Plan. Prepare. Report.

Linklaters

Directors' Remuneration Report – Guide

December 2020

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The Linklaters Employee Incentives team

Introduction

Many companies, following their triennial cycle, adopted new remuneration policies in 2020, in the midst of the Covid-19 pandemic. This led to some investors raising concerns over quantum and disclosure of performance conditions. In normal times, the 2021 AGM season should be a quieter one. But these are not normal times: guidance for UK listed companies and institutional investors sets out approaches for dealing with key issues during the pandemic, including on remuneration. Companies should expect a great deal of scrutiny on their executive pay response to Covid-19. As always, investors – particularly those who have suffered from reduced dividends and share price volatility – will be watching carefully. In addition, there will be public interest in the extent to which executives have 'shared the pain' suffered by workers, particularly in companies which have benefitted from state aid.

Our online tool is being continuously updated for the 2021 AGM season. This update includes:

- Corporate Governance Code 2018;
- Corporate governance legislative changes effective from 1 January 2019;
- Changes implementing the EU rules on directors' pay in the UK;
- The updated Investment Association's Principles of Remuneration, 16 November 2020;
- The Investment Association's 'Shareholder Expectations during the Covid-19 Pandemic', 16 November 2020;
- The ISS Proxy Voting Guidelines for UK and Ireland, 19 November 2020;
- Glass Lewis 2021 Proxy UK Guidelines, November 2020;
- Legal & General Investment Management updated Principles of Executive Remuneration (September 2019) and Corporate Governance and Responsible Investment Policy – UK 2020; and
- PLSA Stewardship Guide and Voting Guidelines 2020.

Forward planning

We expect the following issues will come up:

> **Reducing payouts for 2020:** There will be a lot of pressure on companies to ensure that executive pay since the onset of the pandemic has reflected its impact on the company, shareholders and the workforce. This will apply to payouts of 2020 bonuses, any 2019 bonus deferrals, and LTIPs vesting. Where overall payouts have not been adjusted, companies will have to explain why not.

The pressure will be particularly great on companies which have:

- cancelled or suspended dividends;
- endured sustained share price decline;
- furloughed staff or made staff redundant; and/or
- benefited from other state assistance (apart from the Job Retention Scheme), such as government (or government-backed) loans or business rate relief.

The Investment Association's (IA) November Covid guidance expects these companies not to pay any 2020 bonuses unless there are truly exceptional circumstances. Similarly, where formulaic bonus outcomes have been increased by government assistance (such as business rate relief), companies will be expected to take that into account in determining the final outcome.

If the performance conditions have been met, how do companies reduce or even prevent bonus payouts? Investors have been insisting for some years that remuneration committees have powers to override formulaic outcomes from performance conditions for bonuses and long term incentives. Many companies have introduced these discretions and will be expected to use them this year, more than any other. Where they do not, they could consider using malus or clawback provisions which are almost universal now. In both cases, remuneration committees will need to look carefully at the terms of the discretion or the malus and clawback provisions to ensure that they are wide enough to allow the reduction. A malus provision which follows IA guidelines will allow for reduction where "the business has suffered an exceptional negative event" which, depending on the company's specific circumstances, may be a suitable trigger. But wording in the remuneration policy does not, of itself, give the remuneration committee the power to reduce: *that* depends on the contractual terms of the bonus or incentive which should be checked carefully.

Top tips for 2020 remuneration reports and the 2021 financial year

Companies preparing their 2020 implementation and policy reports should consider these developments and action points for 2021:

> **CEO:employee pay ratios – first year on year comparison:** 2020 will be the second year in which companies have had to include information about the ratios of CEO pay to UK employee pay in their remuneration reports. In the first year, it was only necessary to include the figures for the year. This year it will also be necessary to include some analysis of the year-on-year change. This will be more challenging, especially where pandemic-related changes to the workforce, workforce pay and/or the CEO's pay have affected the ratios.

