

Tomorrow's Capital Markets

A private invitation to work with
Tomorrow's Company to set new
incentive structures for a sustainable world



Contents

01	Foreword
02	Executive Summary
07	Part 1 – Context and background
07	– Context
08	– The changing role of the capital markets
09	– Why a focus on incentives?
11	Part 2 – Mapping the system
11	– Incentives: interactions and interdependencies
15	– The focus on sustainability
17	Part 3 – Challenges
17	– Pay AND performance
17	– Communication gaps
18	– Lack of knowledge and metrics
18	– Personal security and success
19	– Regulation
20	Part 4 – Towards a new system
22	Appendix 1: Summary of codes, guidelines and reviews relating to remuneration
23	Appendix 2: Overview of the research
24	Appendix 3: Examples of those leading change
27	Sources and notes
28	Bibliography
30	We wish to thank...

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Comments on this paper are invited and may be addressed to the authors at tcm@tomorrowcompany.com.

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Foreword



“Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.”
Brundtland Report: ‘Our Common Future’¹

People, planet and profit – all are under enormous stress. This report on Tomorrow’s Capital Markets is being launched to coincide with Rio+20. This should be a time of celebration by the world community of the significant achievements around the Millennium Development Goals. Instead the world economy is gripped by uncertainty, the crisis of the Eurozone threatening to undermine recovery in America, Asia and elsewhere. Leading scientists are warning of a tipping point which means that the biosphere our grandchildren will inherit will be profoundly diminished: the rich bounty of nature which sustains life on earth cannot be taken for granted. These challenges are of course profoundly and inseparably linked.

What has all this to do with Aviva and Aviva Investors? Our purpose is to bring prosperity and peace of mind to 44.5 million customers across the world. Aviva looks after \$500bn worth of funds on behalf of people so that they can plan, invest and save for their futures. We have a duty of stewardship which defines who we are and what we do and has done so for over 300 years.

The Brundtland Commission defined sustainable development for a generation. But what has changed since that historic meeting at Rio twenty years ago is how it can best be achieved, above all the critical role of business and therefore of capital markets. The understanding of how capital markets interact with sustainable development has improved considerably. However, in my view, the policy proposals that we are seeing in the wake of the financial crisis are not sufficient to put our economy onto a path of sustainable development. We need to face this challenge head on – Aviva Investors has I believe played our part in so doing. But there is a deeper truth we all need to acknowledge.

Sustainable development cannot be achieved without sustainable capital markets and this requires much stronger intervention by governments around the world to correct market failures. Finance bridges the past, present and future. It enables resources to be moved across time and space. Finance must provide the means to achieve the intergenerational equity that lies at the heart of sustainable development. Correctly harnessed it can fuel innovations in the state of technology and social organisation that Brundtland recognised limit our ability to meet present and future needs. Finance is the currency of stewardship.

Or rather that is what finance should be. But it isn’t. Capital markets have different priorities and behaviours. To establish tomorrow’s capital markets we will need policy interventions that do what capital markets can’t and won’t be able to do for themselves, through fiscal measures, market mechanisms and market supporting regulation that address market failure. But there is much that we in capital markets can and must do: playing our fullest possible role in shaping those effective policy interventions; better training on the materiality of sustainability issues on valuation; and better information, which is why we are proud to have led the Corporate Sustainability Reporting Coalition* at Rio+20.

None of this will be achieved however if we fail to understand the power of incentives of all the key players within capital markets – and then set out a strategy for reform. Hard incentives including pay as well as other softer incentives which drive the actions of individuals and institutions of intermediaries throughout the capital supply chain. This is why Aviva Investors together with UNEP FI and Berwin Leighton Paisner, Hermes, Korn/Ferry Whitehead Mann and UBS have commissioned this agenda setting programme from Tomorrow’s Company. This report sets out their progress to date.

This is very much Tomorrow’s Company’s work and view, but I am pleased they have found that many within capital markets know that significant change in this area is needed. Respondents recognise that we need a solution that is systemic and long-term, but also comes to terms with complexity of markets and the detail of how incentives work in practice. In the UK there is some good work being conducted in this area by Professor Kay, whose final report on the UK Equity Markets and Long-Term Decision Making will be with us imminently. This is why this report is also an invitation – for others to work with and partner Tomorrow’s Company as they move forward into the next phase, testing and refining this initial ‘agenda for change’, through a deeper programme of research and inquiry and above all action by key players to chart a practical programme of incentives reform to establish tomorrow’s sustainable capital markets.

For my part, our own experience of partnering with Tomorrow’s Company has been outstanding and I strongly commend the experience to others looking to build a more sustainable capital market.

Paul Abberley
Interim chief executive, Aviva Investors

* For more information on the CSRC, please see: www.aviva.com/earthsummit2012

Executive summary

We believe in the ability of capital markets to act in a way that promotes the long-term sustainability of companies. As they are structured today, this is not being fully realised.

Companies and equity markets are key partners. Companies are the engines of wealth creation for societies. The equity capital markets were formed for the purposes of generating long-term capital for companies, and through the secondary markets, to provide liquidity for the original investors.

We are now in a different era. One where we are facing significant global, social and environmental challenges. Progressive companies recognise that creating long-term sustainable value depends on understanding the interdependency between financial, social and environmental factors. Companies also have the innovative capability and capacity to produce the solutions to many of the challenges facing the world.

There is a mismatch between the financial support the real economy needs and what the equity markets are delivering and the gap needs to be closed to harness the capability of everyone to achieve sustainable development.

Leveraging the financial self-interest of many in the system provides one of the keys to changing the system. Therefore this study has focussed on what changes to incentives are needed to ensure capital markets are better structured to incentivise sustainable business behaviour. Its primary focus is on the equity markets within an Anglo-American context and has involved both a systems level analysis together with a detailed examination of the incentives of the individual players within the system.

We have found **a growing appreciation that success should be measured in ways other than just financial performance** and that this is starting to flow into how incentives are structured. This momentum for change is welcome but in many cases **the current incentives of those in the system still work against the long-term sustainability of companies.**

There is a lack of alignment between incentives, the interests of beneficiaries and business strategy. The criteria on which performance and hence reward is based are still too often founded on financial and market value based measures. In part this is a reflection of the lack of knowledge, understanding, common language and metrics about what drives sustainable performance. Discussions about sustainability often default to ESG, SRI, the 'green agenda' or are simplified to discussions about long-term versus the short-term horizons. And for outsiders, it is hard to obtain detailed information on how incentives are structured and designed – there is a lack of transparency. Financial incentives do not operate in isolation – neither are they the only incentives for those in the system. Reputation, personal success and security, organisational values and culture, regulation, fiscal policy and reporting models, all play their part.

There is a growing sense the system has reached a pivotal point in its evolution and the time is right for change. Public outrage, shareholder activism and the scrutiny of regulators is growing. More importantly, many who have deep and long experience of working in the system believe change is needed.

Change needs to be created and owned by those in the system and those who are responsible for the system. Interventions need to be carefully judged, and require both a systemic and collaborative approach.

We set out an agenda for change and invite those in the system to work with us to develop this agenda and help translate it into practical actions to move the system towards achieving more sustainable outcomes to meet the needs of today and of future generations.

An agenda for change

We set out below some principles for the structure of all forms of financial remuneration to better encourage sustainable outcomes. These are presented as a framework for engagement and discussion and to inform the detailed work required with participants in the system to design new and appropriate incentive structures. They draw on existing codes and principles.



Stewardship is the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition.²

Alignment

- **To the interests of beneficiaries:** incentives take into account and are aligned to the needs and wishes of the ultimate beneficiaries, recognising the degree to which they wish stewardship to be taken into account. This should include both today's direct beneficiaries and future generations who will be affected by business decisions made today and the impact they have on future economic, social and environmental performance, acknowledging that to achieve this requires some difficult judgements and compromises to be made.
- **To business strategy:** the organisation's remuneration policy is in line with its stated long-term strategy, objectives and values, taking into account the interests of employees, suppliers, customers, community, the environment and society and should not encourage risk taking beyond the risk tolerance level of the organisation.

Transparency

The basis on which an organisation's reward packages are structured and paid is publicly available and communicated in a way that is easily understood and analysed.

Performance

- **Linked to sustainable outcomes:** benchmarks and other measures of performance include elements linked to material issues impacting on long-term success and sustainability
- **Link between reward and performance**
 - there is a clear link between overall reward and the creation of value for the ultimate beneficiary, society and the organisation
 - the assessment of performance takes account of underlying business cycles of the firm and risks, and is set in a multi-year framework that prioritises the delivery of longer-term performance over short-term financial performance and/or comparative performance against a specified market index
 - bonus payments are once again designed to reward truly exceptional performance and are in the context of sustainable value creation.

