FIT Remuneration Consultants

Christmas comes but once a year, but proxy guidelines come in threes

Introduction

Over the last week or so, each of the three main proxy firms (the Investment Association, ISS and Glass Lewis) has issued its annual guidance update.

As we have come to expect, they each largely replicate the previous guidance and include the usual responses to in-year areas of interest. Again, they each include a mix of genuine matters, where a significant body of investors now have strong expectations, and matters which in reality are somewhat more aspirational.

Investment Association

The IA's 'Principles' are drafted as a 'state of the nation' reflection of the views of its members and unashamedly point out where there is more than one view on a topic. This is particularly evident as regards restricted stock.

However, what is clear is that the Principles, and particularly the accompanying introductory letter, adopt a more aggressive tone than was previously the case, commenting that some remuneration committees are not striking an appropriate balance between the interests of management and those of shareholders and that many shareholders feel that some consultations have not reflected (or acted) properly on feedback.

Other points of interest include:

- **Malus and clawback**: companies should think more about the actual circumstances in which these may need to be invoked and how they can be enforced
- **Shareholding requirements**: there is a clear push to see post-cessation guidelines adopted 'at a minimum by the company's next policy vote'. This is already a key point of discussion at remuneration committees and, we feel, one better suited to a broader policy review. Interestingly, the Principles clarify that deferred bonuses may count towards share ownership guidelines on a net of tax basis (given that they are not subject to performance conditions beyond employment) which many companies will see as a relaxation
- **Pensions**: while a move to alignment of the contribution rate between new joiner executives and staff generally has been gathering pace in recent years, this calls for the rates to be similarly aligned for incumbents 'with no compensation awarded for this change' which may be perceived as somewhat aspirational
- **Restricted stock**: The IA states that a majority of their members are now willing to consider such an approach if an appropriate strategic rationale is put forward but that they will challenge this if there has been a recent history of no-payment (arguably it should be looking at future prospects rather than past experience). It also highlights some of their more detailed expectations and, interestingly, states the need for over-riding discretion but that its members are mixed on the need for a more formulaic underpin
- **Discretion**: picks up on the UK Corporate Governance Code which is looking for remuneration committees to have a broad discretion and to set out clearly any exercise of such discretion. While we expect to see most companies review their policies to ensure they have suitable flexibility in this regard, it is necessary to balance the incentive impact of providing management with clarity of their objectives. Accordingly, we consider it critical that such discretion is only employed exceptionally

ISS

This policy is more matter of fact, and while they reflect the views of its subscribers which they collect in advance of publication, ISS' approach is much less 'committee like' than IA's. Points of interest include:

- **Director elections**: in extraordinary circumstances, ISS will consider voting against a director's re-election for egregious actions related to the director's service on other boards. Glass Lewis also adopts this approach

- **Bonus for target performance**: following investor focus on high bonus pay-outs in recent years, ISS states that the target bonus should typically be no more than 50% of the maximum bonus opportunity and any payment above this level should be supported by a sufficiently robust explanation. While its voting recommendations will not be set mechanistically around this point, it will be considered alongside other factors such as overall quantum, historical pay/performance alignment and the remuneration committee's track record
- **LTIP vesting and holding periods**: reflecting the changes to the UK Corporate Governance Code and market practice, ISS has strengthened its wording to say that share awards <u>should</u> be subject to a total vesting and holding period of five years or more. This has become a clear expectation across the piste
- **Post-employment share ownership requirements**: ISS states that post-employment shareholding requirements are becoming increasingly common and that 'the Code states that the remuneration committee should develop a formal policy for post-employment shareholding requirements encompassing both unvested and vested shares'
- **Scaling back LTIP awards**: while many investors have had this expectation for a while, ISS now explicitly refers to consideration of reducing the size of the LTIP award at grant following a material decline in a company's share price. This has also been IA's stance for a number of years
- **Non-executive directors' fees**: ISS' policy has referred to any increases to NED fees being considered alongside increases to directors' salary increases and those for the workforce and the update now additionally goes on to state that the fee level should not be excessive relative to similarly-sized companies in the same sector. This perhaps indicates a greater focus on NED fee levels than has previously been the case (and is now occasionally mentioned as a point of concern in proxy reports—particularly where the company chairman is receiving a significant increase)
- **LTIP dilution limits**: the guidelines will be brought in line with the IA's long held stance by making reference to the 5% and 10% in 10 years' dilution limits covering discretionary and all schemes. We suggest that it may come as a surprise to many that they were not previously aligned

Glass Lewis

There are no significant changes to Glass Lewis' policy from a remuneration perspective.

However, it has updated its policy to include CEO pay ratios but states that this will not have a material impact on voting recommendations at this time.

Glass Lewis has also clarified that it assesses realised pay received by executives over at least three years when evaluating a link between pay and company performance.

FIT Comment

While there are few surprises, many of the changes above demonstrate a further hardening of attitudes towards executive pay and the difficult balance which remuneration committees need to strike. 2019 looks set to bring its own challenges!

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If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111.