APFI Research paper: LTIP & Remuneration Transparency

Clear Incentives to do Right?

Every day I seem to read about executive pay. We are all too aware how fee compression and a growing hunger for transparency is changing our industry. It is the backdrop of the Active-Passive debate every bit as much as abstracts like Active-Share. As part of the Transparency Task Force I feel the wider fees debate is currently amiss two things: 1) research costs and soft commissions and 2) fund management remuneration structures. In this paper we tackle the latter.

Should we conduct more due diligence of fund manager remuneration? We have recently seen how some firms have moved to a flat basic pay structure. This may sound very admirable until you read the small print and see that managers received inflated salaries to adjust for loss of bonus. Imagine waking up on the first morning of the new working year knowing the money is in the bank irrespective of how you perform? Of course flat structures may engender better behaviours but then that was the purpose of Long Term Incentive Plans (LTIP). Following the IA's new 'Principles for Remuneration', few seem to question the City having a say on executive pay, yes they are de facto representatives of shareholder assets but they are themselves also highly paid executives, in many cases reporting to shareholders. The conflicts of interest are so complex and opaque that it is hard to know if asset managers can be unbiased. Should we not first address the City's remuneration, so it can exact change across BIG business? We start by acknowledging the inequalities within the City itself:

"And yet, although the finance industry today displays many examples of egregious excess, the majority of those engaged in it are not guilty or representative of that excess. They are engaged in operating the payments system, facilitating financial intermediation, enabling individuals to control their personal finances and helping them to manage risks. Most people who work in finance are not aspiring Masters of the Universe. They are employed in relatively mundane processing activities in banking and insurance, for which they are rewarded with relatively modest salaries. We need them, and we need what they do." John Kay, June 2015.

As a fund selector I can see through my DDQs that just about every house has a form of LTIP and that just about every version is different. Which is right and importantly which works are great unknowns within our industry. It is not helped by the commingling of executive pay and fund manager pay, one is an issue for shareholders, the other for investors. Executive pay is subjective (sorry subject) to corporate governance, remuneration NED committees and shareholder voting, the other is not and largely driven by assets, performance, competition and asset manager war games. Commonality itself is good from a transparency point of view but the underlying motives, factors and outcomes will differ. Should there be a universal standard for LTIP and remuneration? What hasn't been done is an assessment of what sort of remuneration structures work, how much is paid out, how many in each firm are eligible and what sorts of customer outcomes emanate from each firm. The answers are not readily available so I suggest fund buyers start with questions in their Due Diligence. Questions to the fund manager that might include:

1. Do you subscribe to the current LTIP standards, if yes, which? E.g. AIFM Remuneration Code, Kay Review, Stewardship Code, UK Corporate Governance Code, IA, AIM Code.

2. Is your firm a public listed company, a subsidiary of a public listed company, a partnership or a limited company?

3) How many employees do you employ? Of those how many employees do you employee to analyse markets, set asset allocation, manage funds or otherwise involved in the portfolio management process? Of your total employees, how many are eligible to LTIP or other form of variable pay or bonus structure?

4) Do you pay only a basic salary or a variable package, for example LTIP? If basic only, do you benchmark that salary to the market including other asset managers that do pay bonus related packages?

5) Do you employ either; Long Term Incentive Plans, Deferred Bonus, Performance Share Plans, Share Ownership Plan Trust ('ESOP'), Joint Share-Ownership Plans (JSOPs), Enterprise Management Incentive Plans (EMIs), Equity Participation Plans, Shares for Rights, Nil cost Options, Restricted Stock Units, Restricted Stock, Vesting equity schemes or other bonus/variable structure in addition to basic salary?

6) How is your LTIP calculated, what factors used, like win loss ratios, information ratios, capital loss, active-share, degrees of freedom etc? How is it weighted, is it ever clawed back and paid over what timescale? How do you measure success of those paid LTIP?

7) What is the total cost of your staff remuneration per annum, of that how much is paid by LTIP, bonuses or variable salary?