The following support the achievement of these principles:

Leadership

Incentives operate within and are influenced by the culture of the organisation.

Strong leadership creates the conditions for incentives to achieve their intended outcomes – by CEOs and boards setting the right ‘tone from the top’, and by voluntary cross-industry initiatives and professional and industry bodies setting the appropriate guidelines.

Knowledge

- Investors and their advisers are better educated in financial matters and issues affecting the long-term sustainability of the economy, society and the environment so that investment objectives, risk parameters, time frame and returns, both financial and non-financial are incorporated into investment mandates
- Participants in the equity markets share knowledge about the non-financial drivers of sustainable performance – with others in the system and across existing silos created by internal functional boundaries
- Analysis and investment appraisal decisions take these non-financial factors into account.

Metrics

- Creative use is made of existing metrics and through better sharing of information across all the participants and expert bodies, the development of new metrics is hastened and their use encouraged by participants in the system in making investment decisions.

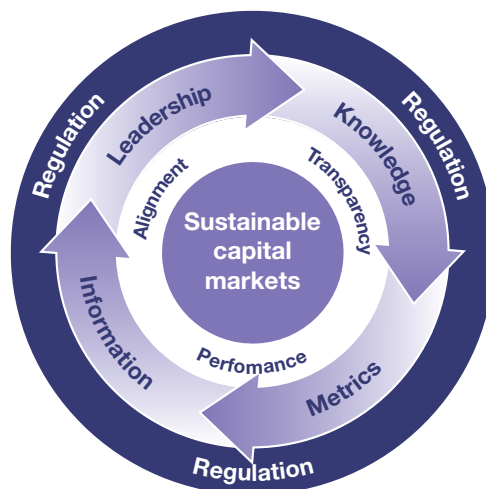
Information

- Information flows throughout the system are better aligned with investor needs and time horizons, and provide a more balanced and holistic view of strategy, risk and performance including:
 - the remuneration and incentive plans for the board and the principles for the rest of the organisation
 - the integration of material sustainability issues impacting long-term value creation
 - the culture and values of a company – the ‘tone from the top’ and how the board monitors corporate behaviour.

There are a number of initiatives that are progressing the above such as the work of the International Integrated Reporting Council (IIRC), the Global Reporting Initiative (GRI) and the Corporate Sustainability Reporting Coalition (CSRC).

Regulation

Regulators have set framework conditions that not only protect the interests of beneficiaries and the integrity of the system but also take into account issues affecting long-term sustainable outcomes.



What does this mean for participants in the system?

Using the principles outlined, some potential actions for further discussion and development are:

For pension fund trustees and other asset owners

- Set investment mandates and associated incentives in a way that incentivises sustainable investment behaviour by being specific on key factors such as the degree to which they wish stewardship to be exercised, time horizons, benchmarks and basis of incentives. For example, to include a balance of fixed and performance fees based on hurdles linked to longer-term performance
- Through their investment arms, insurance companies are stewards of the funds entrusted to them by policyholders. In order to fulfil their stewardship responsibilities, they need to better separate the interests of those policyholders from those of their shareholders.

For investment consultants

- Advise and work with pension fund trustees to develop the enhanced mandates, incentive structures and performance criteria mentioned above
- The remuneration of investment consultants to be linked to the long-term performance of the funds creating better alignment with the interests of pension fund trustees.

For fund managers

- Where mandated by assets owners or through a proactive approach, develop ways to measure their activities in line with the 'UK Stewardship Code' and give an account of the scope and impact of their engagement and of their performance both in terms of investment returns and stewardship. The report '2020 Stewardship' published by a group of investors with Tomorrow's Company, provides a framework to help achieve this aim and recognises that while not every shareholder can or needs to be a good steward, a critical mass of active investor stewards is vital to support the code³
- Devote at least 5% of the incentive commission that goes to brokers to research that takes sustainability factors into account. This would further support the momentum created through the original Enhanced Analytics Initiative which is now being extended through the PRI Enhanced Research Portal.⁴

For stock exchanges

- The performance and remuneration of the executives of stock exchanges contain measures that relate to the quality of the companies being listed e.g. standards of corporate governance, reporting on material sustainability issues. This could be achieved through the development of a 'sustainable stock exchange benchmark' against which relative performance could be assessed.

For brokers and analysts

- To include material issues relating to the long-term sustainability of companies in the research they undertake as a matter of course.

For investment banks

- To provide an account of the value added or destroyed as a result of deals in which they have been involved and for a percentage of remuneration to take this into account over a longer time frame.

For policymakers

To consider the merits of regulatory change to overcome a wide range of conflicts of interest which currently act as a barrier to embedding sustainability. For example:

- the scope and range of broker reports
- to help fiduciaries be more confident in taking sustainability issues into account in their investment decisions by introducing a form of protection that disallows litigation against them where they have followed due process and acted in good faith
- the introduction of a 'comply or explain' process with respect to sustainable investing. Under the UK Pensions Act (1995) pension funds are currently required to state whether they take social, environmental and ethical considerations into account, but not *why* they choose not to do so.⁵

Perspectives

“Investors were considered to be primary regulators of companies. That wasn’t the primary role of the stock exchange or the capital markets. That was to capitalise international trade and investment and allow the individual investor to share their risks among many different projects. That remains the case... but I think a third role has emerged, which is a very self-interested role of the individuals who operate within the capital markets where the presence of the markets, the structure of the system, the pay that they receive, their own income becomes an end itself. So the market exists now to also help fund the lifestyles of those who have become the market.”

“The fact that the system works at all is remarkable. If I was observing where we are today, and particularly where we are since 2008, it would be one where we have deep concerns about how far we are able to sustain these principal-agent relationships with massive diversification and with high levels of asymmetric information – all of which, are pretty fundamental critiques of whether or not you will end up having an effective equilibrium.”

“Things move at an almost glacial pace in the pension world. The degree of change that we need within our economy is so radical in moving to a low-carbon economy that it is a project that will take 20/30 years to achieve. And the problem is that that goes well beyond the electoral ambitions of even the most enthusiastic politician. And the temptation to put off to the next government difficult choices is immense and the possibility that whole countries will go down the free rider route is a very real issue.”

“The incentive structures are the genesis of everything. It’s the genesis of the bad stuff – the global credit crisis, the US credit crisis... and they can’t be changed overnight. To build momentum for change you have to affect people at every level, their brains, their logic, but you also ultimately have to affect the way they feel – you have to ‘get’ people at every level of intellect and emotion.”

“For a lot of big change issues you do need a trigger event. The challenge is actually using it to produce something better. To be honest I feel that we have missed the boat a bit because there was a lot of panic and a lot of talk of reform, but obviously these things take time and a lot of the response was too immediate and failed to deal with the underlying problems. We should remember that it is also about cultural and behavioural change – as with any change management process you can’t just change one person – you need to change everyone and they need to feel that change through a number of influences.”

“I would say the capital markets are working for some shareholders but for the majority of shareholders, which is Jo Public, they’re not working. The word fiduciary is another old word, but to me it’s fundamentally about a new social contract, in the broadest sense of the phrase.”

Part 1: Context and background

Context

The focus of the Rio+20 United Nations Conference on Sustainable Development, is to shape how we can reduce poverty, advance social equity and ensure environmental protection on an ever more crowded planet to get to the future we want. Sustainable development is defined in the Brundtland Report 'Our Common Future' as:

*"Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs."*⁶

The capital markets and the companies they serve are a vital part of how these objectives will be met – yet there is growing concern as to whether they are able to realise their potential in doing so.

The global financial crisis beginning in 2007/2008 has resulted in widespread criticism of the operation of financial markets. Free-market capitalism, the effectiveness and scope of government regulatory systems are all being questioned and are promoting calls for change. Financial incentives have become a 'touch paper' for many, in large part being seen to encapsulate the stress lines in the system – inequality, selfishness, short-term opportunism and a general disregard for the impact on other stakeholders and wider society. This focus on remuneration has prompted the creation of a number of codes and guidelines specifically covering the structure of remuneration in financial services companies in addition to existing governance codes. (see *appendix one*).

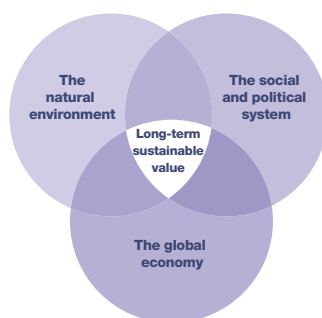
Thinking and practice involving sustainability – whether in terms of 'sustainable development' or 'sustainability' as companies define the term or 'sustainable investing' – requires a systemic view of the world. This involves an understanding of the interdependencies between three distinct but interdependent systems – environmental, social and political and global economic.

