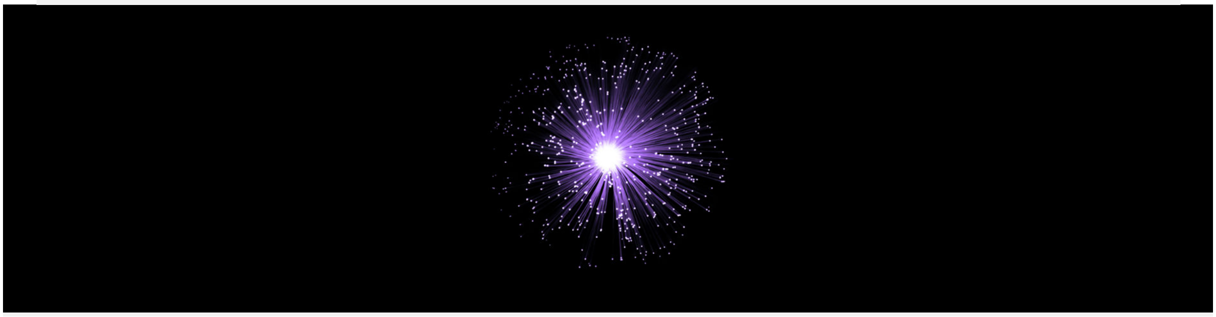

Investment Association

Principles of Remuneration 2017

3rd November 2017

The Investment Association (IA) has issued an update of its Principles of Remuneration and an accompanying open letter to remuneration committee chairmen.

Issues to consider for 2018 AGM season

In its letter to remuneration committee chairmen, the IA highlights the following issues as areas of focus for the 2018 AGM season.

Levels of remuneration

- All companies should follow the example set by some, predominantly large, companies to exercise restraint on variable remuneration increases and consider whether the remuneration potential should be reduced. The IA also highlights concerns with incremental increases to variable remuneration maximums and with the impact of salary increases and even "automatic" inflationary salary increases on total compensation.

- Companies need to justify to investors the level of remuneration paid to executive directors, and take into account the wider social context of executive pay, rather than looking at benchmarking alone.

- Companies are expected to disclose the pay ratios between the CEO and median or average employee, as well as the CEO and the executive team, as part of justifying and explaining the levels of executive remuneration in the business.

- The IA reiterates that executive directors should have pension contribution rates at the same level as the general workforce.

Remuneration structures

- *Restricted shares:* Whilst there are a number of shareholders that are unsupportive of restricted shares, there are a growing number of shareholders that will support the introduction of restricted shares for the right company, in the right circumstances. In some cases, new remuneration structures are being proposed only when the current remuneration structures are not paying out to executive directors, which is not seen as a reason to move to a restricted share model.

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- *Shareholder consultation:* It is critical that dialogue between companies and shareholders is meaningful and treated as a two-way process. The IA notes that failure to properly understand the views of shareholders has led a number of companies to withdraw their resolutions prior to the AGM and that these companies should ensure that they conduct a full analysis of shareholder feedback and consult further before re-submitting their remuneration policies.

Pay for performance

- *Financial target disclosure:* Full disclosure of threshold, target and maximum performance targets is expected to be disclosed either at the time of payment of the award, or within 12 months where an explicit explanation of the commercial sensitivity has been set out.

- *Target adjustment:* If metrics used for executive remuneration have been adjusted from headline KPI or reported numbers, companies must set out why this is appropriate, and provide a breakdown of how the remuneration target has been adjusted from the headline KPI.

- *Non-financial target disclosure:* The IA reiterates that members expect a thorough explanation as to why personal or strategic targets have paid out, not just a description of non-financial performance indicators. Insufficient information on non-financial targets will trigger an Amber Top. There will be increased scrutiny on payments made for non-financial performance where financial targets are not met.

Accountability of Remuneration Committee Chairs

- The letter notes that the 2017 AGM season saw an increase in the number of investors voting against the re-election of individual directors based on the decisions they make at the Remuneration Committee and highlights that members have a range of escalation approaches in their voting policies. For example, some members vote against the Remuneration Committee Chair if they vote against a remuneration resolution in two successive years, or if a remuneration resolution does not get majority support, some members vote against the re-election of the Remuneration Committee Chair at the next AGM.

Changes to the Principles

Discretion

- Any discretion specific to a particular incentive scheme should be disclosed in the remuneration policy in addition to the plan rules.