The details of the year-on-year analysis required are set out in Parts B and E but briefly, there must be:

- an explanation of any reduction or increase in any ratio;
- whether the change is due to changes in CEO pay or employee pay or employment models (e.g. outsourcing); and
- any trend in the median pay ratio over the two years.

With only two data points, one of which could be skewed by a global pandemic, companies might reasonably conclude that they cannot yet discern any meaningful trend.

> **CEO:employee pay ratios – impact of Covid-19:** A substantial proportion of respondents to a survey the GC100 conducted in early October felt that the pandemic would affect their pay ratios. Respondents had cut CEO pay more than employee pay so the general pattern may be for the ratios to look 'better' (i.e. lower) this year than last. But measures taken to respond to Covid-19 could skew either side of the ratio:

> **Directors' shareholding and post-employment shareholding:** Many companies have now complied with the new requirement in the Corporate Governance Code (supported by investor bodies) that director shareholding requirements continue for a period after leaving, but a few were called out last year for failure to do so. Companies which are still not complying should consider making changes this year. Changes can generally be made to the directors' shareholding requirements without shareholder approval so there is no need to wait until the next policy renewal. The ISS now focus on the shareholding requirements including an appropriate post-employment requirement, when considering support for a new policy.

  Also, whilst investors were happy with the introduction of post-employment shareholding requirements, the IA particularly highlighted where companies have not followed the levels of shareholding they would like to see: the lower of actual holding or the required holding for at least two years. The IA now require more disclosure from companies on the enforcement mechanisms they have in place to enforce this shareholding requirement, especially where a director has left the company. These could include setting up trusts or nominee accounts.

> **FCA review of Corporate Governance Code compliance:** The FCA's November report reviewed how companies reported compliance for the first time against the 2018 Corporate Governance Code. The FCA says there's "mixed picture", with some companies continuing to treat the Code as a box-ticking exercise. This leads to formulaic reporting without a meaningful explanation of non-compliance. The FRC is also worried that some companies claimed full compliance with the Code, but closer inspection showed that they have not done so. For example:

  – Four companies did not have a formal policy for post-employment shareholding, but failed to report that they were not complying with the Code Provision requiring this; and

  – Companies which have not fully aligned pension contribution rates cannot gloss over this when reporting on overall Code compliance.

  On remuneration, the FCA found better reporting on workforce pay, discretion, and Code Provision 40 (issues to address when setting director pay). But disappointing reporting in relation to KPIs, pension contributions, and workforce engagement. See this briefing for details and further guidance from the FCA for 2021 reports.

Sources: what does the Guide cover?

The table below sets out the documents which are covered in the Guide, the abbreviations used to refer to them and whether or not they are legally binding.

In general, where the Accounts Regulations require a disclosure which is also recommended by guidance of an investor group, this is not mentioned separately.

Abbreviation	Document	Legally binding?
Accounts Regulations	The Large & Medium-sized Companies and Groups (Accounts & Reports) Regulations 2008. These regulations were enacted under the Companies Act 2006 and last amended by the Companies (Miscellaneous Reporting) Regulations 2018.	✓
BEIS 2018	BEIS Q&A guidance on The Companies (Miscellaneous Reporting) Regulations, November 2018. This provides guidance, among other things, on the enhanced illustrations of remuneration in the policy and the CEO:employee pay ratios disclosure.	✗
BEIS 2019	BEIS Q&A guidance on the Companies (Directors' Remuneration Reports Policy and Directors' Remuneration Report) Regulations 2019	✗
Board Effectiveness Guidance	The FRC's Guidance on Board Effectiveness accompanies the CGC 2018 and provides guidance to boards on how to apply the CGC 2018.	✓

Continued on next page »

Part A

Overview of how the rules work

1. To whom do the rules apply?

1.1 By law

The legislation relating to remuneration reports applies to UK-incorporated companies which are listed on the London Stock Exchange, an EEA exchange, the New York Stock Exchange, or NASDAQ. From 10 June 2019, this includes UK-incorporated unquoted traded companies (see below).