Tomorrow's Company refers to this interdependence as the 'triple context'. These three systems continually overlap and interact with each other to create, on a global scale, an all-encompassing system resulting from the complex feedback loops existing between them. The diagram below clearly illustrates the point at which the three systems intersect – a space where the opportunity to create long-term sustainable value exists.

*"Sustainable investing" is long-term investing that is intergenerationally efficient and fair.*⁷

*Sustainable companies are those that create long-term sustainable value by building economic, social and environmental capital to provide ever better goods and services in a way that is profitable, ethical and respects the environment, individuals and the communities in which they operate.*⁸

The 'triple context'



All organisations, whether companies, pension funds or the world's stock markets, that operate within this space need to take all three sectors into consideration to deliver the practical and innovative solutions that are urgently required to address many of the major global problems that society faces and, in doing so, build a more resilient, equitable and sustainable future.

The changing role of the capital markets

“There is a strong tendency to see the development of the global securities market solely from the perspective of those who raised money through the issue of stocks or bonds. However, of equal or even greater importance was the position of those who bought, held or traded those securities. In many ways the driving force behind the growth of the global securities market has not been the needs of governments and business because their financial requirements could be met in a variety of different ways, but the desire by investors for an asset that was easily divisible, mobile and flexible in terms of space and time, as well as delivering a return, either through income or capital appreciation.”

Professor Ranald Michie.⁹

Liberalisation of the system

The dominant economic ideology of the last 25 years which has largely determined the way the global capital markets have developed reflects the so-called ‘Washington Consensus’ – a set of ideas about the efficiency of markets. This traces its roots to longstanding policies of the International Monetary Fund (IMF) and to adoption by the World Bank of ideas in vogue in Washington early in the Reagan administration concerning deregulation and supply-side economics, the policies of the Thatcher government in the UK and neo-liberal tendencies of the business community and the economics profession in the US.

Among the favoured policy prescriptions of the Consensus is financial liberalisation in both the developed and the developing countries, involving the removal of controls and regulations on both the inflows and outflows of financial instruments that move through foreign exchange markets.

It is the implementation of these ideas and policies that has been perhaps the single most important cause of the surge in global financial flows over the past 25 years. An additional factor has been the influence of technological advances that have facilitated the growth of 24-hour electronic trading.

The reason why this context is important is that it has changed the dynamic of the whole system. It has changed the relative size and influence of the primary and secondary markets, it has changed the value chain, and most critically it has changed the motivations and behaviours of organisations and individuals.

The financing or allocation of new capital (the primary market) represents only a fraction of the activity of the capital markets.

It is well documented that the existence of a strong and liquid secondary market is an important component of economic development in terms of allocating capital across productive purposes and enabling growth and trade. It can also act as a good discipline on management. But its effect is different to the primary market. The buying and selling of stock results in a rearrangement of the ownership of existing capital and its impact on capital allocation arises from the signalling effect that emerges indirectly through research and share price movements, which influence companies’ management, their strategies, investment and the operating decisions they take.

Understanding what is driving the differing purposes, activities and motives of those in the capital markets today is critical to the development of the system in the future.

Why a focus on incentives?

Since human beings are purposeful creatures, the study of incentive structures is central to the study of much economic activity – both in terms of individual decision making and in terms of organisational behaviour.

The current system is primarily focussed on financial value and this is reinforced through the ways in which results and behaviour are currently rewarded.

Understanding incentive structures is therefore potentially a key to the behavioural changes which will be essential if we are to ‘reboot’ the capitalist model in a way that will enable it to service the needs and expectations of society in this century.

Yet financial reward is only part of the picture. An incentive is any factor (financial or non-financial) that motivates a particular course of action, or counts as a reason for preferring one choice to the alternatives. It is a stimulus, positive or negative, that encourages people to behave in a certain way.

Our examination of incentives has covered both financial and non-financial incentives, of which there are four main types:

- financial
- moral – the drive to do what is ‘right’
- personal – the satisfaction of individual needs such as status, achievement, self-esteem etc.
- response to an outside force such as regulation, public opinion, peer pressure etc.

These categories are not mutually exclusive; one and the same situation may, in its different aspects, carry incentives that come under any or all of these categories. In modern society, for example, economic prosperity and status in the community are often closely intertwined. Similarly, a financial incentive such as a bonus intended to encourage an employee to stay with his company may be reinforced by the feeling of doing the right thing i.e. staying loyal.

Neither do individuals exist in a vacuum – they are subject to the influence of others’ beliefs, motivations and actions driven by their own incentives. Much of traditional economic theory is based on the concept of rational expectations – the idea that people make choices based on their rational outlook, available information and past experiences. In fact they often do the very opposite.¹⁰

Financial incentives do not operate in isolation – neither are they the only incentives for those in the system. Reputation, personal success and security, organisational values and culture, regulation, fiscal policy such as carbon pricing and reporting models, all play their part.

Effective incentive structures are therefore not easy to design and those offering incentives are often unable to predict all of the ways that people will respond to them.

Imperfect knowledge can often lead to unintended consequences or, indeed, to ‘perverse incentives’. For example, with the use of simple stock option schemes, CEOs can either profit from soaring stock prices by making sound decisions and reaping the rewards of a long-term price increase, or alternatively reap profits from short-term share value increases while leaving a company facing long-term decline due to lack of investment or loss of trust on the part of customers.

In the capital markets, a primary objective of incentives should be to align the goals of different participants with the ultimate beneficiary. For example, between the management of a company and its shareholders in an attempt to overcome the agency problem, or between asset owners and asset managers to ensure that investment outcomes meet the needs of the beneficiaries. However, it is questionable as to what degree the needs of the beneficiary are prioritised and whether there is alignment in the outcomes being sought across the investment chain serving that beneficiary.

(Appendix two provides an overview of the research methodology).

Perspectives

“Investors are able to take a long-term view, as long as their incentives are properly aligned. However they still need to be aware of the near-term realities of the market. It is possible to balance both short and long-term successfully so long as you have a clear understanding of what your mission is.”

“I think there has been quite a lot of knee-jerk – we’ll do this and things will be different – without understanding the underlying causes and the interconnectedness of the whole economy – let alone capital markets and the role they play.”

“Fundamentally, you come back to what drives people’s behaviour at work and that is that you do what your boss wants you to do. You do what makes your boss happy, the things that are in your KPIs and your annual appraisal, the things that are used to measure your performance. There are financial rewards associated with that but there are also non-financial rewards – like respect from other people and thinking that you are actually good at your job.”

“For me the current structure of long-term incentives is broken and this is one thing that needs to change. Shareholders do not feel that they have the right performance measures, and this is why we have the focus on rewards for failure. There is a misalignment in the eye of the beholder. If we are looking at plcs then there is too much of an emphasis on the potential value contained in the LTIP which executives in general (although not everybody) are disillusioned with. They feel these fail as an incentive and are not even a retention tool as they don’t put any value on them. Then on the other side of the street you have a group of investors debating what they feel to be an appropriate performance measure and coming back in 18 months feeling hoodwinked because it was too soft or was inappropriate. I think that we as UK plc and shareholders in particular are spending an awful lot of time and effort trying to refine something when actually it would be much better just to start again.”

“As I think about the system that you’re investigating and its incentives... my advice would just be to be cautious. You do need some good incentives in a system but I think that we’re increasingly reaching a stage where we need to move to thinking about whether over-contracting on things is actually having some knock-on effects elsewhere. I think the issue is how do we move to simple trust based trustworthy systems?”

“I think the invisible hand will be busy over the next few years, as people get more long-term and as profit margins come under pressure. I think profit margins are going to go down in the next 5-10 years, as the credit boom goes through, and people will be less tolerant of these abnormally large pay packages.”

“Not everybody wants to make the most money and feels that is the definition of success. It turns out that compensation for most people is 4, 5, or 6 on the list of what is most important. Nobody wants to be taken advantage of, and people want to live well. You can define what well is, but people want to be able to feed their family, and you have to take that into consideration, but you certainly can create cultures and broader incentive structures that reflect different orientations.”

“When it comes to setting incentives, if the incentives were measured by reference to the right thing, then I don’t think incentives would be a problem. The problem is that they are set with reference to the wrong thing, and so encourage the wrong behaviours.”

“There is a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals.”