There are far more questions belying these (see Appendix), and as an industry we need to tackle remuneration if we are to tackle costs and transparency. Collectively we seek fund managers who are paid for good customer outcomes, not for the size of assets accumulated or by virtue of status. That equation could boil down as something simple as:

> ***Sum [Amount (£€$) a fund manager returns in excess returns (over target or benchmark) LESS value of bonuses, including via performance fee, earned/ Divided by # funds managed]***

Other work needed includes gathering experience from asset managers and empirical analysis of LTIP structures versus investor outcomes. We may need to first baseline benchmarking and performance targets to level the playing field, either via correlation or common sense approach.

Creating a cross-industry panel to canvass opinion, conduct analysis and debate the future direction of asset management remuneration is more than just desirable; it is absolutely critical to the wider cost transparency debate, executive pay and the future reputation of the City.

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APPENDIX

Section A. IA 2016 PRINCIPLES for REMUNERATION

It is important to note that the principles do not tackle fund manager pay directly or specifically. See: https://www.ivis.co.uk/media/11101/Principles-of-Remuneration-2015-Final.pdf

Key relevant content contained in the principles include;

5. Remuneration Structures
a. The Remuneration Committee should select a remuneration structure which is appropriate for the specific business, and efficient and cost-effective in delivering its longer-term strategy. These Principles do not seek to prescribe or recommend any particular remuneration structure.
b. Complexity is discouraged. Shareholders prefer simple and understandable remuneration structures; simplicity can be improved by limiting variable remuneration to an annual bonus and one long term incentive scheme.
c. Executives and shareholders can have divergent interests, particularly in relation to time horizons and the consequences of failure or corporate underperformance. Incentive structures should have a long-term focus.
d. To avoid payment for failure and promote a long-term focus, remuneration structures should contain a careful balance of fixed and variable pay. They should include a high degree of deferral and measurement of performance over the long-term.
e. Structures should also include provisions that allow the company, in specified circumstances, to:

- Forfeit all or part of a bonus or long-term incentive award before it has vested and been paid (‘performance adjustment’ or ‘malus’); and/or
- Recover sums already paid (‘clawback’)

4. Performance Adjustment/Malus and Clawback
As stated above, structures should include provisions that allow the company, in specified circumstances, to:
- Forfeit all or part of a bonus or long-term incentive award before it has vested and been paid (‘performance adjustment’ or ‘malus’); and/or
- Recover sums already paid (‘clawback’)
Shareholders believe the circumstances in which performance adjustment and clawback can be
implemented need to be agreed and documented before awards are made.

11. Special Awards and ex-gratia Payments
Effective remuneration planning involving a balance of short and long term plans, carefully selected and calibrated performance measures and targets, and annual grants, should make exceptional awards unnecessary. A need for special grants, particularly for continuing management, indicates poor planning by the Remuneration Committee. Special awards may be acceptable when, for example, a new team is brought in to turn around a company. If such awards are made, the Remuneration Committee must justify them.

Shareholders believe that retention awards for main board directors rarely work. Retention concerns on their own are not sufficient grounds for remuneration to increase. Shareholders do not support the practice of paying transaction related bonuses.

SECTION C – VARIABLE REMUNERATION

A significant proportion of executive remuneration should be performance related, and tied to the achievement of the agreed corporate strategy and long-term value creation. These Principles do not seek to prescribe or recommend any particular remuneration structure. Shareholders prefer simple remuneration structures; simplicity can be improved by limiting variable remuneration to an annual bonus and one long term incentive scheme. Remuneration committees may consider non-financial performance criteria in variable remuneration, for example relating to environmental, social and governance (ESG) objectives, or to particular operational objectives. ESG measures should only be used if they are material to the business and quantifiable. In each case, the link to strategy and method of performance measurement should be clearly explained.
No element of variable pay should be pensionable.

