The Investment Association's new principles of remuneration for 2019

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Introduction

On 22 November 2018, the Investment Association ("**IA**"), wrote to the chairmen of the remuneration committees of FTSE 350 companies attaching its updated Principles of Remuneration.

These changes to the IA guidelines have been made against the backdrop of the new remuneration provisions in the UK Corporate Governance Code and the changes to the reporting of directors' remuneration which is due to come into force for accounting periods beginning on or after 1 January 2019.

However, it appears that many of these principles are aimed at reducing the risk of "excessive" pay or increasing the justifiability of pay.

Main areas in respect of the principles of remuneration

The main policy areas for the new principles are as follows:

Levels of Remuneration

It was noted that levels of remuneration must reflect corporate performance and pay should be no more than necessary and linked to long term value creation.

The remuneration committee should seek points of reference against which appropriateness and quantum of pay is judged. Useful reference points are:

- prescribed policy that links remuneration to overall corporate performance
- the remuneration policy of the company as a whole
- fairly constructed peer universe
- remuneration paid to groups of employees including the median, upper and lower quartile through the use of pay ratios

Discretion

The IA observed that the discretion of the remuneration committee can assist in ensuring that executive pay schemes properly reflect overall corporate performance and value creation. It also observed that payment of variable remuneration to executive directors should be discouraged even if specific targets are met where the business suffers a negative effect and in such circumstances shareholders should be consulted.

The IA recommends that:

- the remuneration committee should be accountable for the way in which discretion is used and should have sufficient legal power to exercise discretion
- discretion should be used diligently, aligned with shareholders' interest
- discretion to be exercised within policy boundaries
- use of discretion should be clearly disclosed

Pay for Employees below Board Level

The IA recommended that:

- the remuneration committee should have a role in pay for senior management and review workforce remuneration especially where the levels of pay or the risks associated with the activities are material to the overall performance

- the remuneration committee should fully explain why the pay figures are appropriate where they are reported and disclose any action necessary to rectify issues

Shareholder Consultation

IA expressed its concern that shareholder consultation is being used as a validation of decisions taken by the remuneration committee rather than taking and understanding shareholders' views.

IA recommends that:

- consultation needs to focus on major strategic remuneration issues
- details of whole remuneration structure should be put forward so that the investors are provided with a full picture and sufficient information so that they can make an informed voting decision
- shareholders' feedback and response should be listened to by companies
- remuneration committee should understand the voting policies of the shareholders
- after the end of the consultation process and before finalising details in the remuneration report, the remuneration committee should review policies taking into account subsequent events occurring in between so that the proposal remain appropriate

Malus and clawback

The IA observed that the current standard trigger events (gross conduct or misstatement of results) for malus and clawback are rarely used in practice. Moreover, even if a trigger occurs, it is difficult to relate the same to an individual director. It therefore recommends a significant strengthening of these provisions.

The new principles recommend that:

- a "more substantial" list of specific circumstances should be established when malus and clawback could apply and they should also be disclosed to the shareholders
- the malus and clawback terms are set out clearly and accepted by the executive (executives should sign a form of acceptance at the time of the award)
- LTIP rules, allied documentation and communications materials are consistent in

relation to the scope and application of malus and clawback provisions

- remuneration committees should develop clear processes for assessing whether malus or clawback is triggered and how and when they will exercise a discretion to apply the such provision; the process and decision must be clearly documented

Shareholding requirement

The new principles include a recommendation that:

- executive directors and senior executives should build up a significant shareholding

- executives are encouraged to purchase shares out of their own resources to align their interests with the other shareholders

- remuneration committees should set out minimum shareholding levels and the time period in which to reach them for executives and also the consequences for non-compliance

- shares only count towards an executive's shareholding if vesting is not subject to any further performance conditions; unvested shares not subject to performance conditions can count on a net of tax basis; vested shares subject to a holding period or clawback count towards the shareholding requirement

- shareholding used in hedging arrangements or as collateral for loans should be fully disclosed

Post-employment shareholdings

The new principles include a recommendation that:

- companies should set up post-termination shareholding requirement for a period of at least two years and at a level equal to the lower of the company's shareholding requirement in force immediately before leaving or the executive's actual shareholding on leaving

- remuneration committee should determine the structure and processes (which might involve using an employee benefit trust or nominee arrangements) to ensure compliance with the post-employment shareholding requirement

- the post-termination shareholding requirement should be introduced for all new and existing executive directors as soon as possible and by the next remuneration policy vote at the latest.

Pensions

The new principles include a recommendation that:

- pension contribution rates for executives should be aligned with those available to the majority of the workforce
- new executive directors and directors whose roles are being changed should be appointed on the new pension contribution level
- contribution rates for existing directors should be reduced over time to comply with this requirement. Clearly this reduction cannot be made without the agreement of the director concerned

Restricted Share Awards

Restricted shares (in the UK) are awards of shares (or nil cost options) which vest to the relevant director based on time only and not according to main performance conditions. The new principles include detailed recommendation on the awards of restricted shares, including:

- restricted share awards may be appropriate depending on the sector and situations such as turnaround situations; they should be assessed on a case-by-case basis, considering the context and the strategic rationale
- remuneration committees should have the ability to exercise discretion on vesting outcomes to ensure there is an appropriate connection between pay and performance and non-payment on failure; some investors have expressed a preference for a quantitative underpinning condition to be achieved prior to vesting
- vesting periods for restricted share awards should be at least five years; in addition, the post-employment shareholding rules should also apply
- if there is a proposal to switch to restricted share awards, investors will consider the company's previous approach to remuneration, comparing the proposed award levels, performance and vesting criteria with previous award levels and performance conditions
- if the company moves from an LTIP to a restricted share awards, the remuneration committee should consider the appropriate discount to award levels; the discount should be at least 50% and grant levels should be held without gradual increase.

Leaver provisions

A new 'leaver provision' has been added with a recommendation that:

- individuals who are not 'good leavers' should be regarded as 'bad leavers'; in other words there should not be any 'intermediate leaver' category
- for 'good leavers', only a portion of the award may vest based on time in service and achievement of the original performance conditions; however, if the award needs to vest early, for example on death, awards should vest by reference to performance criteria achieved over the shorter period
- deferred bonus and LTIP awards should continue to be satisfied in shares and subject to appropriate performance conditions
- appropriate mitigation clauses should be included in awards to deal with individuals retiring as a good leaver to take up further executive roles

For further information contact JD Ghosh or Michael Landon.

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