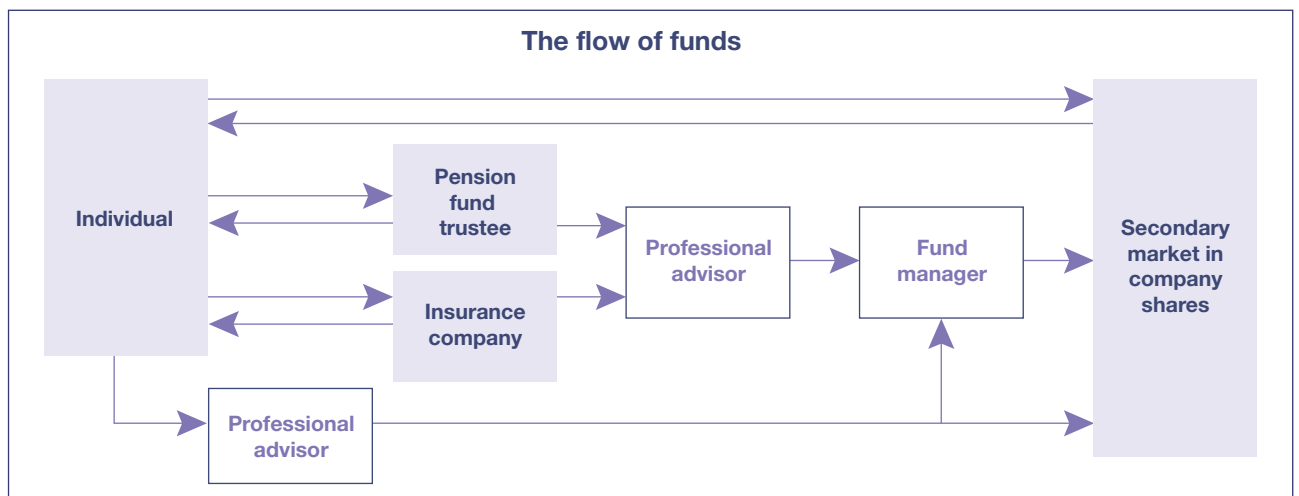
Part 2: Mapping the system

This part of the report highlights some of the main interdependencies and interactions that exist as a result of the structure of current incentives and examines the degree to which participants in the system take into account sustainability.

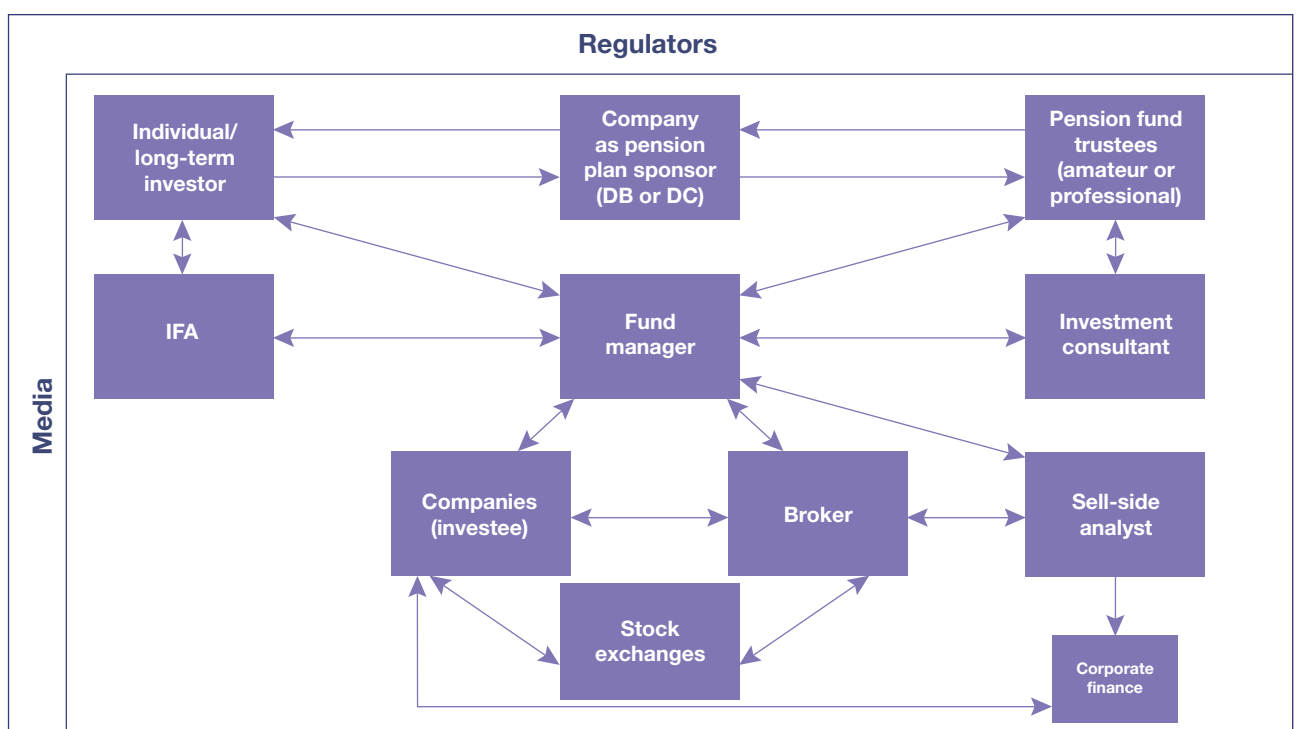
Much of the research has been at a granular level and has been excluded from this report for the sake of brevity. However, for those readers who are interested in the underpinning detail, this is provided in supporting documents that are available at www.tomorrowcapitalmarkets.com.

Incentives: interactions and interdependencies

Most readers will be familiar with the investment chain that connects the individual saver through to the stock markets in which these savings are invested – a typical visual representation of this is shown below.



However, when it comes to considering the impact and interaction of incentives across the system, more participants are involved and the map becomes more complex due to the level of intermediation that exists. The diagram below shows some of the main interactions and interdependencies that arise through the impact of their incentives and the knock-on effect onto others in the system. The arrows represent the direction of these impacts.



Interactions and interdependencies

The pension scheme member and the company as pension plan sponsor

- In the past the incentive for a company to offer its employees a defined benefit pension fund with contributions from both employer and employees was straightforward. A sound, generous pension scheme, it was widely assumed, would aid in the recruitment and retention of employees.
- Many pension fund sponsors have found themselves facing substantial funding deficits. This has led to the creation of a strong incentive for many companies to either close their defined benefit schemes (or at least close them to new members), shift the risk from company to employee through setting up defined contribution schemes, or share the risk with the pension fund members through some form of hybrid pension fund.

The company as plan sponsor and pension fund trustees (PFTs)

- The pension plan must have an interest in ensuring that the company's financial policy and investment behaviour does not jeopardise the pension promise through paying out excessive dividends and taking too much risk.
- The sponsoring company has an interest in controlling the risks transferred back to it through the pension plan's own investment policy and therefore place pressure on trustees to ensure they are monitoring the fund closely to eliminate fund deficits and keep contributions to the minimum.
- PFTs who are also directors or senior managers of the sponsoring company experience a conflict of interest between the financial health of the company and the funding level of a defined benefit scheme. In many cases this conflict has been eliminated, as far as future service is concerned, by closing the scheme. But it is still a real issue in the case of past service, particularly when there is a significant funding shortfall, given that trustees have the power to call for the winding up of the scheme, with the potential consequence that the employer is forced into liquidation.

Pension fund trustees and investment consultants

- Pension fund trustees are rarely investment experts. They are therefore heavily reliant on the advice of investment consultants and, in the UK; they have a legal requirement to take such advice although they do not have to act on it. The prevailing interpretation of their fiduciary duties has become a 'lemming standard' as the duty to 'invest prudently' is set by reference to the behaviour of other investors.¹¹ Many trustees fear that departure from these norms – however well-justified – could leave them exposed to legal liability.
- Investment consultants tend to charge a fixed hourly rate and therefore have an incentive to be active in order to maximise their income. They therefore offer an increasingly wide range of services that they encourage trustees to use.
- Pension fund trustees will monitor the performance of their investment consultants according to a number of criteria. These criteria are not generally related to the fund's performance. It can be argued that this is necessary as investment consultants are not the investment decision-makers, but it does create a misalignment of interests.

Investment consultants and fund managers

- Investment consultants have differing views on the key aspect of their role which adds most value for their pension fund clients. Some believe it is through advice on asset allocation while others believe it is through the fund manager selection process.
- Investment consultants advise on the selection of the appropriate benchmark against which the fund manager's performance is measured. They will also monitor performance and report back to pension fund trustees. These services form a central part of the value added by investment consultants.
- However there is the opportunity to generate substantial income through the fund manager selection process investment, so consultants may be incentivised to encourage fund manager turnover. However, clearly this should be balanced against the need to retain the client's business by not generating unnecessary expense.

