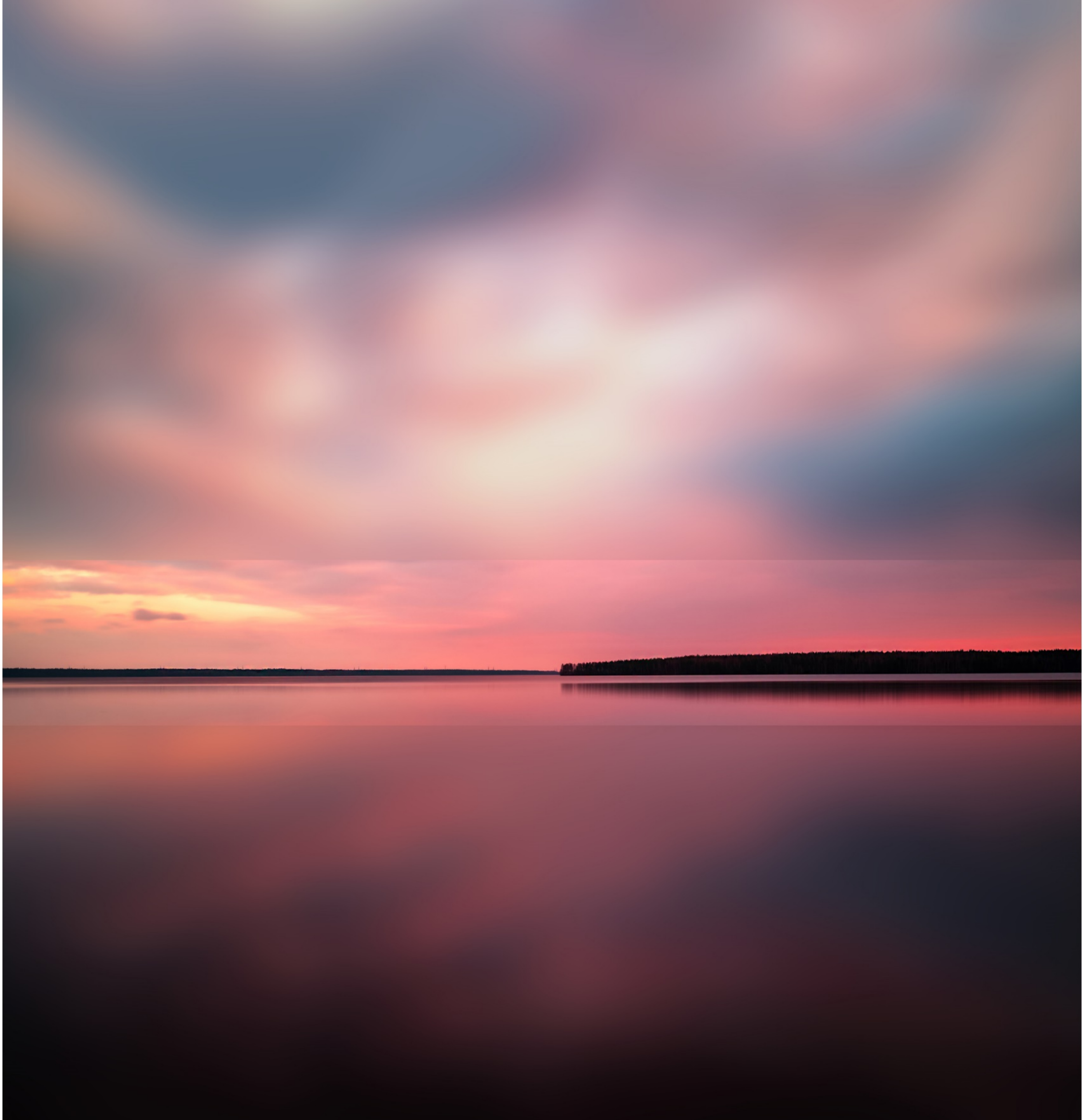
CLIFFORD CHANCE



2019-20 UK PAYROUND AND AGM SEASON REMUNERATION: WHAT'S ON THE HORIZON?