- Shareholders discourage the payment of variable remuneration to executive directors if the business has suffered an exceptional negative event, even if some specific targets have been met. In such circumstances, shareholders should be consulted on the implementation of the remuneration policy and any proposed payments should be carefully explained.

Pay for employees below Board level

- When fulfilling relevant reporting obligations in relation to workforce pay, such as the Gender Pay Gap Reporting legislation or when publishing executive pay to employee pay ratios, Remuneration Committees are expected to provide context relevant to the business and fully explain why these figures are appropriate.

Shareholder consultation

- As part of the consultation process, Remuneration Committees should provide details of the whole remuneration structure, not just the proposed changes, so that investors can have the whole picture of the remuneration framework.

- After the conclusion of the consultation process and prior to finalising the details in the ARR, the Remuneration Committee should review proposals in light of any events which have occurred subsequently to ensure that the proposals remain appropriate.

Benefits

- Any benefits relating to the relocation of an executive should be disclosed at the time of appointment, be in place for a limited period, and details should be disclosed to shareholders. Each element of any relocation benefits should be detailed in the ARR.

Annual bonus

- The definition of any performance measure should be clearly disclosed. Any adjustments made to the metrics as set out in the company's accounts should be clearly explained and the impact of the adjustment on the outcome disclosed.

- The wording around the timeframe within which bonus targets must be disclosed has been strengthened, now stating that targets for performance at threshold, target and maximum levels should be disclosed no later than twelve months following the payment of any bonus awards.

- The wording on bonus deferral has also been strengthened, with an expectation inserted that a portion of the bonus should be deferred where opportunity is greater than 100% of salary.

Types of long term scheme

The section on long term schemes has been restructured. The IA emphasises that the chosen remuneration structure should be appropriate for the specific business, and efficient and cost-effective in delivering its longer-term strategy. The selection of a scheme should be well justified to shareholders. Some changes were made to the LTIP and restricted shares sub sections:

- *LTIPs:*
  - Performance conditions should be carefully chosen, so they are suitable for measurement over a long period of time.
  - Threshold vesting amounts, should not be significant by comparison with annual base salary. Full vesting should reflect exceptional performance and should therefore be dependent on achievement of significantly greater value creation than that applicable to threshold vesting.
- *Restricted shares:*
  - The total vesting and post-vesting holding period should be at least five years.
  - Restricted share awards should be accompanied with significant shareholder requirements.
  - Some members expect that restricted share awards should be subject to an appropriate underpin.
  - The Principles now state that the expected discount rate for moving from an LTIP to restricted share awards should be a minimum of 50% of grant levels (previously it stated that the ratio should be 50%) and should be held at this level in future and not gradually increased over time.
  - Companies that have demonstrated a history of sensible approach to remuneration and have established a relationship of trust with its investors are more likely to get acceptance for such a scheme.

The Principles of Remuneration can be found here.

Deloitte view

There are limited changes to the principles, mostly emphasising investors' focus on transparency and expectation that broader stakeholders are taken into account when determining executive pay, which companies should bear in mind as they draft their remuneration reports.

Companies will note that the IA has renewed its call for companies to show restraint on overall quantum of remuneration and will want to bear this in mind as they make their pay decisions.

At this time of year, a number of companies are engaging with shareholders on pay matters. We encourage companies to always include a summary of their existing arrangements and proposed changes and keep their letters short and to the point, in the context of the business strategy and circumstances. Investors for their part should dedicate sufficient resources to these engagements and aim to respond quickly and clearly so that companies can factor their feedback in their final decision. It would also be helpful for investors to provide more information about their use of proxy advisors.

We are pleased to see the IA’s reminder that companies should seek to adopt the remuneration structure most appropriate to their needs and that investors are becoming more open to alternative structures such as restricted shares. This was echoed in an ISS global survey that showed that the majority of investors believe restricted shares could be appropriate for UK companies in certain circumstances.

The IA’s expectations on the disclosure of ratios goes beyond what is currently envisaged by the Government, asking companies to disclose not only the ratio of CEO versus broader employee pay, but also a ratio of CEO versus executive team pay. We agree that remuneration committees should be mindful of pay differentials within the executive team and our experience is that this data is shared with the Committee. However, we believe that external disclosure is likely to have unintended consequences as it would effectively result in disclosing executive committee pay and experience has shown that increased disclosure tends to lead to pay ratcheting.

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