Pension fund trustees and fund managers

- Where pension funds outsource investment management responsibilities to an external fund manager the fund manager's remuneration is often tied to the size of funds under management. This incentivises fund managers to increase the size of the fund. This creates a challenge for active fund managers because the larger the fund the harder it is to create a portfolio that is significantly different from the index. Fund management fees vary according to the nature of the fund manager. Fees for segregated funds are higher than for pooled funds. Passive fund management fees are substantially lower than active fund

management fees. There is a constant pressure for active fund managers to outperform the index to justify these higher charges. Evidence has shown that it is increasingly difficult to beat the index.

- The close and frequent monitoring of fund management performance by PFTs can also result in fund managers feeling pressured to maintain high levels of short-term performance relative to the benchmark to retain funds.
- Financial incentives are not the only incentives. Active fund managers will also wish to show good performance over the longer term, as this then allows them to build their personal reputation enabling them to move to a more lucrative role or set up their own funds in due course. Also, a PwC survey, conducted in 2011, found that culture and compensation were weighted equally as key areas of focus for the attraction and retention of talent and recommended that asset management firms continue to resist pressures to increase base salary and instead look to major on their culture as another way of retaining key staff.¹²

Sell-side analysts, brokers and fund managers

- Sell-side analysts' remuneration is largely tied to how the market rates the quality of research and advice provided. This often translates into an annual rating based on fund manager votes. Accordingly, for the highly ranked analysts one could argue there is a high alignment of interests.
- Brokers' remuneration is directly tied to trading volumes. As a result they have a powerful incentive to encourage market activity although this needs to be balanced against the desire not to acquire a reputation for driving churn.

Sell-side analysts, brokers and investee companies

- Sell-side analysts need to have good access to senior management within the companies they are covering to provide the kind of insight valued by the buy-side. This allows them to attain 'all-star' rankings, which has been found to drive higher levels of overall remuneration.
- Full service brokers benefit from association with high quality analysts in terms of reputation and hence business generation.

Corporate financiers and sell-side analysts

- As highlighted by the SEC in the US, analysts who work within the umbrella of a larger investment bank may have a potential conflict of interest around IPOs and new rights issues, however the existence of such a relationship should not be taken to automatically mean an analysts research is biased. There are strict codes of conduct, but research has shown that analysts may still feel under pressure to produce positive reports on the client company.¹³

Corporate financiers and investee companies

- Corporate financiers' incentives are weighted towards deal completion. This can lead to a misalignment of interests as investment bankers' motivation to complete a deal may ignore what is in the longer-term interests of the company and its shareholders.
- Senior management incentives may be tied to growth. In lieu of a long-term strategy pursuing organic growth some will instead favour growth through M&A activity as this offers the opportunity for greater near-term rewards.

Fund managers, stock exchanges and investee companies

- Nearly half of all exchanges are companies listed on their own exchange and are therefore subject to shareholder pressure to maximise returns. The largest sources of revenue for demutualised, for-profit stock exchanges are reliant on market activity. This results in an incentive for exchanges to create inducements for trading activity.
- Exchanges need companies to list on their exchange in order to generate activity. This creates an incentive for them to keep listing rules as simple as possible avoiding onerous conditions and associated costs. At the same time, exchanges need investors to have confidence in the companies listing on their exchange in order to encourage trading. This creates an incentive for them to put in place listing rules that ensure robust corporate governance. These two incentives are somewhat contradictory but in others mutually reinforcing, stock exchanges must strike a balance between the two.

Impact of the media

- The primary goal of the (financial) media is to increase revenue by reputation and size of readership. They do so by generating news and analysis that will maximise their audience, enhance their reputation and, accordingly increase their advertising revenues.
- There are large differences in the quality of news and information from financial media. At best they help provide useful information for investors, especially the retail investor. At worst they add to the noise which can obscure important information about fundamental company performance.

What does this all mean for companies?

The focus of this research is on what changes to incentives are needed to ensure the capital markets are better structured to incentivise sustainable business behaviour.

The impact of these interactions on companies is:

- Where fund managers feel under pressure to maximise their own performance against the benchmark they may pass this pressure on to investee companies through the tenor of their meetings, their questioning and research and their voting behaviours.
- Depending on the type of and relationship with institutional investors, they may feel pressure to alter their strategic decisions to focus on short-term financial returns.
- Although there are moves towards long-term incentive plans, the underpinning performance measures on which much CEO remuneration is based encourage a focus on short-term financial returns and on share prices. Growth through acquisition may be chosen over organic growth, often leading to the destruction of value in the long term.
- Since the incentives of some participants in the system are linked to trading, volatility in share price can occur that is not based on the underlying health and fundamental performance of the business.
- The financial crisis and market volatility have made providing guidance to the market difficult. Some companies, such as Unilever and GlaxoSmithKline, have decided not to provide short-term earnings guidance, others have ceased giving annual guidance, but continue to provide quarterly guidance. But these companies are in the minority.¹⁴
- The growth of social media and financial news aggregators means that the influence of independent financial media is also now playing a key role in shaping attitudes towards publicly traded companies, both large and small. Some of this can be beneficial in terms of providing signals to the market but in other cases can create unnecessary noise and share price fluctuations.

The focus on sustainability

Our research has also looked at the degree to which sustainability is embedded in the day-to-day activities of those in the investment chain.

As already mentioned we have taken a broader and deeper view of sustainability. However, it is important to note that in undertaking this research, most of the available information and data is couched in terms of ESG or SRI or RI, which is a finding in and of itself.

There is an emerging and important patchwork of initiatives and change and there are those in the system who are leading the way forward. But despite this progress, there remains room for improvement. Barriers such as lack of client demand, resources and awareness of evidence regarding the positive effect on performance of taking sustainability factors into account still exist:

- Lack of awareness coupled with the lack of evidence regarding performance means that for most retail investors the only incentive to invest in SRI and related funds is that of a moral sense – that it is the ‘right’ thing to do.
- Pension fund trustees have doubts and are confused as to whether, as part of their fiduciary duty, they can or should take sustainability factors into account when overseeing the implementation of investment policy and/or selecting fund managers. Scheme members are however becoming more vocal in their views regarding sustainability issues so trustees need to be aware of the process they have in place for managing this. Also, if a company pension fund is not taking account of environmental and social issues to the same extent of the employer, they run the risk of causing reputational damage to the plan sponsor.
- The degree to which investment consultants take into account factors relating to the long-term sustainability of companies is dependent on:
 - the degree to which pension fund trustees wish to take them into account, and
 - the cost of maintaining dedicated research teams and the lack of good long-term comparable data.
- Asset owners will often look to their representatives (such as investment consultants) to drive the integration of long-term sustainability factors into investment practices.
- Fund managers will often wait for direct instruction from asset owners before modifying their approach, although signatories to the Principles for Responsible Investment (PRI) commit to taking a more proactive approach by considering ESG issues as they regard this to be part of fulfilling their fiduciary (or equivalent) duty.
- Index fund managers as holders of substantial blocks of shares can bring their influence to bear on company boards in the interests of sustainability. However, the relatively low management fees may make this kind of research and engagement unaffordable.
- Many mainstream investors routinely factor in a broad range of non-financial metrics into their analysis. However, whether because of a lack of credible data, or lack of insight into the value-relevance of that data, indicators of the long-term sustainability of performance can often be missed.
- Broker recommendations will continue to remain largely coloured by client demands, but there is some evidence that demand is shifting towards the inclusion of more information on sustainability factors.¹⁶ However, giving an adverse comment on such factors, such as the quality of the governance, risks damaging their relationship with companies and their future ability to get the information they need as the company may look to another broker.
- Stock exchanges are not leveraging all the avenues through which they can influence the flow of capital towards sustainable business behaviours such as:
 - providing sustainability guidance for listing companies; and/or
 - mandating non-financial reporting.
- Analysts continue to be heavily reliant on fund managers and corporates expressing the value they attribute to mainstream investment research which fully integrates sustainability analysis.

Perspectives

“Trustees often will voice their concerns about sustainability issues, but don’t know what to do about it in practice. For a single trustee in a quarterly meeting, that’s bogged down by equities not performing generally and huge deficit type discussions, expressing a voice about a desire to be more ethically sensitive is not likely to be a top item on the agenda, or to get a lot of time.”

“In the UK, unfortunately, the culture is that trustees defer to the consultant and you have to be a very brave trustee to go anywhere else. That means that you’ve got a handful of very, very powerful [investment consultant] institutions. I think that’s the nexus of power, control and oversight if their approach to sustainability could be changed then trustees would respond.”