NOVEMBER 2019

2019-20 UK PAYROUND AND AGM SEASON: WHAT'S ON THE HORIZON?

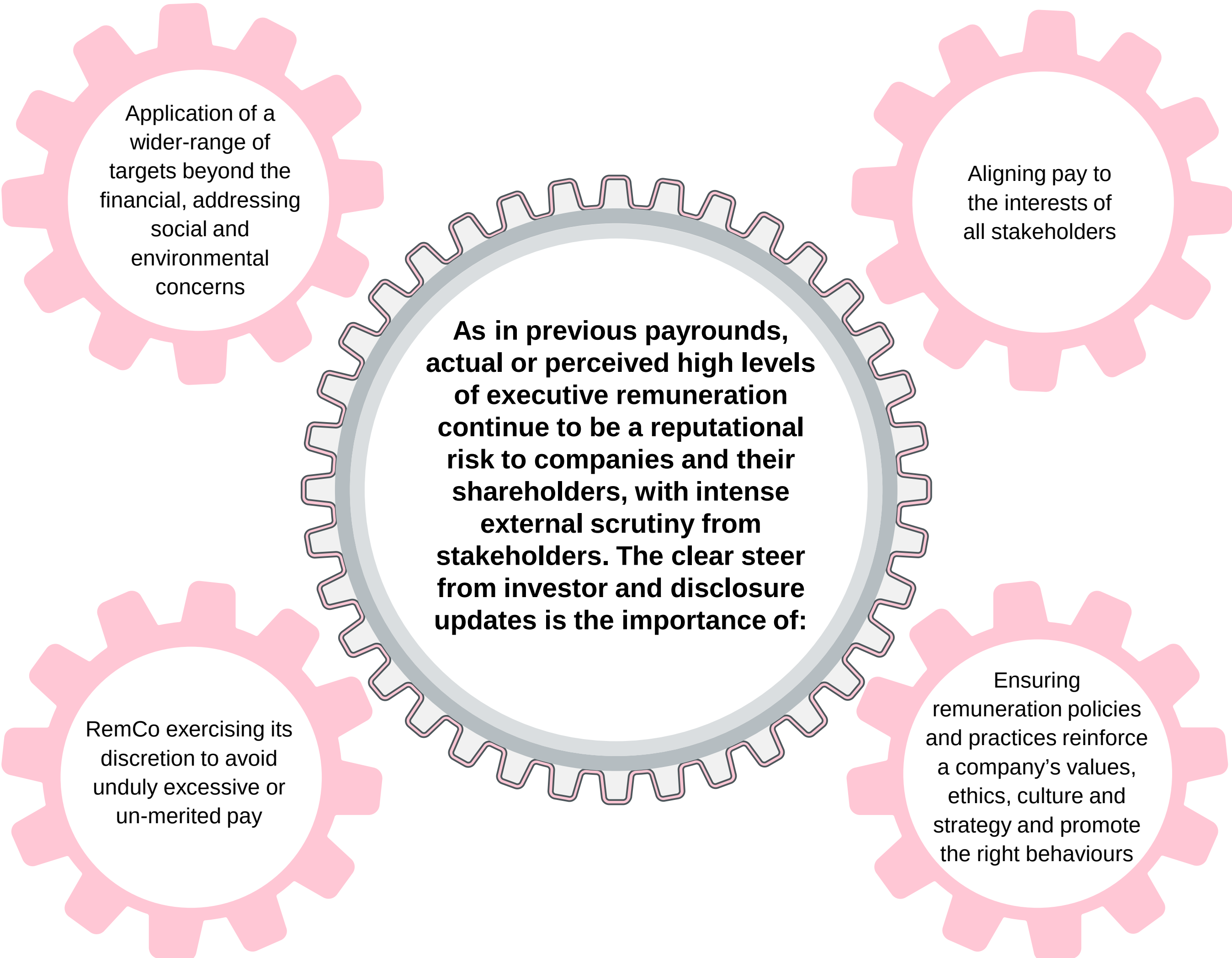
Executive remuneration remains in the spotlight in the UK as we enter the 2019-20 payround.