In practice, many London listed companies which are incorporated outside the UK produce remuneration reports as if they were UK companies. The IA recommend that where companies are not subject to the regime, they should apply similar high standards. For such companies which are not listed in the EU, the vote on the remuneration policy is not technically binding: if the report is voted down, the company may agree to seek approval for a revised policy but there are no general constraints on its ability to pay directors in the meantime. Even if companies choose not to do this, they will have to comply with the CGC 2018 or explain any non-compliance. Media and investor pressure may also mean that non-UK companies do follow the Companies Act requirements.

From 10 June 2019, the new EU-wide directors' pay regime applies to London-listed, EU incorporated companies. They will need to ensure they are complying with the rules for their country of incorporation, as well as manage the CGC 2018 and investors' expectations for London-listed companies.

In addition, there are some UK-incorporated companies which are:

> not listed in London, but on another EEA exchange, the New York Stock Exchange, or NASDAQ; or

> listed on an EEA exchange (or the LSE) but outside an official list (mostly on the LSE's Specialist Fund Segment), these are "unquoted traded companies".

They are caught by the rules and need to comply.

5. Personal data

Remuneration reports for financial years starting on or after 10 June 2019 must not include any data:

> which refer to a director's family situation;

> revealing an individual's racial or ethnic origin, political opinions, religious or philosophical beliefs or trade union membership;

> concerning an individual's health or sex life or sexual orientation; or

> relating to criminal convictions and offences or related security measures.

Some benefits disclosures (e.g. partner/spouse travel costs) may reveal such data, depending on the level of details given. So companies should ensure compliance when disclosing such items.

They must also not include genetic data and biometric data for the purpose of uniquely identifying an individual, though this is most unlikely to be relevant for remuneration reports.

6. Website disclosure

6.1 Remuneration reports

Each remuneration report must now be:

> kept on the company's website for at least ten years; and

> removed after the ten years if it contains "information relating to an identified/identifiable living individual".

In practice, this means most of the implementation report and some parts of the policy will need to be removed. Stripping this information out would be possible but would leave little useful information and no context. So companies should make sure they remove the remuneration report after ten years, to avoid breaching the legislation.

1.4 Previous approved policies

The policy must state which provisions of any previously approved policy are to continue to apply after the new policy receives shareholder approval, and for what period of time it is intended that those provisions should continue to apply 4.

Schedule 8, Paragraph 24(2)

1.5 Decision-making process

Policies adopted after 9 June 2019 must include an explanation of the decision-making process followed for determination, review and implementation of the policy. This should include:

> measures to avoid or manage conflicts of interest 5; and

> where applicable, the role of the remuneration committee or other committees concerned (unless covered elsewhere in the report).

Schedule 8, Paragraph 24(1A)

1.6 Remuneration policy table

1.6.1 A table 6 See Part B, section 1.7 setting out:

A description of each component of the remuneration package for the company's directors 7.
See Part C, section 3.2

Schedule 8, Paragraph 25(1)

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See Part C, section 3.2

Schedule 8, Paragraph 25(1)

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A payment must be within the policy at the time it is made. Incentive awards are usually granted under one approved policy but vest under another, which may not necessarily include that form of award because e.g. the company's policy has changed due to market practice. To ensure that the payment is lawfully paid under an approved policy, companies need to include in the subsequent policy a reference to their intention to make payments under awards granted under previously approved policies. They will also need to identify which provisions in those policies will continue to apply and for how long those provisions will apply e.g. until vesting of those awards.

Most companies broaden this wording to cover other commitments made under one policy which fall to be honoured under another (e.g. promises to make grants or termination payments), and also commitments made before a person became a director or, where applicable, before listing.

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The **GC100** (4.2, page 32) suggest that this might include procedures surrounding executive attendance at remuneration committee meetings and ensuring external advice received by the committee is independent.

