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NAPF
Corporate Governance Policy & Voting Guidelines 2014/15

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“Remuneration is seen by many investors as a litmus test for wider corporate governance practices; it encompasses board effectiveness, challenge and oversight, strategy and risk management. Shareholders will therefore continue to examine remuneration policies critically, with a view to ensuring that they are closely aligned with their interests and are driving long-term strategic success”.

The National Association of Pension Funds (NAPF) has issued an update of the Corporate Governance Policy and Voting Guidelines.

The guidelines have been restructured and updated with a focus on a ‘holistic and sustainable approach to governance’. The updated guidance particularly focuses on the role of both companies and shareholders and notes the responsibilities of shareholders in promoting effective corporate governance.

The guidelines note that the voting recommendations are not intended to be prescriptive. It is assumed that shareholders will evaluate explanations for non-compliance and in doing so will take into account the company’s specific circumstances and that they will, where appropriate, engage with the company.

Equally the guidelines make it clear that it is the company’s duty to avoid ‘boiler-plate’ explanations and that poor disclosure makes it difficult to arrive at an informed opinion about the quality of compliance and may lead investors to take a less sympathetic view of explanations of non-compliance.

The guidelines are now structured with the core principles first, followed by the key issues, with the detailed voting guidance set out in a format which mirrors the format of a standard AGM agenda.

Key changes in relation to voting recommendations on remuneration issues

As last year the guidance is based on the five principles developed with other pension fund investors – Hermes EOS, BT Pension Scheme, RPMI Railpen and USS Investment Management – which set out a framework for remuneration committees to use when determining and implementing remuneration policies. These are unchanged but are worth repeating here:

- Remuneration committees should expect executive management make a material long-term investment in shares of the businesses they manage.
- Pay should be aligned to long-term strategy and the desired corporate culture throughout the organization.
- Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders.
- Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance.
- Companies and investors should have appropriately regular discussions on strategy and long-term performance.

Although not a new principle, it is worth noting that the NAPF expect remuneration policies to stand the test of time and that in general they should only be put to a vote on a triennial rather than an annual basis.

Voting guidelines

The voting guidelines on policy and the report are likely to be viewed independently, a vote for/against one does not necessarily equate to a vote for/against the other.

Remuneration policy

- A new guideline has been added under shareholdings which states that companies should consider ‘that executives are exposed to some tail risk for an appropriate length of time after they leave the company’.

- The guidance states that investors may decide to vote against the policy if it fails to meet the principles. If, after engagement, the policy still fails to meet the principles this is likely to be escalated to a vote against the chair of the committee or in extreme circumstances the chairman of the board.

The specific things that may trigger a vote against are listed and these include, as previously, inappropriate metrics or insufficiently stretching targets, guaranteed pensionable discretionary or one-off annual bonuses or termination payments, any provision for retesting and layering of new share schemes on top of existing schemes. New items are:

- The guidance previously suggested that a requirement of less than 2 x salary may be considered insufficient to provide an alignment with shareholders. The guidance now adds that higher levels may be warranted commensurate with higher levels of reward.
- Lack of a link between performance metrics and strategy.
- No provisions to clawback sums paid or scale back unvested awards. These provisions would ideally not be restricted solely to material financial misstatements.
- Excessive flexibility provided for 'exceptional circumstances'.
- Vague recruitment policies or substantial headroom over and above policy.

Remuneration report

- The guidelines now include a specific provision that investors may vote against the report where awards fail to reflect the wider circumstances such as serious reputational issues, or if upwards discretion has been used without appropriate explanation.

The specific practices which are likely to cause concern and may trigger voting sanctions are predominantly the same as before (salary increases above inflation or above those awarded to the wider workforce, over frequent benchmarking, awarding of sign on bonus with no conditionality and which pay for awards not yet vested at previous employment, ex-gratia and other non-contractual payments, change in control provisions which trigger earlier and/or larger payments, absence of service contracts). Also now included are:

- Inappropriate use of discretion, for example not scaling back awards in light of how performance was achieved.

- In relation to the guidance on the disclosure of the scope of annual bonuses and performance conditions, the guidance now clarifies that 'retrospective disclosure of performance against targets is a minimum expectation'.

Guidance removed

The previous guidance on procedure (previously D.2.1 to D.2.10), which related primarily to disclosure and to the role of remuneration committee advisers, has been removed.

Other key changes

A few changes have been made to the general principles:

- 'Governance should be considered holistically'. This is about setting the tone, or culture, from the top and giving consideration to mitigation of long-term risk to financial sustainability.

- The principles now state that the Nomination Committee ‘is vital and should anticipate change by ensuring the proper planning of succession’ and ensuring boards have a ‘diversity of perspectives, skills and experiences’. The principles also now note that boards should consult shareholders over ‘sensitive’ board appointments.

- The Remuneration Committee should design rewards that drive long-term strategic success.

- The principle which related to the use of shareholder resolutions as a means of drawing attention to shareholder concerns has been removed and replaced with a principle which states that ‘effective engagement with shareholders is crucial’.

- A specific principle has been added in relation to investment companies where there are often alternative governance approaches in place. The principles note that the Association of Investment Companies Code of Corporate Governance provides a comprehensive guide to best practice but stress that the board should be, and should act, fully independently of the firm providing fund management services. It is also important that shareholders are provided with sufficient information to allow them to understand the risk/reward balance to which they are exposed.

- On the voting guidelines the suggestion that shareholders may use an abstention to convey a strong signal of concern or dissent has been removed.

Effectiveness

The guidelines have been expanded slightly in relation to succession planning. Shareholders not only want to see evidence that a succession plan is in place but also how it links to the company strategy. It is also suggested that advance communication with shareholders when board changes are planned will help alleviate any concerns.

In the statement on succession planning there should always be reference to the efforts made in the development of internal talent in order to create a pipeline to the board.

Accountability

This section now includes some specific comments relating to risk. The accounts are expected to present a ‘true and fair’ view of the state of the business and this should include the board’s view of the key strategic and operating risk, including environmental, social, governance and reputational risks and how these risks are managed. The guidance provides an example of reputational risk in relation to the company’s approach to tax management: ‘artificial or aggressive tax strategies create risks for a company and need to be considered at board level. The approach to tax management can offer investors a useful insight into the culture of a company and its wider risk appetite’.

The guidance also notes that companies should consider emerging risks such as those related to cyber security and climate change and that companies should articulate how they are responding to any risks that may have materialised over the year.

Relations with shareholders

This now includes a comment that ‘both companies and investors should be prepared and equipped to have intelligent holistic conversations about the business and its strategy and how governance arrangements support this’.

The guidance also notes that where a significant number of votes (based on the judgement of the board and in the context of the type of resolution) have not been registered in support of management (this includes votes against and active abstentions) the actions taken in response should be disclosed in the next report and accounts.

The full guidelines can be found at:

http://www.napf.co.uk/PolicyandResearch/Corporate-Governance/NAPF-Corporate-Governance-Policy-and-Voting-Guidelines.aspx

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