Pay decisions and disclosures continue to be areas of intense scrutiny for shareholders, employees, regulators, the government and other stakeholders, with an increased focus on the alignment of pay to a company's culture and values.

Changes to the UK directors' pay and reporting regime and investor guidance will also bite for the first time as part of the upcoming AGM season.

HERE'S WHAT YOU NEED TO KNOW

KEY THEMES AND TRENDS: ALIGNING PAY WITH WIDER INTERESTS



COMMENTARY

RemCo discretion remains a key factor in combatting perceived excessive pay. A RemCo needs to be confident that it is taking the right steps to ensure that executive pay is appropriate and in line with both performance and a company's culture. It should be satisfied that it has adequate discretions available to it to ensure that remuneration decisions are not unwarranted or unduly high.

As was the case for 2018-19, pension contributions and salary increases will remain an area of focus for the 2019-20 AGM season. Investors will be looking closely at how any increases to executive director salary, pension contributions or variable remuneration are justified by a RemCo, with excessive increases not in line with the workforce open to censure.

Reinforcing a company's values and cultural behaviours is also tackled by an added emphasis on non-financial drivers in pay structures. RemCos are encouraged to apply a wider-range of targets to incentive awards, addressing health and safety, diversity and environmental concerns.

In view of such increased scrutiny and disclosure obligations, companies will need to ensure that RemCo oversight is sufficient and robust, with appropriate clarity around decision-making processes and a clear articulation of rationale to be disclosed in annual reports.

DIRECTORS' REMUNERATION: UPDATES TO DISCLOSURE OBLIGATIONS

Changes to the directors' remuneration reporting and policy rules (under the amended Schedule 8 to the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 and the 2018 Corporate Governance Code (**Code**)) will apply for the first-time during the 2019-20 AGM season. For Code requirements, "comply or explain" remains the general principle and an appropriate explanation will be needed if a company is not fully compliant with any of the provisions.

KEY POINTS

DIRECTORS' REMUNERATION REPORT ('DRR')

- **Pay ratio reporting** – The requirement to report on the difference in pay between a company's CEO and its UK employees will officially apply for the first time to financial years beginning on or after 1 January 2019. Many companies chose to comply early, but for those who have not, the disclosures will first appear in annual reports as part of the 2019-20 AGM season. For companies that have disclosed early, additional narrative may be required in the DRR if a different calculation methodology is now being adopted.
- **Exercise of discretion in pay decisions** – A statement from the RemCo Chair should be added to the DRR setting out any discretion exercised in awarding director remuneration.
- **Share price appreciation** – Disclosure will be needed on the amount of any share award (or estimate of the amount of an award) that is attributable to share price appreciation. Where discretion is exercised in respect of an award because of share price appreciation or depreciation, this should be disclosed.
- **RemCo disclosures** – The Code sets out a number of factors to be addressed by a RemCo when determining policies and practices (clarity, simplicity, risk, predictability, proportionality and an alignment to culture). A fuller description of the work that RemCo carries out will now also be required, including specific factors set out in the Code, e.g. how it engages with the wider workforce, the alignment of executive pay to broader company pay and the extent of any exercise of discretion to pay outcomes.
- **Remuneration consultants** – The appointment of remuneration consultants should be the responsibility of RemCo, with appropriate disclosure in the DRR on any other connection the consultants have with the company or individual directors.
- **Non-executive director independence** – In determining independence, companies will need to consider any remuneration paid in addition to a director's fee.
- **Publication requirement** – The DRR must be made available on the company's website for ten years (without charge).

Early adoption? Some amendments to the DRR disclosure regime were made in 2019 to comply with the Shareholder Rights Directive II. The changes apply to financial years beginning on or after 10 June 2019, however some companies are considering early adoption, not least as the changes are relatively minor for most listed companies. They include, for example, a change to the 'single total figure table' to show the split of aggregate fixed vs variable remuneration. Additionally, the percentage change in pay of a company's employees will need to be compared against the pay of each director over a five-year period (as opposed to CEO pay only).