1. AnnualBonuses

Annual bonuses incentivise performance and reward achievement in line with the agreed corporate strategy. Annual bonuses exist to reward contribution to the business during the year above the level expected for being in receipt of a salary. They should be clearly linked to business targets, ideally through the KPIs reported in the Strategic Report. Where other measures are chosen, these should be explained and justified. The KPIs can be both financial and non-financial.
The measurements chosen must be quantifiable and the targets set at the start of the year. Companies should clearly disclose and justify the performance measures chosen and the related targets. Where consideration of commercial sensitivities 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.

Following payment of the bonus, companies should provide a full analysis in the Remuneration Report of the extent to which the relevant targets were actually met.

Maximum participation levels should be disclosed and any increases in the maximum from one year to the next explicitly justified.

Deferring a portion of the bonus into shares can create a greater alignment with shareholders, particularly where there is no long term incentive. However, this should not result in an increase in the overall quantum of the bonus.

Shareholders discourage the payment of annual bonuses to executive directors if the business has suffered an exceptional negative event, even if some specific targets have been met. In such circumstances, shareholders should be consulted on bonus policy and any proposed payments should be carefully explained.

Discretion should be retained to ensure that a payment that is inappropriate in all the company's circumstances is not made. Companies should disclose the range of discretion which can be applied to bonus awards.

2. Long-Term Incentives

i. General
Long-term incentives exist to reward the successful implementation of strategy and the creation of shareholder value over a period appropriate to the strategic objectives of the company. Equity based long-term incentive schemes are the most effective way to align the interests of participants and shareholders.

The performance period should be clearly linked to the timing of the implementation of the strategy of the business, which should be no less than three years and shareholders would generally prefer longer. The use of additional holding periods is now commonly expected by investors, so that in total the performance and holding period should cover a period of at least five years.
All new incentives or any substantive changes to existing schemes should be subject to prior approval by shareholders by means of a separate and binding resolution. Any change in quantum should be fully explained and justified.

Scheme and individual participation limits must be fully disclosed in share incentive schemes.
The operation of share incentive schemes should not lead to dilution in excess of the limits acceptable to shareholders.

ii. Performance Conditions
The widely differing nature of business models and industry characteristics means that the appropriate performance measures and conditions for different companies may vary significantly. Performance measures and vesting conditions should be fully explained and clearly linked to the achievement of appropriately challenging financial performance which will enhance shareholder value.

Whilst other considerations may apply in particular circumstances, for example, restructuring, shareholders will expect that remuneration policies and structures will normally be consistent with the following criteria:
Shareholders have a clear preference for financial measures linked to value creation.
Performance criteria should be linked to the Company's long-term strategy and targets reflect an appropriate balance between the shorter- and longer-term.

Remuneration Committees will need to consider, and explain, appropriate performance criteria in the light of the specific business characteristics of the group in question.
Performance criteria should fully reflect the performance of the business as a whole and should be applied consistently across measurement periods.

- The definition of any performance measurement should be clearly disclosed.
- Retesting of performance conditions is not acceptable.

Remuneration Committees should ensure that, when using in isolation either comparative or absolute performance metrics, the result does not produce outcomes that are not in line with the overall performance of the company, its future prospects or the experience of its shareholders over the performance period.

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

Where operational measurements are used, they would generally be expected:
o To include, subject to business strategy, one or more measures relating to overall business volume or growth

o To include one or more measures relating to business efficiency or profitability
o To avoid the risk of providing an implicit incentive to take undue operational or financial risks or, in particular, to adopt an unduly risky capital structure.

Where Total Shareholder Return (TSR) relative to a relevant index or peer group is used, 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.

The calculation of starting and finishing values for TSR should be made by reference to average share prices over a short period of time at the beginning and end of the performance period.

Lengthy averaging periods should be avoided. 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.

