January 26, 2023

Skadden

Executive Compensation and Benefits Alert

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed below or call your regular Skadden contact.

Louise Batty
Counsel / London
44.20.7519.7245
louise.batty@skadden.com

Kate Crompton
Associate / London
44.20.7519.7120
kate.crompton@skadden.com

Clara Rupf
Trainee Solicitor / London
44.20.7519.7510
clara.rupf@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

40 Bank Street, Canary Wharf
London, E14 5DS
44.20.7519.7000

Executive Compensation: Considerations for UK Companies for the 2023 Voting Season

Introduction

U.K. institutional investor bodies, including the Investment Association (IA),[1] Institutional Shareholder Services (ISS),[2] Legal & General Investment Management (LGIM)[3] and Glass, Lewis & Co. (Glass Lewis)[4] recently published their updated guidance on remuneration practices for 2023. Investor expectations in this area remain largely in line with established principles, advocating for alignment of remuneration policies with long-term corporate strategy, the linking of senior executive pay to the long-term success of the company and ensuring the executive experience remains commensurate with that of stakeholders (including shareholders, customers and the wider workforce) and reflective of the economic environment.

While the COVID pandemic is no longer dominating headlines, the IA specifically notes remuneration committees should be mindful of the current cost-of-living crisis, inflationary environment and continuing economic uncertainty in determining 2022 pay outcomes and setting 2023 remuneration policy.

Remuneration committees face a continuing tension between the need to effectively incentivise executives and senior management — after several years of restraint during testing times for companies and management and in response to increasing scrutiny from investors, the public and politicians — and the continuing expectations for moderation in executive pay. This tension is particularly relevant for the many companies that are due to put their remuneration policies back to shareholders for approval this year.

Salary

One key change in approach in this year's guidance relates to sentiment on base salary increases. In previous years, the IA considered it to be acceptable, in normal circumstances, for increases in executives' base pay to be in line with the increases given to the wider workforce. This year, the IA has advised companies to show "additional restraint,"

[1] The Investment Association, "Principles of Remuneration" (Nov. 9, 2022).

[2] ISS, "Europe, Middle East, and Africa (EMEA) Proxy Voting Guidelines: Benchmark Policy Changes for 2023 for U.K. & Ireland, Continental Europe, Russia & Kazakhstan, Middle East and North Africa, Sub-Saharan Africa, and South Africa" (Nov. 30, 2022); "United Kingdom and Ireland Proxy Voting Guidelines: Benchmark Policy Recommendations" (Dec. 13, 202 2).

[3] "LGIM's UK Principles on Executive Pay" (Oct. 2022).

[4] Glass Lewis, "United Kingdom 2023 Policy Guidelines."

stating that current inflation in the U.K. economy is disproportionately affecting lower-paid workers and recommending that, if salary increases are needed, remuneration committees should consider increases below the rate of salary increases given to all employees. The IA guidance further reminds companies to carefully justify all executive increases. The ISS echoes this approach and notes that keeping directors' salary increases "low and ideally lower proportionally than general increases across the broader workforce" is good market practice. LGIM is urging companies to exercise caution if they plan to use the average workforce salary increase in setting executive pay where companies have given employees a significant pay increase to address the concerning cost-of-living crisis. Investor groups continue to articulate that companies should remain mindful of the leveraged impact of an increase in base pay on total variable compensation.

Committee Discretion (and 'Windfall Gains')

Investor groups remain aligned that use of discretion is key for remuneration committees in ensuring executive pay outcomes reflect both individual performance and contribution to overall corporate performance as well as the wider stakeholder experience and economic conditions, and similarly that companies must clearly disclose and explain to shareholders the use of discretion.

A key area where use of remuneration committee discretion is relevant this year is in relation to the scope for "windfall gains" on share awards granted in 2020 during the COVID pandemic, which on the typical three-year vesting cycle are due to vest this year. Caution against allowing windfall gains has long been a feature in investor guidance, but is of particular focus following the pandemic, especially this coming year with many awards granted in 2020 due to vest in 2023. The IA in its 2020 COVID guidance[5] warned that "windfall gains" on long-term incentive plan (LTIP) awards may arise if the level of awards expressed as a multiple of salary was maintained following a substantial fall in a company's share price: A higher number of shares may have been awarded than in a typical reward cycle, which may result in a windfall gain when the share price recovers. The guidance recommended that remuneration committees either reduce the grant size or explain how the risk of windfall gains would be avoided (with the majority of companies taking the latter approach). The IA notes in its 2023 principles of remuneration that where no scaling back took place at grant and windfall gains have subsequently been realised, shareholders expect the remuneration committee to consider exercising discretion to ensure "vesting outcomes are not inflated by windfall gains." LGIM echoes this approach and notes that adjustment of vesting outcomes rather than of the initial award is not its preferred solution, and that where companies make adjustments, companies must provide a clear explanation to investors. Remuneration committees will need to clearly articulate how they have considered the impact of any potential windfall gains when determining vesting outcomes and why any reduction is or is not appropriate in the circumstances.