DIRECTORS' REMUNERATION: UPDATES TO DISCLOSURE OBLIGATIONS (CONTINUED)

DIRECTORS REMUNERATION POLICY

- **Vesting, deferral, holding periods and contracts** – Remuneration policies being brought to shareholders must expressly set out vesting, deferral and holding periods for share-based pay and an indication of the duration of directors' service contacts.
- **Loss of a shareholder vote** – Where a company loses a remuneration policy vote, a new policy must be brought to a shareholder vote at the next AGM or other general meeting.
- **Decision-making process** – A policy being brought to shareholders will need to set out the decision-making process for its determination, review and implementation (including to manage conflicts of interest).
- **Illustration of share price growth** – Where targets apply for more than one year, an indication of maximum remuneration receivable, assuming a share price appreciation of 50% over the performance period, is to be included.
- **Voting results** – The date and results of the shareholder vote must be published on the company's website.

When updating policies, thought will be needed as to how the provisions of the Code and investor guidelines more broadly are reflected in the drafting, e.g. the Code and IA's guidance on shareholding requirements and alignment of pension contributions to workforce, as discussed elsewhere in this briefing.

DIRECTORS' PAYMENTS FOR LOSS OF OFFICE

Payments for loss of office that are not consistent with an approved remuneration policy may now only be made if an amendment to the policy allowing for such a payment has been approved by shareholders.

WIDER WORKFORCE DISCLOSURES

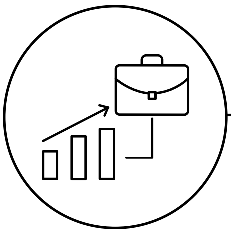
- **Board assessment and monitoring of culture** – Where the board is not satisfied that policies, practices or behaviours throughout the business are aligned to a company's values and strategy, it should seek assurances that management has taken corrective action. It should also include an explanation of the company's approach to rewarding its workforce. This applies to remuneration policies and practices as well as more widely.
- **Employee Voice** – Companies will need to disclose in their directors' reports how directors have engaged more generally with employees, including how they have considered employees' interests in their decision making.

THE INVESTMENT ASSOCIATION (‘IA’) PRINCIPLES OF REMUNERATION FOR 2020

Each year the IA sets out its members’ views on executive remuneration and key areas of focus for the upcoming AGM season.

The IA published its updated Principles on 1 November 2019. As part of their shareholder engagement, companies should consider the extent to which their remuneration policies and practices are aligned with the Principles and how areas of non-compliance are addressed in its DRR.

KEY POINTS



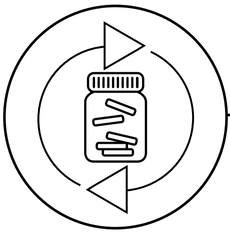
- **Discretions / vesting outcomes** – Paying variable pay to executive directors is discouraged if the business has suffered an exceptional negative event. This includes events which impact stakeholders, like the workforce (e.g. a significant health and safety failure or a poor outcome for clients). The IA also encourages RemCos to consider introducing discretion in incentive plans to cap incentive payouts (with implementation and any cap applied being matters for the RemCo).
- **Annual bonuses / pay for performance** – Weightings, achievement and outcomes of personal and strategic bonus objectives should be disclosed separately in the DRR. There should be ‘robust transparency…so that the link between pay and performance can clearly be seen.’
- **Pensions** – The Principles confirm the position in the IA’s paper on its approach to director pension contributions, from September 2019. See next page for more detail.
- **Leavers** – Key changes have been introduced for departing executive directors, namely:
  - payment in lieu of notice payments to consist of contractual entitlements, be limited to salary, pension and benefits and reflect the length of the notice period;
  - notice should start immediately on resignation or when a decision has been taken that the individual is leaving;
  - bonuses should only be paid to good leavers and deferred bonuses should continue to be settled in shares on the normal deferral schedule; and
  - companies should disclose if an individual is a good or bad leaver and the reasons for that status.
- **Incentive grant size** – Where there is a substantial fall in share price, award grant levels should be scaled back to avoid windfall gains.
- **Levels of remuneration** – RemCo should have appropriate discretion to ensure that remuneration outcomes are commensurate with company performance and are not excessive. Investors will scrutinise any increases to basic salary or variable pay and will expect RemCos to show restraint on overall quantum.
- **Shareholder consultation** – RemCos should consider sending shareholders consulted a wrap-up letter setting out the final approach that the RemCo will be taking.
- **Shareholding requirements and post-employment shareholding requirements** – The IA also reminds companies that these requirements were updated last year and the IA’s clear expectation is that they are reflected in all new remuneration policies being approved by shareholders.

