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Changes to the Investment Association's Principles of Remuneration for 2021 and guidance on Shareholder Expectations during the COVID-19 Pandemic

The Investment Association (the "IA") recently published changes to the IA's Principles of Remuneration for 2021 (the "IA Principles") together with an update to its guidance on Shareholder Expectations during the COVID-19 pandemic ("COVID-19 Guidance"). A high-level summary of the key changes to the IA Principles and COVID-19 Guidance and the key areas of focus for the IA's members for the 2021 AGM season is set out below.

A link to the revised IA Principles and the COVID-19 Guidance can be found on the IA website at www.theia.org/industry-policy/guidlines/guidelines-investee-companies.

Background

The IA Principles set out the principles that members of the IA expect companies to follow in their policies and practices on executive pay and long term incentives, including the structure and operation of employees' share schemes. The IA Principles predominantly apply to companies that are listed on the main market of the London Stock Exchange, but are also relevant to companies listed on other exchanges, including AIM. Whilst they are a voluntary set of guidelines, they are often regarded as a key barometer of what constitutes best practice and good corporate governance with regard to executive pay in the UK and as such play an important role in the approval, setting and operation of remuneration policies and practices.

Changes to the IA Principles: Key areas of focus for the 2021 AGM season

1. Use of Non-financial Performance Measures in Variable Remuneration

The guidelines as they relate to variable remuneration and, in particular, annual bonuses have been updated to reflect the impact that material Environmental, Social and Governance ("ESG") risks have on the long-term value of companies. The revised guidelines state that it is appropriate (but not obligatory) that Remuneration Committees consider the management of material ESG risks as performance conditions in variable remuneration provided that they are clearly linked to the implementation of a company's strategy. In relation to the use of personal and/or strategic measures these must be linked to long-term value creation and it is expected that financial metrics continue to comprise the significant majority of the overall bonus.

SH comment: There is no requirement to impose ESG targets; however, to the extent set, they should be clearly linked to the company's strategy and value creation, and not be seen as a 'box ticking' exercise.

2. Post-employment Shareholding Policies

The guidelines concerning the holding of shares post-employment have been finessed slightly. There is now greater emphasis on the continued enforcement of post-employment shareholding policies, particularly after a director has left the company.

SH comment: Companies are encouraged to disclose in their next directors' remuneration report how they will monitor and enforce post-employment shareholding guidelines for former directors. The guidelines recognise that it may be necessary to set up an employee ownership trust or nominee account for holding the shares.

3. Deferral of bonuses

The guidelines regarding the deferral of a proportion of annual bonus have been tightened. Where the bonus opportunity is greater than 100% of annual salary, a proportion of the whole bonus should now be deferred into shares rather than a proportion of that part of a bonus above a certain threshold.

SH comment: Companies are encouraged to review and, where necessary, amend their annual bonus and deferral policies and communicate any changes to executives. Remuneration Committee's should ensure, if they have not done so already, that going forwards the Remuneration Committee has absolute discretion to determine the percentage of a bonus that may be deferred into shares.

4. Approach to pensions in 2021

In relation to new executive directors (including internal promotions), the current approach will continue and a vote against will be recommended where pension contributions are not set and aligned with the level of the majority of the workforce.

For incumbent directors companies must have in place a credible action plan to reduce pension contributions to the level of the majority workforce by the end of 2022. For these purposes, a credible action plan is one where the pension contribution is consistently reduced on a phased basis over time rather than a one-off reduction to take effect on 1 January 2023. A vote against the remuneration report will be recommended where no credible action plan is disclosed and the pension contribution for incumbent executive directors is 15% or more of base salary.

SH comment: The IA's approach to executives pensions continues to harden. Companies are encouraged to review policies (and in some cases re-review policy changes approved in 2020) and arrangements for reducing pension contributions paid to incumbent directors, and consider whether it is appropriate to accelerate the rate of reduction to contributions over the next two years to ensure compliance with the majority workforce rate by the end of 2022.