Where appropriate, Remuneration Committees should take account of The Investment Association Guidelines on Responsible Investment Disclosures: https://www.ivis.co.uk/media/5893/ABI_RID_guidelines.pdf

iii. Vesting
Threshold vesting amounts, reflecting expected performance, should not be significant by comparison with annual base salary.
Awards' structures with a marked 'cliff edge' vesting profile are considered inappropriate.
Full vesting should reflect exceptional performance and so be dependent on achievement of significantly greater value creation than that applicable to threshold vesting.
Sliding scales and graduated vesting profiles are a useful way of ensuring that performance conditions are genuinely challenging. They generally provide a better motivator for improving corporate performance than a 'single hurdle'.

iv. Grant Size
Windfall gains may arise if the level of share or option grants expressed as a multiple of salary is maintained after a substantial fall in the share price. Where this risk exists, grants should be scaled back.

vii. Pricing and Timing of Awards
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.

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

Re-pricing or surrender and re-grant of awards or ‘underwater’ share options is not appropriate.

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

viii. Life of Schemes and Incentive Awards

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

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 ten years from the date of grant.

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.

In other circumstances of cessation of employment1, some portion of the award may 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 necessary2, awards should vest by reference to performance criteria achieved over the period to date.

Section B. FUND MANAGER/ FIRM LEVEL QUESTIONS

A) Is your firm a public listed company, a subsidiary of a public listed company, a partnership or a limited company?

B) How many employees do you employ?
- How many employees do you employee to analyse markets, set asset allocation, manage funds or otherwise involved in the portfolio management process?

C1) Do you pay only a basic salary? Yes/No
- If yes, do you benchmark that salary to the market including other asset managers that do pay bonus related packages?

C2) Do you employ Long Term Incentive Plans, Deferred Bonus, Performance Share Plans, Share Ownership Plan Trust ('ESOP'), Joint Share-Ownership Plans (JSOPs), Enterprise Management Incentive Plans (EMIs), Equity Participation Plans, Shares for Rights, Nil cost Options, Restricted Stock Units, Restricted Stock, Vesting equity schemes or other bonus/variable structure in addition to basic salary?
- If yes, what type?
- Do you provide a compulsory or voluntary arrangement?

- Do you offer enhancements to pension contributions related to performance or otherwise as a variable bonus?
- Does the scheme vary from year to year?

D) Of your total employees, how many are eligible to LTIP or other form of variable pay or bonus structure?

E) How much Assets Under Manage do you control?
- What is the median Annual Management Charge and Ongoing Charge of Fund for your firm?
- What % of your AUM is split between Passive and Active investing?
- What % of your total Annual Management Charge is made up of portfolio employee costs?

F) Do you believe there should be an industry standard for LTIP and remuneration?

G) Of those eligible, what % of employees trigger a LTIP/bonus?

H) Example Table: Can you supply the following breakdown:

1. Total number of employees

2. Total cost of basic salaries paid in most recent 12 months

3. Number of employees eligible to LTIP, total paid out in LTIP in most recent 12 months

4. Number of employees eligible to other awards and vesting programmes, total paid out in most recent 12 months

I) Are your bonuses, LTIP and deferred schemes related solely to performance, quantitative or customer outcomes? Yes/No
- If No. What other discretionary factors do you consider when paying bonuses/LTIP?

J) Does your bonus and remuneration framework consider Corporate Governance, Ethical, Environmental or Social factors?

K) How is your remuneration framework aligned to your investors? How?

Section C. LONG TERM INCENTIVE PLAN QUESTIONS

L) Do you subscribe to the current LTIP standards, if yes, which? E.g. AIFM Remuneration Code, Kay Review, Stewardship Code, UK Corporate Governance Code, IA Guidelines, AIM Code.

- If yes, do you believe the current standards are sufficient?
- Should there be a universal standard for LTIP and remuneration?

M) Do you currently employ a Long Term Incentive Plan (LTIP) or otherwise Deferral scheme for employees? Yes/No

N) How much did you pay out in 2016 (or latest 12 months) on LTIP?

O) On average what % of your employees (those eligible to LTIP) annual earnings were derived from LTIP?

P) Do you have an independent remuneration committee, do they decide the structure and management of remuneration packages including LTIP/deferred bonuses? Are bonuses subject to any other independent scrutiny or audit?

Q) What is the soonest period which your LTIP begins to reward the employee?