Other notable updates include the Glass Lewis Guidelines (published November 2019) which set out an intention to closely scrutinise LTIPs where threshold vesting is at more than 25% (previously set at 50%).

THE IA UPDATED GUIDANCE ON DIRECTORS' PENSIONS

The IA published a pensions position paper in September 2019 confirming its approach to executive directors' pensions contributions for the 2019-20 AGM season. The paper builds on similar guidance given by the IA and the Institutional Voting Information Service ('IVIS') in February 2019 and requirements in the Code.

KEY POINTS



- **Pension contributions for new directors or any director changing position -** The expectation is that contributions are aligned to the rate that applies to the majority of the workforce from the start of appointment. Non-compliance (including any new remuneration policy that does not clearly state that pension contributions will be set in line with the workforce) will receive a 'red top' from IVIS.
- **Disclosure of pension contribution rate** – The IA expects disclosure in the DRR of the pension contribution rate considered to be given to the majority of the workforce. This includes an explanation of how the rate has been calculated (e.g. is it an average of all employees, UK employees only, or the rate given to all new joiners?). IVIS will 'highlight' a report if this information is not disclosed.
- **Pension contribution of all employees** - The IA considers it important for boards, RemCos and management teams to consider pensions contributions provided to all employees, not just executive directors. IVIS will 'highlight' companies that have increased the pension contribution provided to all employees.
- **Incumbent directors** – IVIS will continue to 'amber top' a remuneration report where the executive director's pension contribution is 25% of salary or more, provided that a 'credible action plan' is proposed to reduce the contributions to the level of the majority of the workforce by the end of 2022. Where no 'credible action plan' is disclosed and the contribution rate is at 25% of salary or above, IVIS will issue a 'red top'.

While the IA acknowledge that individual executive directors may have a contractual right to a certain pension provision or contribution, its stance is clear - contributions are to be aligned with the level of the majority of the workforce, as soon as possible, and by no later than the end of 2022. Care must be taken on the design and articulation of 'credible action plans' which will be a continued area of focus.

