Executive Compensation: Current Issues for Remuneration Committees and Considerations for the 2022 Voting Season

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02 / 07 / 22

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The Investment Association (IA) (Remuneration Principles), along with Glass Lewis (2022 Policy Guidelines) and the Institutional Shareholder Services (ISS) (2022 Benchmark Policies) have published updated guidance for the 2022 voting season. Key areas of focus remain the impact of the COVID-19 pandemic, effective disclosure of executive pay, alignment with best practice (for example, as regards post-employment shareholding requirements and pension contribution levels), and the incorporation of the company's environmental, social and governance (ESG) strategy in remuneration structures and performance metrics.

The expectation of pay restraint remains, as the impact of the pandemic on a business and, more widely, on workforce pay and conditions continues to be felt. Investor bodies are clear in their guidance that stakeholder experience and wider market conditions must be factored into any remuneration decisions. Remuneration committees must clearly communicate the rationale for any significant increase to any elements of remuneration.

Salary

The IA notes that, for most remuneration structures, increasing salary will have a "multiplier effect" on the overall quantum of remuneration. The IA also recommends that benchmarking peer groups be specific and clearly disclosed to investors, and reiterates that salary increases should not be justified by reference to benchmarking only. According to Glass Lewis, factors of particular concern would include "significant increases in quantum, absent a sufficient rationale," and where a remuneration policy does not include structural safeguards and risk mitigating features, such as clawback/malus provisions, deferral, post-vesting holding periods, and in-post and post-employment shareholding requirements.

2021 Bonus Determinations

Determination of bonus for the 2021 financial year will see remuneration committees having to assess the ongoing impact of COVID-19 against returning performance metrics. Where a company has relied on government or shareholder support, the expectation continues to be that bonuses should not be awarded. To the extent targets set last year are considered conservative, likely due to the backdrop of the pandemic, there will be investor pressure for the remuneration committee to apply its discretion for downward adjustment. Investor scrutiny of disclosure of the assessment of nonfinancial targets and remuneration discussion in relation to those is to be expected.

Alternatives to Traditional Long-Term Incentive Plans

A recent increase in companies considering use of restricted share plans (RSPs) and value creation plans (VCPs) has led the IA to issue specific guidance in this area. The IA notes that selection of a long-term incentive plan (LTIP) should be based on the company's long-term, not short-term, strategy and should not be changed regularly. The IA had previously suggested a discount rate of 50% on the normal grant level would be appropriate when introducing an RSP to replace a traditional LTIP. The IA has noted in its updated guidance that this level of discount may be insufficient where there has been a substantial fall in the share price since the first LTIP grant.

The IA has updated its Remuneration Principles to include a specific section on investor expectations on VCPs. The IA notes these should only be used where appropriate in the company's circumstances, alongside a clear rationale for their introduction, any targets and the chosen monetary cap. The IA recommends including substantially more stretching and robust targets for a VCP and placing a cap on the total value of awards and number of shares that can be granted, as remuneration committees must be mindful of the potential additional dilution.

2022 LTIP Awards

The IA had updated its guidance to note that where the company's share price has fallen, remuneration committees should scale back LTIP award levels at grant rather than using their discretion at vesting, to address the potential for windfall gains. The IA has long warned against windfall gains as a result of share price movement; the specific recommendation to scale back at the time of grant will be noted by companies, many of which would have previously relied on discretion at vesting to address any windfall gains. As economic uncertainty continues, the setting of performance conditions for 2022 LTIP awards will present similar challenges for remuneration committees to last year. As was the case in 2021, wider ranges in performance targets are likely to be considered appropriate, and remuneration committees will need to carefully analyze forecasts and consider appropriate levels of stretch, against shareholder expectations.

ESG Metrics in Executive Remuneration

The IA welcomes that companies are increasingly incorporating the management of ESG risks into their long-term strategy and variable pay structure. The IA continues to note that ESG metrics should be quantifiable and clearly linked to value creation and the company's long-term strategy, and that the rationale for choosing them should be disclosed to investors. The ISS is aligned with this approach and will assess compensation plans accordingly. Where companies have incorporated ESG metrics into their long-term strategy but have not yet reflected them in their pay structures, the IA advises companies to include an explanation on the approach they intend to take going forward. Glass Lewis, while generally supportive of ESG metrics when used appropriately, stresses the importance of flexibility, particularly regarding where to place these metrics, in order to suit the company's wider remuneration framework.

Pensions

Ensuring the alignment of executive pensions with the wider workforce continues to be a hot topic. Investors will expect to see a plan to align pension contributions for directors with the contribution levels of the wider workforce by the end of the year, as part of wider efforts to ensure fairness and good employee relations. Writing to the chairs of FTSE 350 remuneration committees, the IA confirmed that 90% of FTSE 100 companies analyzed have already met these ambitions. As was the case for 2021, the Institutional Voting Information Service (IVIS) will "red top" (the IVIS' highest level of warning) any new remuneration policy that does not align the executive director pensions with the contribution levels of the general workforce, or will "red top" a remuneration report that does not set out a credible action plan for alignment by the end of 2022.

Conclusion

The updated investor body guidance should contain few surprises for remuneration committees. While the IA acknowledges the leadership that these committees have shown during the pandemic, the 2022 voting season is likely to continue to present them with challenges, as they seek to balance the need to effectively and appropriately incentivize executive performance during demanding times — against the backdrop of heightened scrutiny in this area — with the demand to make decisions regarding pay that reflect the wider business environment and shareholder and workforce experiences.