Shareholder Expectations during the COVID-19 pandemic: key changes to the COVID-19 Guidance

In April 2020, the IA provided additional guidance on shareholder expectations during the COVID-19 pandemic. This guidance has now been updated in light of the current expectations of members, the key themes of which are summarised below:

- **Salary**

Companies are urged to exercise restraint in relation to any salary increases and, to the extent made, ensure that they are in line with changes to the wider workforce.

- **Bonuses for FY 2020 or FY 2020/21**

Unless there are truly exceptional circumstances, bonuses should not be paid to executives if the company has taken direct Government support (e.g. Coronavirus Job Retention Scheme ("JRS") payments, government loans or other direct government support) or additional capital from shareholders. Where bonuses are paid they should reflect the wider employee experience and be fully explained and justified, particularly in relation to pay-outs for non-financial performance measures. Remuneration Committees should also consider deferring a greater proportion of any bonus for FY2020 into shares.

- **Disclose the impact on remuneration outcomes where indirect Government support received**

Companies that have benefited from indirect Governmental support e.g. business rate relief, should consider and disclose the impact the support has had on financial performance and remuneration outcomes.

- **Companies that have suspended or cancelled dividends in FY2019 or FY2019/20**

Where dividend payments were suspended or cancelled during FY 2019 or FY2019/20 members of the IA will expect to see a corresponding impact on remuneration outcomes. In particular, where dividends have been cancelled in 2019 or 2020, members expect to see a reduction in deferred bonuses for 2019 or to bonus outcomes for 2020.

- **Adjusting performance conditions to take account of COVID-19**

No adjustments should be made to the performance conditions applying to in-flight bonuses or long-term incentive awards and Remuneration Committees are expected to confirm that no such adjustments have been made in the next directors' remuneration report.

Exceptionally, if the Remuneration Committee considers it necessary to amend any performance conditions, it should first consult with shareholders. Again, full disclosure and an explanation of the adjustments should be made in the next remuneration report.

- **Cancellation and re-grant of long-term incentives**

Companies should not cancel and re-grant long-term incentive awards or increase variable pay in 2021 to compensate for lower variable pay received in 2020 due to the pandemic.

- **Windfall gains and reductions to long-term incentive awards granted in 2020**

In respect of long-term incentives granted in 2020 (including restricted share awards), the Remuneration Committee should explain and set out how they intend to deal with any future windfall gains associated with such grants and, where long-term incentive awards (including restricted share awards) have been reduced, explain how the reduction was determined.

- **Future performance conditions**

The performance conditions applying to future awards should continue to remain sufficiently stretching and demanding and Remuneration Committees are expected to explain how the targets were set and determined.

Remuneration Committees should anticipate having to exercise discretions in the future to overturn formulaic outcomes and to ensure that the performance out-turn is reflective of company and executive performance as well as the experience of shareholders and other stakeholders.

- **Restricted share schemes**

The inability to set meaningful performance conditions for long-term incentive awards is not of itself a sufficient reason to consider seeking approval for a restricted share scheme for executive directors.

SH comment: All companies, shareholders, stakeholders and employees have been affected by COVID-19 in one way or another; however, not all have been hit financially and, from a pure share price perspective, there have been some high profile "winners", particularly (but not exclusively) in the digital technology, pharmaceutical and medical supplies sectors. What is clear from the revised guidance and from comments made by investors and commentators generally is that the Remuneration Committees of all companies should have regard to the direct and/or indirect impact that COVID-19 has had on company performance (for good or ill) and the wider experience of shareholders, stakeholders (including employees) and society. These impacts and experiences may or may not change the outcome of any assessment and determination of executive remuneration; however, Remuneration Committees will be expected to demonstrate that they have considered these issues alongside the usual key financial and individual performance indicators, and be able to explain and justify the decisions made.

If you have any questions in respect of the changes made to the IA Principles or the COVID-19 Guidelines and the impact they will have on company remuneration, please contact Barbara Allen (Barbara.allen@shlegal.com) or David Baxter (david.baxter@shlegal.com), or your usual adviser at Stephenson Harwood LLP.

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