“Let’s take a giant asset management organisation that becomes a signatory of PRI. If they haven’t imposed mandatory training of every one of their PMs and analysts to understand the ESG analysis they really shouldn’t have signed up to PRI or they should be kicked out.”

“Time-horizons are so important. Things that matter in terms of sustainability are going to be playing out over 3-5 years or more – they will not be paying out over a single quarter... This is because what makes a share price go up and down on a daily basis are not the fundamental drivers. If you are holding a company for 1-3 years, on average, then you start looking at these [non-financial] issues as they will have an impact.”

“The active manager’s job is, in comparatively short periods of time and with comparatively short measures, to beat whatever benchmark that they’ve been given. Their job is not to meet your interests as the person who originally sent the money – not even to meet it in financial terms, let alone in the broader social and ethical terms.”

A momentum for change

Aviva Investors report that 89% of new business ‘requests for proposals’ and ‘requests for information’ asked about ESG issues between Q1 2008 to Q3 2010.

In the US, Sustainable and Responsible Investing as defined by USSIF, has grown significantly over the period 1995 to 2010 and now represents nearly one in eight dollars under professional management (12.2% of the US\$25.2 trillion total assets under management) as tracked by Thomson Reuters. Average support for environmental and social shareholder resolutions topped 20% for the first time in 2011.¹⁶

There are a number of organisations promoting responsible institutional investment such as the Equator Principles, and the UN-backed Principles of Responsible Investment which now has over 1,000 signatories representing more than US\$30 trillion of assets under management. Both of these sets of principles express responsible investing through a combination of environmental, social and governance (ESG) issues and active ownership of investee companies.

In the UK, the Stewardship Code aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities.

One step towards recognising the value of sustainability is the recent work of Robert G. Eccles (Harvard Business School, HBS), Ioannis Ioannou (London Business School) and George Serafeim (HBS).

Using a matched sample of 180 companies, they found that corporations that voluntarily adopted environmental and social policies by 1993 – termed as ‘High Sustainability companies’ – exhibit fundamentally different characteristics from a matched sample of firms that adopted almost none of these policies – termed as ‘Low Sustainability companies’. In particular, they found that the boards of directors of these companies are more likely to be responsible for sustainability and top executive incentives are more likely to be a function of sustainability metrics. Moreover, they are more likely to have organised procedures for stakeholder engagement, to be more long-term orientated, and to exhibit more measurement and disclosure of non-financial information.

The study provides evidence that ‘High Sustainability companies’ significantly outperform their counterparts over the long term, both in terms of stock market and accounting performance. The outperformance is stronger in sectors where the customers are individual consumers, companies compete on the basis of brands and reputation, and in sectors where companies’ products significantly depend upon extracting large amounts of natural resources.¹⁷

Part 3: Challenges

The complexity of incentives across the equity element of the capital markets system is a reflection of how complex the system has become.

The following areas represent the primary challenges and imbalances to be addressed to achieve a system that is better able to promote sustainable outcomes.

Pay AND performance

As we write this report, remuneration is under the spotlight. And most of the focus is on top-level executive remuneration. However, the levels of reward that can be earned by many other participants in the system are also relatively high. This has the effect of:

- locking people into lifestyles dependent on high earnings, which adds to the fear of losing one's job, further reinforces 'herd' behaviour and can lead to inappropriate risk taking and/or a focus on short-term financial returns in order to maintain reward levels
- exacerbating a short-term view amongst some participants as they can earn enough within a relatively short time to enable them to leave and even retire
- creating a ratchet effect within the system as organisations fight for the recruitment and retention of talent.

But the issue is not just the quantum of reward but whether it is sufficiently justified, and can be seen to be justified, by performance.

In terms of this research, the relevant question is to what extent are the underpinning performance objectives and benchmarks against which performance is assessed fit for purpose in terms of a system that promotes sustainable outcomes?

There are some moves towards ensuring that remuneration packages have a longer-term horizon e.g. three to five years but are these timescales appropriate? Is quarterly benchmarking of fund management performance appropriate against the investment time horizon of pension funds and other asset owners?

Communication gaps

There is a body of research that indicates that CEOs consider sustainability to be an important factor for future business success.¹⁸ Leading economist, Michael Porter, is arguing that companies need to widen the perspective about how to create value and profit and look towards shared value rather than shareholder value – shared value being about creating economic value by creating social value.¹⁹ And there is an increasing emphasis on sustainability factors in assessing company performance.

But in our discussions, there is a lack of common understanding as to what is meant by the term 'sustainability.' Discussions about sustainability often default to ESG, RI, SRI, the 'green agenda' or are simplified to discussions about long-term versus the short-term horizons.

Whilst many across the system may share the same concerns and objectives – the prevalent culture of the organisations in which they work results in a communication gap when in discussion with others.

CEOs who are concerned about the sustainability of their companies, talk in terms of all the material factors that drive the long-term success of the company, taking into account both the opportunities and risks and the wider impacts of the company. They will often say that they feel the investment community is only concerned with the 'last quarter's' financial results and are rarely interested in the long-term strategy of the company.

However, many of those in the investment community are concerned to ensure that they have as much information as possible about the issues that are material to a company's success. Some fund managers will devote significant time and/or resource to ensuring that they build a deep understanding of what drives the long-term success of the company and the associated risks.

So why the apparent disconnect? One reason given is the level of 'noise' that can interfere with the more thoughtful conversations that companies and investors can have and do have. This 'noise' is often worse at the time of earnings reports and is being generated by a small part of the investment community, exacerbated by the media. This drowns out the more productive conversations between investors and companies and the deeper analysis being undertaken.

The problem is that the noise often becomes the real conversation creating a communication gap which is unhelpful in building the relationships needed to enable a company to pursue a more sustainable business strategy. At worst, the noise can create movement in the company's share price and trading divorced from the fundamental value of the company.

Lack of knowledge and metrics

The current lack of good information and robust and comparable metrics is cited as hampering the incorporation and assessment of sustainability factors into investment decisions.

It is extremely difficult for any within the investment chain to demonstrate the value of non-financial information without widespread reporting on these areas by companies, in accordance with a consistent framework and standards. Much of the understanding tends to exist in specialist silos (governance/SRI specialist teams and academic papers) and the segregation of expertise further exacerbates the overall lack of awareness across the system.

The need for education and awareness extends to the whole of the value chain but is particularly important for end investors, whether pensions trustees, other institutional investors or individual investors:

- pensions trustees, although open to incorporating sustainability factors into mandates, are still primarily concerned that any investments that take such factors into account may impact negatively on financial returns. This is due to a narrow interpretation of their fiduciary duty
- individuals on the whole will be guided by financial advisors and the availability of products which take sustainability into account. To date there are few products that go beyond 'screening out' particular sectors, although this is a useful start, and few advisors who have the knowledge and understanding should an individual have a more sophisticated understanding and want a more tailored approach at an acceptable cost.

Personal security and success

Being entrusted with the life savings of people is an important and daunting endeavour. The same can be said about looking after one's own livelihood and welfare. And the two become inextricably linked through the equity system. It is therefore unsurprising that fear is a strong incentive and driver of behaviour across the system:

- pension fund trustees fear letting down the beneficiaries of the pension plan, they fear litigation due to failing in their fiduciary duty
- fund managers fear losing their reputation for consistent performance and therefore losing funds under management on which their remuneration is based and even their jobs and future employment opportunities
- analysts fear losing their reputation and therefore their job
- directors of research fear losing their jobs if they vocalise their concerns or wish to act contrary to the accepted 'norm'
- CEOs are fearful of the market's response to the company's short-term performance and the impact on their tenure.

All participants fear the possible impact of stepping outside the current rules, frameworks and established 'norms' or doing something that has adverse economic consequences.

Creating sustainable outcomes is still not the widely accepted view. It takes new approaches, ways of thinking and decisions. Fear reinforces a 'herd' mentality, that is arguably too self-centred and comfortable with the status quo which together act as a strong barrier to learning and change.

Regulation

Finally, it would be incomplete to ignore the behavioural incentives which flow from the vast swathes of regulation which pervades most aspects of the equity value chain.

The importance of regulatory compliance can be measured by the size of compliance teams in all institutions and the enormous budgets that are now committed to this important business area. While most regulation was conceived to deal with a particular issue and was no doubt well intentioned in its aims, its growing size and prominence has arguably highlighted two critical issues and mistakes that have been made in the past. First, one cannot use regulation as a surrogate for trust and secondly that if one ignores the behavioural response in designing regulation you are likely to be disappointed by the outcomes.