Linking Pay to Environmental, Social and Governance (ESG) Criteria

The effective incorporation of ESG strategy into incentive arrangements remains a priority for investors, with previously inconsistent expectations of different investor groups starting to converge. LGIM expects companies to incorporate managing ESG matters into the strategy of the business, and where companies are exposed to high levels of ESG risk, to establish relevant targets that are meaningful, measurable and aligned to the company's strategy, with environmental and social targets subject to third-party verification. Further, LGIM recommends that companies within sectors that have significant effects on climate change link a portion of executive pay to delivering the companies' climate change mitigation goals, and link environmental targets to approved plans by the Science Based Targets initiative (SBTi) to achieve net zero emissions by 2050 at the latest. Companies should design these targets not only to improve revenue, but also to positively impact the environment. Starting in 2025, LGIM will expect to see climate-related targets in long-term plans for companies in certain sectors before the firm will support a new remuneration policy, with the targets (ideally SBTi approved) serving stated transition goals to accomplish net zero emissions across the value chain. The weighting for delivering climate-related targets should represent at least 20% of the overall LTIP award or, for restricted share plans, companies should specifically link one underpin to achieving carbon reduction targets. Glass Lewis has set out that, where environmental and social targets are not explicitly included as targets in incentive plans, it expects a company to provide additional disclosure explaining how the company's compensation strategy is aligned with its sustainability strategy.

The IA notes that companies are increasingly incorporating the management of material ESG risks and opportunities into their long-term strategies, and therefore remuneration committees should consider the extent to which these goals should be reflected as performance metrics in variable remuneration. Such ESG performance conditions should be quantifiable, explainable and clearly linked to the company's overarching sustainability goals. It is important that ESG metrics set suitably stretching goals and are not used to reward business-as-usual activity. Remuneration committees should also be able to explain how progress

[5] The Investment Association, "Executive Remuneration in UK Listed Companies Shareholder Expectations During the COVID-19 Pandemic" (April 27, 2020).

is measured and how performance will be disclosed. The Financial Reporting Council in its 2022 Review of Governance Reporting (the FRC Report)[6] emphasises that, as companies do with any other performance metric, they should clearly link ESG measures to strategy, explain the weighting of ESG metrics and report the degree to which the related targets are achieved, and detail how the achievement links to granted awards.

Regarding employee engagement and governance, LGIM proposes that companies set targets for employee retention in order to measure successful employee engagement (rather than using employee engagement targets, which should be routine activity in a well-governed company). The FRC Report highlights the "better practice" of holding dedicated forums to engage with the workforce on remuneration.

Pensions

The IA guidelines reiterate that pension provisions for executive directors — both incumbent and newly appointed — should be in line with those granted to the wider workforce by the end of 2022. The IA notes that failure to create company-wide alignment of pension contributions by this date will result in a vote against a proposed remuneration policy. Similarly, LGIM notes that it will vote against a remuneration policy if no changes are proposed to solve a disparity in pension provisions by 2023. Likewise, Glass Lewis states that "in the absence of a cogent rationale for any delay in such a reduction and/or a failure to provide a commitment to align contributions in the near-term," it "may recommend" that shareholders vote against the remuneration policy at hand. Broadly, ISS agrees that companies should align directors' pension arrangements with the workforce's, but allows for "exceptional circumstances" and a case-by-case approach. The FRC Report notes that, despite no striking changes in the rate of noncompliance with the U.K. Corporate Governance Code's provisions (as compared to last year), there was a clear increase compared to 2020 in noncompliance with provision 38 (aligning executive pensions to those of the workforce). The number of companies disclosing the nonalignment of their pensions jumped from 11 (2020) to 30 (2022).

NED Fees

The IA acknowledges that nonexecutive director (NED) fees have not always captured the complexity and time commitment required of NEDs in serving on a company's board and its subcommittees, and notes that NED fees should properly reflect the effort and complexity of the role. Companies must justify and clearly explain to shareholders any increase in NED fees. The IA further notes a recent trend of companies introducing minimum shareholding guidelines for their NEDs (as opposed to participation in incentive award arrangements, which the IA and other investor groups continue to recommend against).

Combined Incentive Plans

The 2023 Glass Lewis guidelines pay special attention to "combined" or "omnibus" plans. These are incentive plans that combine both short (one-year) and long (spanning three years or more) incentive plans, offering a payout of part of the award after a short period of good performance while reserving the rest of the award for a later payout, subject to time vesting and/or additional performance criteria. Glass Lewis expresses skepticism about combined incentive plans, as these plans typically remove long-term performance conditions, and the deferred portion can effectively become a guaranteed payment. Glass Lewis highlights that a multi-year vesting period, gateway conditions and post-vesting holding periods (of typically two years) to access the deferred portion are crucial to avoid a vote against a remuneration policy.

Further, if a company removes existing variable incentive plans at the same time as it introduces a combined incentive plan, Glass Lewis expects a substantial reduction in the total target and maximum opportunity to reflect the reduction in risk profile of the incentive plans.

Conclusion

As U.K. listed company remuneration committees consider remuneration outcomes for 2022, and for the many U.K. listed companies putting their remuneration policies back to shareholders for approval this year, we will likely see highlighted messaging and commentary about restraint, particularly regarding determinations on salary and windfall gains, and in approaches to variable pay opportunities. In response to the continuing investor and public expectations regarding approaches to meeting ESG-related targets, we will likely see a further increase in companies incorporating such metrics into their incentive arrangements, with potentially a step change in inclusion of such measures in long-term incentive plan metrics, and expanded use of social and governance metrics (in addition to more established environmental metrics).

Effectively retaining and incentivising executives and management while also appropriately navigating investor and public expectations around executive pay remains a challenge for remuneration committees. Companies will need to ensure they present to investors sufficient and appropriate disclosures about executive pay and decision-making, showing that approaches to remuneration structures are tailored to the particular company and its long-term strategy, in alignment with applicable investor group guidance and reflective of the wider economic backdrop and broader stakeholder experience.

[6] FRC, "Review of Corporate Governance Reporting 2022" (Nov. 2022).