The Investment Association and ISS issue updated guidance

The Investment Association (IA) and ISS recently issued updated guidance on executive remuneration ahead of the 2021 AGM season. On 12th November, ISS published a summary of changes to its voting guidance policy, with the only significant change relating to gender diversity on boards. On 16th November, the Investment Association (IA) released updated Principles of Remuneration for 2021. The Principles contain updated guidance on pension alignment, bonus deferral and the use of ESG performance measures. Alongside the Principles, the IA also published updated guidance on executive remuneration in light on the COVID-19 pandemic. This briefing alert summarises the key issues raised in the updated guidance.

Key points from the updated ISS Policy guidelines

Only minor modifications are proposed to the ISS policy guidelines for UK and Ireland, which are effective for meetings held from 1st February 2021. The changes relate to gender diversity, pensions and post-employment shareholding requirements and "over boarding".

- In line with recommendations of the Hampton- Alexander Review, ISS will generally recommend a vote against the Chair of the Nomination Committee of FTSE 350 companies where the Board does not comprise at least a 33% female representation, (a one-year transition period applies where voting recommendations will not be negative if there is public commitment to comply by the 2022 AGM). For FTSE SmallCap, ISE20, and AIM companies with a market cap of over £500m, ISS will generally recommend a vote against the Chair of the Nomination Committee, where there is not at least one female member of the Board.

- In making voting decisions on executive remuneration, ISS will pay particular focus on the extent to which executive pension contributions are aligned with those of the wider workforce and whether an appropriate post-employment shareholding requirement is in place.

- When applying its policy on the appropriate number of board appointments a director may hold, the guidance has been updated to confirm that ISS may apply a more lenient approach to directors who serve on the boards of less complex companies (for example, externally managed investment companies).

Mercer commentary: *the update recognises pensions and post-cessation shareholding requirements as potential drivers of ISS voting recommendations, where the remuneration policy is submitted to shareholders for approval and reflects the prominence of these issues since the 2018 UK Corporate Governance Code came into force. On pensions for incumbent directors, existing ISS guidance* *encourages companies to seek to align with the workforce contribution rate over time, recognising that many investors in the UK will expect this to be "achieved in the near-term". No specific guidance is given on post-employment shareholder requirements, but the IA recommendation in this regard is referenced in the "good market practice" section (i.e. that the post-employment shareholding requirement should apply for at least two years at a level equal to the lower of a) the shareholding requirement immediately prior to departure and b) the actual shareholding on departure).*

The full ISS UK & Ireland policy guidelines will be published at the end of November and will be followed by FAQs in December. ISS voting recommendations in 2021 are also likely to be determined by how companies have made decisions in response to the COVID-19 pandemic. ISS issued global policy guidance in response to the impact of the pandemic in April 2020 and have indicated that they intend to carry this or similar policy guidance into 2021, updating as required. We will report on any changes to these guidelines and their implications for our clients as they arise.

Key Changes to the Investment Association's Principles of Remuneration for 2021

The Investment Association has made some minor changes to its Principles of Remuneration to reflect developments in market practice and investor expectations, as follows.

- Any remuneration policy that does not state explicitly that new executives will receive a pension in line with the majority of the workforce will receive a Red Top from IVIS. Any new director, or director changing role, whose pension contribution is not aligned with the level of the majority of the workforce will trigger a Red Top on the remuneration report.

- Where the Committee has not disclosed a credible action plan to align an incumbent director's pension contribution to the majority of the workforce rate by the end of 2022, IVIS will Red Top the remuneration report if the pension contribution received by the executive director is 15% or more (*note: trigger was previously set at 25% or more*). Fixing the monetary value of the pension is generally not considered to be a credible plan for alignment.

- Shareholders continue to expect the majority of the bonus to be based on objective financial measures. Strategic/ personal objectives in annual bonuses must demonstrate a link to long term value creation and not for actions considered to be 'doing the day job'. Whilst the IA is supportive of ESG measures being used, any ESG-based performance conditions should be clearly linked to implementation of the company's strategy.

- Where an annual bonus opportunity is greater than 100% of salary, a proportion of the entire bonus should be deferred.

- On post-employment shareholding requirements, Remuneration Committees are encouraged to disclose the structures in place to enforce the requirements, particularly after the director has left the company.

- The guidance on leavers has been expanded to clarify, that “bad leavers” are not expected to receive annual bonus payments.

Mercer commentary: the most notable change relates to the enhanced expectations on pensions alignment for incumbent directors, reflecting the strength of feeling from the governance community on this topic. Approximately one-third of FTSE 350 executive directors have a pension contribution rate aligned with or lower than the workforce rate. For those companies that have not yet aligned, a further 22% have already communicated an action plan for alignment reflecting the direction of travel in this area. The revised guidance on how companies should be structuring bonus deferral, reflects a preference for deferral to apply to a proportion of any bonus earned rather than only the bonus above a set level (i.e. the top slice). Practice on bonus deferral is mixed, but around 10% of the FTSE 350 companies follow the latter approach. To date this has not been an issue for many shareholders but may be something to be considered as part of a company’s next remuneration policy review process.

Investment Association expectations during the COVID-19 pandemic

In April 2020, the IA provided additional guidance on shareholder expectations during the COVID-19 pandemic. This guidance has been updated to reflect members’ latest views on how Remuneration Committees should be reflecting the impact of the COVID-19 pandemic on executive pay. Key points include:

- Companies who have taken Government support or raised additional capital from shareholders are not expected to pay bonuses to executive directors for FY2020

- For companies who have cancelled dividends, there should be a corresponding impact on executive pay (either through malus of the FY19 bonus or reflected in FY20 outcomes)

- Remuneration Committees should be mindful of the wider employee context (furlough, pay-cuts, redundancy) when making decisions on executive pay

- Shareholders do not expect companies to make retrospective changes to performance targets for inflight incentive awards (or to cancel and replace awards) and companies are encouraged to confirm in their remuneration report that no such adjustments have been made

- If the formulaic executive remuneration outcome is not aligned with the shareholder experience, Committees should use discretion on vesting to ensure a strong link between pay and performance and engage with shareholders to explain the rationale

- Continued restraint on base salaries is expected and where increase are given they should be in line with changes to the wider workforce

- Enhanced disclosure will be expected to explain bonus targets and outcomes and Committees should consider whether a higher proportion of bonus should be deferred into shares. Where companies have benefitted from indirect support such as Business rates relief or rent waivers, Committees should disclose how this has been taken into account when assessing performance

- On LTIPs, making awards at maximum opportunity where share prices have fallen substantially is discouraged and the approach for mitigating windfall gains should be explained. Forward looking targets should be sufficiently stretching and should not be adjusted to compensate for reduced outcomes for inflight awards. Any move to restricted shares should be supported by clear strategic rationale (inability to set targets is not a reason in itself).

Mercer commentary: the guidance from the IA is in line with the views expressed to us in recent conversations with leading shareholders and proxy advisers, which we shared with clients on our 3rd November webinar. The clear guidance from the IA is helpful to Committees as they embark upon their year-end decision making process. Whilst the impact of COVID-19 will be different for each company, shareholders will expect Committees to take into account their particular circumstances and the impact on their stakeholders. Failure to take account of Government or shareholder support, and the company's approach to all employee pay, on variable pay outcomes for executive directors could lead to significant voting and reputational ramifications for a company and its shareholders.