In this study we have seen numerous unintended consequences flowing from well-intentioned regulatory interventions of the past, from the impact of the introduction of investment advisors, to the frequency and nature of processes to assess investment performance, right through to the current agenda around remuneration structures and the needs for deferral and claw back arrangements.

Part 4: Towards a new system

Summary

The equity market is a complex, interlocking and self-sustaining system which has become structured for its own benefit and divorced from the expectations of the relationship between business and society in the 21st century.

The current system:

- measures value as financial profit only and ignores significant unpriced externalities
- lacks good information and robust and comparable metrics relating to all the drivers of sustainable performance
- has an overly complex and extended supply chain with increasing complexity of products and services
- has become increasingly remote from the interests, needs and expectations of the primary beneficiary
- has seen a dramatic growth of propriety and speculative trading
- suffers from the complexity and unintended consequences of regulatory change.

Incentive structures are central to the behaviours and orientation of the key players in the equity market

- Incentives across the whole system are significantly influenced by:
 - financial performance
 - market indices and benchmarks
 - regulatory compliance.
- Incentives at the level of an individual institution are influenced by:
 - the above, and
 - market share, size of funds under management
 - client retention
 - corporate reputation, culture and values.
- Individual incentives are influenced by:
 - all the above, and
 - personal security, success and reputation
 - financial reward both absolute and comparative
 - maintaining personal relationships and access across the system.

The main implications of these incentives for the behaviours of those in the equity value chain are:

- a lack of alignment in objectives across the value chain
- growing self-interest
- communication gaps
- high levels of remuneration which are insufficiently linked to long-term sustainable performance
- a culture of fear.

An invitation: shaping tomorrow's capital markets today

In this work we start to identify the complexity of the system and some of the fundamental challenges arising from the way in which current incentives are structured.

We are encouraged to have found out that so many in capital markets already recognise the need for reform – and that effective reform requires new incentives, hard and soft, including but not limited to remuneration.

We may debate the detail of exactly how the system works but the key challenge is to ensure that tomorrow's capital markets will support and finance the creation by business of long-term sustainable value.

We believe that tomorrow's capital markets must identify and secure the present value of the transformative innovation required to enable nine billion people to live on our one world. This is essential for a future for people, planet and profit which harnesses the full innovative capabilities of businesses to achieve wellbeing, equity and sustainability.

We are confident that the system has reached a pivotal point in its evolution and the time is now right for change. We are clear that such a programme of change must be both systemic and collaborative in nature and focussed on encouraging new behaviours – piecemeal change will lead to unintended consequences, change which is not driven by the conviction and interest of key participants will not endure. Above all, we are clear that change must be created and owned by those in the system and those who are responsible for the system. And given the complexity and detail of all that is involved interventions need to be carefully judged, need deep and practical knowledge and experience and must combine principle and practicality.

In so doing we believe it is essential to create an informed dialogue between those within the system and with regulators and policymakers.

We are therefore delighted to launch this first programme report at this meeting of PRI and invite you to join with us as we enter this further phase of the programme we are undertaking. We invite you to work with us to further develop the 'agenda for change' we outline – and to set out the practical steps required to create a clear, robust and credible programme for enduring and successful reform.

We plan a major event in the autumn to engage all players in the system hosted by UNEP FI – with webinar and other activities to ensure engagement worldwide.

We will then follow this up with a programme of dialogues looking in detail at how incentives are working in practice and how they might work in the future, focussing on particular parts of the system as well as the system as a whole, hosted in major financial centres across the world, culminating in a major presentation of our findings and proposals.

To achieve this we need your involvement, engagement and support – joining with our project partners to whom we are immensely grateful. **Please get in touch with me tony@tomorrowcompany.com to discuss how you can help shape Tomorrow's Capital Markets.**



Chief executive, Tomorrow's Company

Appendix 1

Summary of codes, guidelines and reviews relating to remuneration

‘The Kay Review of UK Equity Markets and Long-Term Decision Making’, is examining how well equity markets are achieving their core purposes: to enhance the performance of UK companies by facilitating investment and enabling effective governance and decision making in support of long-term profitability and growth; and to enable investors to benefit from this corporate activity in the form of returns from equity investment. It is considering to what extent equity market participants are excessively focussed on short-term outcomes to the detriment of these core purposes, and if so, what actions might be taken to address this. It is examining the incentives, motivations and timescales of all participants in the equity markets – from individual investors, through pension funds, advisers, fund managers, and the markets, to company boards – and the relationships between them.²⁰

‘Principles of Executive Remuneration’ issued by The Association of British Insurers (ABI) issued September 2011. These contain guidance on its members’ views on the role of shareholders and directors in relation to remuneration and the manner in which remuneration should be determined and structured.²¹

‘Remuneration Code’ issued by The Financial Service Authority. This covers all banks, building societies and Capital Adequacy Directive investment firms in response to their findings that inappropriate remuneration policies were a contributory factor behind the market crisis. The original Code came into force for the largest firms at the beginning of 2010. It was revised and its scope extended on 1 January 2011 following new European legislation – the updated Capital Requirements Directive (CRD3).²²

The ‘Guidelines on Remuneration Policies and Practices’ issued by The Committee of European Banking Supervisors (CEBS) on December 2010, sought to develop risk-based remuneration policies and practices, aligned with the long-term interests of the institution and avoiding short-term incentives that could lead to excessive risk-taking. However whilst some progress has been made, recent research from the European Banking Authority has revealed large disparities in bonus sizes across the region and in enforcing the existing EU pay rules, which limit the upfront cash portion of a bonus to 25% of the total. The survey found that the median average ratio of bonus to salary across the block was 122% for executives and 139% for other risk-takers, such as traders. One country however reported an average ratio of 313% for traders – and one institution had a ratio of 429% for executives and 940 per cent for other staff.²³

In the US, The Federal Deposit Insurance Corporation’s board unanimously approved a draft rule, written jointly with six other regulators, that would require large financial firms to hold on to at least half of top executives’ bonuses for three years or longer. This is still pending at the time of this report.²⁴ The remuneration for the chief executive officers of the three companies rescued by taxpayers has been frozen by the government at 2011 levels.

Integrating ESG issues into executive pay: The UN-backed Principles for Responsible Investment initiative and Global Compact LEAD have facilitated dialogue between institutional investors and companies to identify the rationale and effectiveness of integrating Environmental, Social and Governance factors into executive pay. The resulting guidance document aspires to reflect a common understanding of major opportunities and challenges, as well as provide practical examples of emerging practices. The main objective of the document is to provide a tangible engagement tool to guide dialogue between shareholders and investee companies on this topic, and help improve corporate boards’ practices to the benefit of both companies and their investors.

Appendix 2

Overview of the research

The research has been developed through two distinct and complimentary phases:

- extensive desk-based research including a literature review
- followed by number of one-to-one interviews with system participants.

This has been followed by a review of our findings by a number of participants and experts.

In total we have consulted 38 individuals from 30 organisations across three geographical regions.

Appendix 3

Examples of those leading change

Generation Investment Management

Generation is an independent, private, owner-managed partnership with offices in London and New York. The firm was co-founded in 2004 by Al Gore and David Blood. Generation's vision is to mainstream sustainability in financial markets. The organisation strives to achieve this goal by proving the economic case for sustainability through its investment business and advocating for change through the Generation Foundation. Generation uses both platforms to highlight the fact that a more sustainable form of capitalism does not represent a trade-off with profit maximization but instead actually fosters superior long-term value creation. Examples of how the firm's commitment to sustainability manifests within the company include:

- **Investing for the Long Term:** Generation is committed to an investment philosophy that integrates sustainability research with rigorous fundamental financial analysis. The firm believes this holistic approach to the asset valuation process is the best method of long-term investing to protect and grow the interests of its clients.
- **An Enduring Business Model:** They are committed to an independent employee owned partnership. Furthermore, the incentive structures at Generation reflect the firm's commitment to long-term value creation and are aligned with the interests of its clients.
- **Advocacy & Citizenship:** 5% of the profitability of the firm is allocated to the Generation Foundation, which is dedicated to strengthening the field of Sustainable Capitalism. Generation employees also recognize their responsibility to live in accordance with their values, to be responsible to the communities in which they live and work, and to the world community as well.

"Generation is a partnership. Our compensation structures with our clients are all long-term-oriented, and we drive the bulk of our real profits off performance fees. In the case of Global Equities it is a three-year rolling performance fee. In the case of the Climate Solutions fund and soon to be the Credit fund they are longer-term performance fees. Private equity performance fees can be five years or longer and Credit will be the same. You have to return the clients' capital before you get performance, and therefore it is five years or longer.