1.6 Remuneration policy table

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A description of each component of the remuneration package for the company's directors 7.
See Part C, section 3.2

Schedule 8, Paragraph 25(1)

Part C

Implementation Report – detailed rules

3.14 CEO:UK employee pay ratios 81

See Part E, section 2

For financial years beginning on or after 1 January 2019 and for companies with 250 or more UK employees, **a table** setting out the ratios of pay between the CEO and the UK employees at the 25th percentile, median and 75th percentile. Part E includes full details on when this applies and how the ratios are calculated and set out.

Schedule 8, Paragraph 19A

The following **information** should be set out after the pay ratios table:

- an explanation of why the company chose Option A, B or C and the reason for any change in the option used;
- the reason for any change in the method chosen, from that chosen in the previous year (if applicable);
- the day by reference to which the company determined the employees at the median and 25th and 75th percentiles;
- where the company has used Option B, a brief explanation of how the best equivalents are reasonably representative of P25, P50 and P75 and whether estimates or adjustments have been used;
- where the company has used Option C:
  - the methodology used for estimating the best equivalents, describing any estimates, adjustments, or material assumptions; and
  - a brief explanation of how the best equivalents are reasonably representative of P25, P50 and P75;
- details of any component omitted from pay and benefits, the reason why and whether it was omitted in the previous year;
- where the company has not used the single figure methodology to determine pay and benefits, what method was used and why;
- an explanation of any assumptions or statistical modelling used to determine full-time equivalent remuneration;
- The total pay and benefits and the salary component of each of Y25, Y50, and Y75.

Schedule 8, Paragraph 19E

3.14 CEO:UK employee pay ratios 81

For financial years beginning on or after 1 Janua
a table setting out the ratios of pay between the (
75th percentile. Part E includes full details on wh

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LGIM UK (page 16) expect all companies to provide a pay ratio regardless of the number of UK employees. Part E has a full explanation of the pay ratios disclosure, including Options A, B and C (section 2 of Part E), investor guidance, and template disclosures of the ratios table and the prescribed explanations (Section 9 of Part E).

The following **information** should be set out after the pay ratios table:

> an explanation of why the company chose Option A, B or C and the reason for any change in the option used;

> the reason for any change in the method chosen, from that chosen in the previous year (if applicable);

> the day by reference to which the company determined the employees at the median and 25th and 75th percentiles;

> where the company has used Option B, a brief explanation of how the best equivalents are reasonably representative of P25, P50 and P75 and whether estimates or adjustments have been used;

> where the company has used Option C:

- the methodology used for estimating the best equivalents, describing any estimates, adjustments, or material assumptions; and
- a brief explanation of how the best equivalents are reasonably representative of P25, P50 and P75;

> details of any component omitted from pay and benefits, the reason why and whether it was omitted in the previous year;

> where the company has not used the single figure methodology to determine pay and benefits, what method was used and why;

> an explanation of any assumptions or statistical modelling used to determine full-time equivalent remuneration;

> The total pay and benefits and the salary component of each of Y25, Y50, and Y75.

Schedule 8, Paragraph 19E

3.21 Implementation of policy in the following year

The report must state how the company intends to implement the remuneration policy in the year after the year under review including:

- performance measures to be used and the relative weightings;
- performance targets and how awards will be calculated 99;
- any significant differences between the way the policy was implemented in the year under review and the next year (if the same policy applied in both years) 100 See Note 18 See Note 59; and
- *for financial years beginning after 9 June 2019*, details of any deviations from the implementation of the remuneration policy set out in the policy 101.

Schedule 8, Paragraph 21

Whether or not the size of LTIP grants has been or will be reduced to take account of the Covid-19 pandemic impact.

IA Covid-19 Guidance

3.22 Remuneration waived

Details of any arrangements under which a director has waived or agreed to waive any emoluments or future emoluments 102.

LR9.8.4(5) and (6)

3.23 External directorships 103

The reasons why the board has permitted a director to take up additional significant external appointments should be explained in the annual report 104.