R) Has your LTIP or other plan be subject to shareholder vote? If yes, was it ever rejected?

S) Multiple choice. What is the minimum period that LTIP/Deferred scheme be structured?

- 1 yr
- 2-3 yrs
- 3-5 yrs
- 5 yrs +

T) Multiple choice. What is the minimum (maximum) amount of the total package be allocated to a LTIP/Deferred scheme?

- 10%
- 20%
- 30%
- 40%
- 50%
- 60%
- 70%
- 80%
- 80%
- 100%

Section D. LTIP CALCULATION QUESTIONS

U) Do you apply a risk-adjusted measure to your LTIP? Do you apply upper boundaries for pay-outs to prevent excessive risk-taking?

V) If you apply LTIP, do you apply a single, multiple or weighted investment horizon to how they pay out?

W) Do you apply a success measure to your LTIP like Win/Loss ratio (hit rate)? Is it based on individual performance only, median company performance, pooled or peer group benchmarked?

X) When did you last assess the success (enterprise, innovation, fiduciary alignment) of your LTIP and remuneration programme?

Y) Do you apply a business multiplier to your LTIP or deferred scheme?

Z) Is the multiplier related to asset growth or sales inflows? Do you apply peer company comparisons? Does business retention or new business wins factor?

AA) Do you reduce (clawback) your bonuses/LTIP to reflect breaches, malpractice, fines or poor customer outcomes? If yes, how?

AB) How much have you clawed back in a year from paid bonuses, deferred schemes, LTIP or vesting over the last 5 years?

AC) Do you charge a performance fee on top of your annual management charge?
- If yes, what % of your portfolio earnings were derived from your performance fee?
- Is your performance fee in any way linked to your remuneration package for employees? If yes, how?

AF) Should the LTIP/bonus be triggered with reference to a benchmark or Absolute returns?

AG) Should the LTIP take account of customer outcomes after the deduction of fees?

VESTING Programmes

AD) Do you offer any additional bonuses, equity share or other vesting programme to employees?

AE) If yes, what % of your total employees are eligible?

AF) How much in total did you pay out on these additional schemes?

AG) Of those eligible, what % of their total annual package was held in these additional rewards plus LTIP?

<u>Section E. FUND BUYER QUESTIONS</u>

BA) Do you think fund managers should be paid a basic salary or a variable salary based on customer outcomes?

BB) Should that variable salary be paid immediately or locked-in for a predetermined period?

BC) Do you believe fund managers are paid in line with the value they contribute to investors?

BD) Do you believe that fund manager remuneration is transparent and properly disclosed?

BE) Do you believe there should be an industry standard for LTIP and remuneration?

BF) Do you believe bonuses/LTIP can be clawed back if the fund manager delivers poor outcomes or is subject to regulatory fine/breaches?

BG) Multiple choice. What % of the bonus could be clawed back?

- 10%
- Up to 50%
- 50-75%
- 75-100%
- 100%

BH) Multiple choice. What is the minimum period a LTIP/Deferred bonus should be paid:

- Up to 3 years
- 3-5 years
- More than 5 years

BI) Should the Bonus/LTIP take account of customer outcomes after the deduction of fees?

BJ) If a fund manager is paid only a basic salary, should it be possible to clawback this if the manager delivers poor customer outcomes?

USEFUL LINKS:

http://highpaycentre.org/files/HPC_11_Paid_to_perform_06.pdf
http://www.johnkay.com/2015/06/15/other-peoples-money-introduction/
http://www.telegraph.co.uk/finance/economics/8901055/Who-is-right-in-the-big-pay-debate.html
http://ww2.cfo.com/gaap-ifrs/2016/10/incentive-plans-non-gaap-performance-measures/
https://www.theguardian.com/business/2016/oct/05/boardroom-bosses-advised-meet-workers-justify-pay-practices-legal-general-inequality
http://uk.businessinsider.com/theres-a-problem-with-pay-for-performance-2016-10
https://www.ivis.co.uk/media/11101/Principles-of-Remuneration-2015-Final.pdf