Because we are driven by long-term investment performance, and we are a partnership, we are aligned with our clients, and we are focused on the long-term economic results of our strategies and our investing. We are very transparent. When we review our colleagues, we review them on their three-year investment performance as well as their one-year investment performance. When you are long-term, it doesn't mean you are not noticing what is happening in the short-term. You try to skew it to the long-term, and that is how we have organised our incentive structure and compensation structures."

David Blood, senior partner, Generation Investment Management

Aviva Investors

Remuneration is set by the Aviva Investors Remuneration Committee, who state that they take full account of the company's strategic objectives in setting remuneration policy whilst being mindful of their duties to shareholders and other stakeholders.

Aviva Investors' remuneration framework is based on a total reward approach and is designed to reflect the success or failure against a range of targets. These targets are defined within a Business Balance Scorecard, which includes financial, people, client and investment performance and risk metrics. There are four components of pay:

- Basic Salary – set within an appropriate market range, which is sufficient to allow the possibility, where performance so warrants, that an employee may receive no variable pay
- Annual bonus – a short-term incentive plan where individuals have the opportunity to receive a bonus (which is subject to deferral) based on business and individual performance against targets
- Long Term Incentive Plan – a long-term profit sharing arrangement for key executives and value generators, with vesting being subject to a risk metric
- Benefits in Kind – standard benefits are provided that are appropriate to the market.

Aviva Investors recently established the Global Responsible Investment Team that is responsible for developing their Responsible Investment strategy and policy across all assets under management. This team reports directly to the Chief Executive and over time, ESG engagement and integration will apply across all their mainstream assets under management. Their CEO has committed to work to ensure that ESG will be integrated within all portfolios by all analysts and fund managers and that they will be rewarding for demonstrating engagement with these issues. As a first step, all the investment desk heads in Aviva Investors London and the Global Investment Services divisions now have 5% of their balanced score card assigned to ESG.

The Johannesburg Stock Exchange

At the Johannesburg Stock Exchange the Remuneration Committee sets executive compensation according to the following basic principles (within the overarching frame of creating sustainable value):

1. transparent and understandable
2. aligned with shareholder interests
3. competitive with market norms
4. congruent with strategic priorities
5. linked to corporate and individual performance.

At senior levels variable pay linked to performance constitutes a higher proportion of total compensation. For the JSE's former CEO, RM Loubser, annual variable remuneration accounted for 76% of his total compensation in 2010 compared to an average of 66% for the executive committee.²⁵ Compensation at the JSE also includes a long-term incentive scheme (LTIS) which comprises a full-value restricted share scheme intended to link reward to corporate out-performance over a 3-4 year time-horizon. The LTIS are calculated according to a number of metrics including TSR, return on equity, EBIT growth and other strategic metrics. The remuneration Committee report from 2011 states that when assessing performance at the 3 and 4 year vesting dates the HR committee should consider performance in the light of the JSE's overall strategic mandate – *“to build better financial markets in South Africa and will exercise discretion rather than ‘ticking the metric calculation box’”*²⁶.

UBS Q-Series® and UBS Global I/O® research reports

The UBS Q-Series® initiative is focused on continual questioning, leading a firm-wide drive for more thoughtful, proprietary, valuable research attacking structural industry specific issues. The objective is to focus and leverage the global resources of UBS to form a strong partnership with clients.²⁷ The UBS Global I/O® provides fundamental integrated global research highlighting simultaneous cross-regional and cross-sector investment ideas. It engages analysts in a collaborative effort to articulate clear investment calls (the output), highlighting proprietary/primary research, key data and precisely defined catalysts (the input).²⁸

Both the Q-Series and the Global I/O require a high level of collaboration among analysts, strategists, and research management. With regards to the Q-Series report Erika Karp, global head of sector research at UBS, stated *“You cannot as an analyst create a Q-Series report and publish it without collecting insight from across the world and collaborating. We do “peer assists” and we have global investment review committee meetings. So if you have done a Q-Series report, then we can check backwards to see that you were collaborating – and I can count the number of Q-Series reports an analyst has lead or contributed to. Similarly with the Global I/O multiple analysts will author the report considering multiple regional stock implications. Again you cannot publish a Global I/O without collaborating and I can count the number of Global I/Os that an analyst has done. It is part of the remit of our global analysts to do global I/Os and Q-Series – although we don’t set specific target numbers as this kind of work is driven by grass-roots client demand for it.”*

With regards to the way analysts performance is measured at UBS innovative metrics are used, which have been developed from traditional measures of success and productivity and move towards a new way of measuring the value added by analysts. *“You use the tools and the metrics you already have and you change them in a way that is economically rational to make the business case. We have to use the current existing metrics and measures of the system to find a way to look for progress and to look for outliers, both in terms of the good and the bad... We also have to have these “purpose-built” metrics to drive and measure collaboration.”*

Corporate Sustainability Reporting Coalition

A coalition of institutions led by Aviva Investors, has called on United Nations’ member states to develop a global policy framework that requires listed and large private companies to integrate sustainability information throughout their annual report and accounts – or explain why they are unable to do so.

They believe that an international policy framework should adhere to four key principles:

1. Transparency – Companies should be required to integrate material sustainability issues within their report and accounts – or to explain to the market why they cannot do this.
2. Accountability – There should be effective mechanisms for investors to hold companies to account on the quality of their disclosures, including for instance through an advisory vote at the AGM.
3. Responsibility – Board duties should explicitly include setting the company’s values and standards and ensuring that its obligations to its shareholders and other stakeholders are understood and met.
4. Incentives – Companies should state in remuneration reports whether the remuneration committee consider ESG factors which are of material relevance to the sustainability and long-term interests of the company when setting remuneration of executive directors; aligning remuneration with the interests of shareholders and other key stakeholders, including customers and employees.

They state that corporate boards should be required to consider the future sustainability of the firm that they govern. The sustainability strategy should include performance targets; recent trend data and some level of external assurance. It would be expected to consider factors such as: use of natural resources; levels of workforce training; impact on local communities; the business model and the regulatory context. Companies will also have the option of publishing the explanation as to why the board considers such a strategy to be unnecessary.

Companies should then present the Corporate Sustainability Strategy to a separate advisory vote at its annual general meeting. The main purpose of which would be to create the right kind of discussions within boardrooms, throughout the business and between the company and its shareholders – encouraging investors to think about the sustainability of the firm.

Importantly, this initiative is a market based mechanism that promotes enhanced self-regulation within the market. Individual nations would be free to choose whether to implement this in primary legislation, in their regional Company Law, or via the listing authorities.²⁹

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We wish to thank the following individuals...

David Blood	Stephanie Maier
Alan Brown	Dominic de Mariveles
Peter Cameron	Paul Mills
Damian Carnell	Peter Montagnon
Rafael Castro	Robin Munro-Davis
Michael Clarke	Liz Murrall
Paul Clements-Hunt	Sean O'Hare
Tim Currell	Gavin Oldham
Paul Emerton	Barry Parr
James Featherby	David Phillips
Margret Foran	Arthur Probert
Jane Fuller	Prof. Amin Rajan
Diane Glossman	Daniela Saltzman
Will Goodhart	Richard Saunders
Howard Jacobs	Anita Skipper
Maria Johannessen	Pauline Skypala
Jakob Hans Johansen	Alison Thomas
Adrian Laycock	Paul Whitney
Paul Lee	Gervais Williams
Kenneth Lever	Simon Wong
Jonathan Lipkin	Michael Woodmore
Par Lofving	Yuki Yasui

...and the following organisations:

Aon Hewitt	MAM Funds
Association of Member Nominated Trustees	Mineworkers Pension Scheme
Assured Guarantee Ltd	Parallel Private Equity
CFA Society of the UK	PREVI
Create Research	Prudential
The Financial Times	PwC
Fuller Analysis	Russell Investments
Generation Investment Management	Schroders
Governance For Owners	Towers Watson
Hermes Equity Share Ownership Services	UNEP Finance Initiative
Individual Investors Association	Universities Superannuation Scheme
Investment Management Association	Xchanging
Kromann Reumert	

Tomorrow's Company would also like to express sincere thanks to the following for their support and making this report possible:

Steve Waygood

Michael Buckley

David Pitt-Watson

Richard Emerton

Erika Karp

Jacinto Coello

Aviva Investors

Berwin Leighton Paisner

Hermes Fund Managers

Korn/Ferry International

UBS

The United Nations Environment Programme Finance Initiative (UNEP FI)

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*Source: Hermes, as at 31 March 2012

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Tomorrow's Company

Centre for Tomorrow's Company
Charity registration number 1055908.
Registered office: Samuel House
6 St Alban's Street, London SW1Y 4SQ.

Designed and produced by  studio401

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ISBN 978-0-9572949-0-5



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