CGC 2018 Provision 15

3.21 Implementation of policy in the following year

The report must state how the company intends to implement the remuneration policy in the year after the year under review including:

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Whether or not the size of LTIP grants ha pandemic impact.

3.22 Remuneration waived

Details of any arrangements under which emoluments 102.

3.23 External directorships 103

The reasons why the board has permitte should be explained in the annual report

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The **CGC 2018** (Provision 15) requires that a full-time executive director should not take on more than one non-executive directorship in a FTSE 100 company or other significant appointment. The **ISS** (page 9) set out guidelines on when they may recommend a vote against re-election of a director for "overboarding' (i.e. holding too many external directorships). There will be a vote against if the director holds more than five 'mandates' or if they are executive chair at one company and an executive director at another. For these purposes, a non-executive position counts as one mandate, a non-executive chairship counts as two and a position as executive director as three. But a more lenient view may apply for directors who serve on the boards of less complex companies (for example, externally managed investment companies).

The vote against will not be in relation to the company of which the director is the chair or CEO, but in relation to the other companies for which the individual serves as director.

The **PLSA** (page 32) consider that the role of non-executive directors is an increasingly demanding one particularly for chairing key committees. Shareholders should take into account the size of the outside company, its circumstances and the director's other commitments in forming a view as to whether the director is over-committed. The **PLSA** (page 34) believe that investors should consider voting against the election of the company chair if they are a director of more than four companies and/or chair of two or more global and highly complex companies, unless there is a compelling explanation as to why this will not impact their availability and commitment.

Part D

Single Figure Table details

Part D

Single Figure Table details

Click here to return to Note 41

This table lists the elements in a remuneration package, considers whether the board pay rules require their inclusion in the single figure table of the implementation report, and in which year. It includes statutory references and comments.

"**Year**" in this table means a reporting year.

Element of remuneration	Granted in the year 1	Continuing in the year 2	Vested in the year 3	Paragraph in Schedule 8	Amount included in single figure
Salary and benefits					
Salary	✓	–	–	7(1)(a), 10(1)(a)	Cash paid in or for the year. Only covers pay while a director.
Benefits e.g. car, medical insurance, accommodation.	✓	–	–	7(1)(b), 10(1)(b), 11, 12(1)	Cash equivalent (i.e. the taxable value).
Pensions					
Pay in lieu of pension	✓	–	–	7(1)(e)(i), 10(1)(e)(i)	Amount of payment.

Continued on next page »

Part E

CEO:UK employee pay ratios

Part E

CEO:UK employee pay ratios

Click here to return Part C, section 3.14

This Part of the Guide sets out the key issues to consider when preparing the CEO:UK employee pay ratios for disclosure in the implementation report. Companies required to make the disclosure should allow plenty of preparation time as they will need to gather and process data, decide on the methodology, analyse the resulting ratios and prepare explanations.

The pay ratio figures do not form part of the audited section of the implementation report. But it would be prudent to ensure that they are still verifiable.

This Part of the Guide does not look at the impact of the Covid-19 pandemic on the calculation and disclosure of the ratios. See the discussion on this in the Top Tips section.

1. What does the pay ratios disclosure table look like?

The table must be in the following format:

		Ratios		
Year	**Method**	**25th percentile pay ratio**	**Median pay ratio**	**75th percentile pay ratio**
[year]	[Specify method used: Option A, B or C]	(X/Y25:1)	(X/Y50:1)	(X/Y75:1)
[year]	[Specify method used: Option A, B or C]	(X/Y25:1)	(X/Y50:1)	(X/Y75:1)

Using this document – What these symbols mean:

An audited provision.

A provision implementing the EU's 'say on pay' regime (in the second Shareholder Rights Directive).

Click to see linked document, section or note.

A statutory, regulatory or investor guidance reference.

A main text search tool.

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This symbol indicates a footnote and can be clicked to reveal relevant footnotes.

Icons for footnote type:

Explanatory note.

Investor and other guidance.

Market practice.

Pay design.