuneration, including all benefits in whatever form, granted, in accordance with the remuneration policy referred to in Article 9a, to individual directors, including to newly recruited and former directors, in the last financial year. It shall, where applicable, contain all of the following elements:

(a) the total remuneration awarded, paid or due split out by component, the relative proportion of fixed and variable remuneration, an explanation how the total remuneration is linked to long-term performance and information on how the financial and non-financial performance criteria where applied;

(b) the relative change of the remuneration of executive directors over the last three financial years, its relation to the development of the general performance of the company and to change in the average remuneration of employees over the same period;

(c) any remuneration received or due to directors of the company from any undertaking belonging to the same group;

(d) the number of shares and share options granted or offered, and the main conditions for the exercise of the rights including the exercise price and date and any change thereof;

(e) information on the use of the possibility to reclaim variable remuneration;

(f) information on how the remuneration of directors was established
NEW SHRD (EU Parliament compromise)

2. Member States shall ensure that the right to privacy of natural persons is protected in accordance with Directive 95/46/EC when personal data of the director are processed.

3. Member States shall ensure that shareholders have the right to hold an advisory vote on the remuneration report of the past financial year during the annual general meeting. Where the shareholders vote against the remuneration report the company shall, where necessary, enter into a dialogue with the shareholders in order to identify the reasons for the rejection. The company shall explain in the next remuneration report how the vote of the shareholders has been taken into account.

3a. The provisions on remuneration in this Article and in Article 9a shall be without prejudice to national systems of wage formation for employees and, where applicable, to national provisions on the representation of employees on boards.

4. To ensure uniform application of this Article, the Commission shall be empowered to adopt delegated acts in accordance with Article 14a to specify the standardised presentation of the information laid down in paragraph 1 of this Article.
Total remuneration (non equity-based) of directors
(Average by market index and sector in €.000)
Total remuneration (non equity-based) of directors, by role
(Average in € .000)

<table>
<thead>
<tr>
<th>Role</th>
<th>Remuneration (€.000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MD</td>
<td>843</td>
</tr>
<tr>
<td>Executive chairman</td>
<td>585</td>
</tr>
<tr>
<td>Non executive chairman</td>
<td>266</td>
</tr>
<tr>
<td>Other executives</td>
<td>589</td>
</tr>
<tr>
<td>Other executives non independent</td>
<td>67</td>
</tr>
<tr>
<td>Other independents</td>
<td>52</td>
</tr>
</tbody>
</table>
Composition of MDs' total remuneration (non equity-based)

- Fixed remuneration: 213
- Bonus and other incentives: 105
- Compensation for committees: 1
- Compensation from subsidiaries: 475

Composition of executive chairmen's total remuneration (non equity-based)

- Fixed remuneration: 333
- Bonus and other incentives: 60
- Compensation for committees: 35
- Compensation from subsidiaries: 3

Composition of non executive chairmen's total remuneration (non equity-based)

- Fixed remuneration: 241
- Bonus and other incentives: 11
- Compensation for committees: 8
- Compensation from subsidiaries: 0

Composition of other executives' total remuneration (non equity-based)

- Fixed remuneration: 203
- Bonus and other incentives: 67
- Compensation for committees: 272
- Compensation from subsidiaries: 44

Composition of non executives non independents' total remuneration (non equity-based)

- Fixed remuneration: 32
- Bonus and other incentives: 8
- Compensation for committees: 23
- Compensation from subsidiaries: 0

Composition of other independents' total remuneration (non equity-based)

- Fixed remuneration: 34
- Bonus and other incentives: 16
- Compensation for committees: 0
- Compensation from subsidiaries: 0
- Other: 0
2011-2015 evolution of MDs' total remuneration (non equity-based), by market index

FTSE MIB
FTSE MID CAP
FTSE SMALL CAP