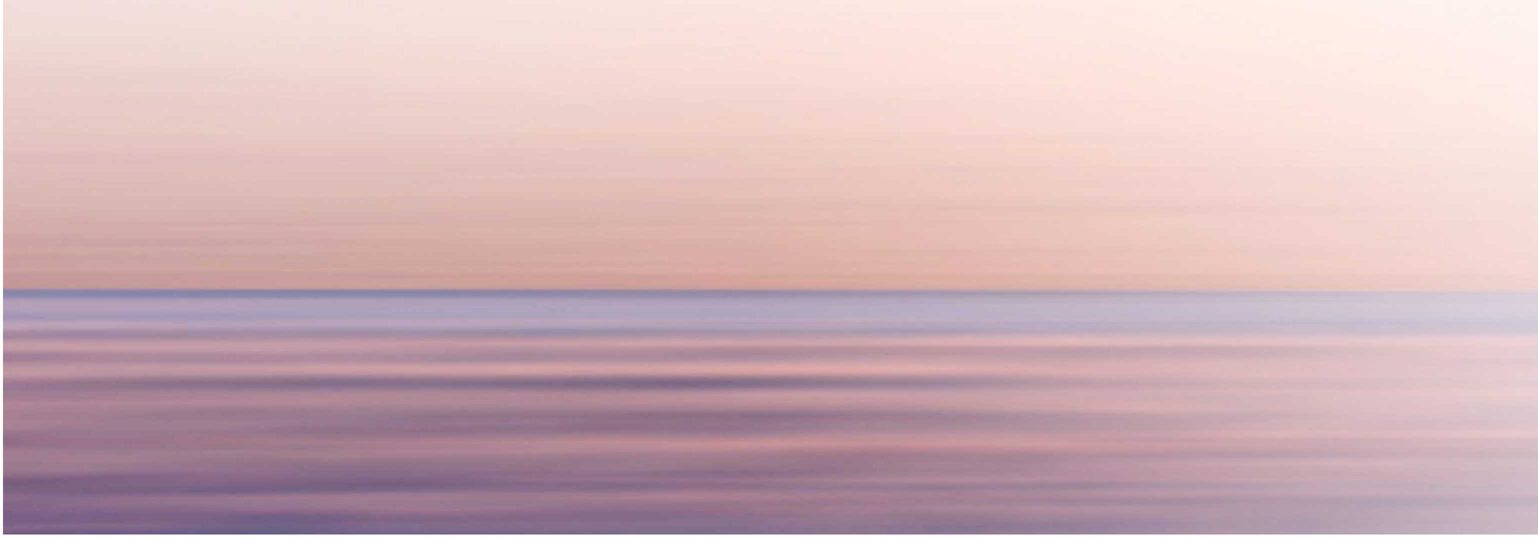
FINANCIAL SERVICES COMPANIES: THE FCA'S 'DEAR REMCO CHAIR' LETTER

In its August 2019 'Dear RemCo Chair' letter to tier 1 firms, the FCA sets out its conclusions on the 2018-19 payround, and how it intends to assess firms for upcoming 2019-20 payround. The FCA's focus is on the accountability of the RemCo chair, diversity and inclusion, ex-post risk adjustments, and the FCA's continuing exploration of transforming culture. For non-tier 1 firms, the letter is still helpful to understand the key areas of interest for the FCA.

As with previous years, the issues of culture and good governance remain key, mirroring developments in corporate governance and investor guidelines more broadly, as discussed elsewhere in this briefing.

KEY POINTS

- **Accountability** – The RemCo Chair (as SMF12) should consider how remuneration policies and practices contribute 'to a healthy culture and drive the right behaviours' within a firm. An explanation of how the RemCo Chair has assured that remuneration policies drive behaviours that reduce potential harm must now also be included in the firm's RPS.
- **Diversity and Inclusion** – Firms need to make improvements by focusing on 'diversity in its broadest forms'. During their engagements with the FCA, RemCo Chairs will need to demonstrate how remuneration policies positively influence diversity and inclusion.
- **Ex-post risk adjustments** – Adjustments continue to be a significant area of interest for the FCA. In particular, the letter focusses on a firm's decision-making process and its ability to provide appropriate justifications for how the level of adjustments has been determined. The FCA's continued expectation is that the RemCo Chair oversees how a firm makes 'consistent judgments on the level of adjustments' including why any differences exist between incidents or the individual decisions. Appropriate oversight includes the ability to ensure that adjustments are made in a 'timely manner'.
- **Transforming Culture** – Certain key themes are highlighted by the FCA, including a renewed focus on non-financial drivers, the increasingly important role of recognition, the need to take into account the impact of interests of different competing stakeholders (such as consumers vs shareholders) and the question of what motivates individuals within the financial services industry.



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"They're an excellent team – they're all a pleasure to deal with and are clear experts in the field of incentives law"

Chambers and Partners 2019 – Employee Benefits, Tier 1

"The team is really adaptable and extremely able to compete in a quickly changing business environment"

Chambers and Partners 2019 – Employee Benefits, Tier 1

"The team is a market-leader in this field. It is fully tuned in to clients' priorities and provides technically sound, commercial advice"

Legal 500 UK 2019 – Employee Share Schemes, Tier 1

C L I F F O R D

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