The Investment Association Outlines Shareholder Expectations on Executive Pay in Light of Coronavirus (COVID-19)

30 April 2020

On 27 April 2020, following requests for guidance by remuneration committees of UK listed companies and their advisors, the Investment Association (“**IA**”) published **guidance** outlining the expectations of shareholders on executive pay in light of the coronavirus (COVID-19) pandemic.

The guidance builds upon commentary on executive pay considerations made in other recent IA publications in response to the economic climate brought on by the coronavirus (COVID-19) pandemic (including the **open letter to the chairs of FTSE 350 companies**), and reflects the broader focus by regulators and investor bodies on the importance of issuers maintaining robust corporate governance procedures at this time.

Key Governance Themes: Disclosure, Engagement and Burden Sharing

The key themes from regulators and investor bodies in response to the sudden economic downturn have been to guide issuers to be transparent and fulsome in disclosing the rationale for their decision-making and to participate in meaningful engagement with shareholders before such decisions are made. These themes were, for example, both central to the **Pre-Emption Group’s updated guidance on its Statement of Principles**, which, whilst allowing companies more flexibility to self-help with equity fundraising, sought to ensure issuers fully explained to the market the particular circumstances around the capital raise and consulted with major shareholders prior to launch.

Another key message to issuers has been that whilst the board and senior management cannot be held accountable for much of the disruption brought on by the coronavirus (COVID-19) pandemic, they should shoulder some of the burden alongside other stakeholders. The **International Corporate Governance Network’s open letter** to companies, regulators and stakeholders setting out governance priorities during the coronavirus (COVID-19) pandemic delivers this very message, stating that executive remuneration policies should reflect the experience of the overall workforce – particularly in relation to staff redundancies, furlough programmes, pay level reductions or bonus awards – and emphasises comprehensive communication with all stakeholders. All of the larger cashbox placings by UK listed companies in recent weeks have involved some participation from senior management directly subscribing for new shares, and the Pre-Emption Group has made it clear that options granted to directors and management should not be normalised to set-off the dilutive effect of a non-pre-emptive offering of up to 20% of the issuer’s existing shares. In addition, **existing IA guidance** is clear that it is not appropriate for UK listed companies to re-price or surrender and re-grant “underwater” share options or awards (for example, to take account of a drop in share price).

The IA Guidance

As with other recent guidance, the new IA guidance acknowledges the need for issuers and their remuneration committees to strike a balance between ensuring the continued incentivisation of executive performance in a time where management is required to demonstrate strong leadership and resilience, and ensuring that executive remuneration appropriately reflects the experience of shareholders, employees and other stakeholders.

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The guidance also recognises that the impact of coronavirus (COVID-19) will be different for individual companies and remuneration committees should take into account the specific circumstances of the company, particularly when considering the impact on the company's stakeholders.

The guidance considers the following topics:

1. Adjustment to bonus outcomes for FY 2019 following suspension or cancellation of a dividend in relation to FY 2019.

The boards and remuneration committees of UK listed companies are expected to consider how executive pay should reflect the suspension or cancellation of a dividend. For companies where the bonus outcome had already been determined (and potentially already paid) prior to cancellation of the dividend, the remuneration committee should consider the use of discretion or malus provisions to reduce any deferred shares related to the 2019 annual bonus by a corresponding amount. Alternatively, the suspended or cancelled dividend should be fully reflected in 2020 bonus outcomes.

2. Shareholder support for adjustment of performance conditions to take account of coronavirus (COVID-19).

There is no expectation to adjust performance conditions for annual bonuses or in-flight long-term incentive awards to account for the impact of the coronavirus (COVID-19) pandemic. However, if the remuneration committee considers that there is a gap between executive remuneration and the performance of the company, it should use its discretion to close this gap, and should ensure that there is engagement with shareholders and appropriate disclosure on such use of discretion.

3. Expectations in relation to ensuring a windfall gain will not be received by executives where a company has already granted 2020 LTIPs.

For companies that have already granted 2020 long-term incentive plans (i.e., those with December year ends), the guidance draws a distinction between those with longer-term share price underperformance and those where the fall in share price is solely related to coronavirus (COVID-19) market movements. In the case of the former, the expectation is that such underperformance is accounted for and an appropriate scaling back is applied. For the latter, the general expectation is that shareholders will accept that there does not need to be an adjustment to the grant size. However, the remuneration committee should ensure that windfall gains will not be received on vesting and use its discretion to reduce vesting outcomes where windfall gains have been received.

4. Expectations on long-term incentive grant sizes and performance conditions for LTIP grants expected to be made in the coming months.

The guidance highlights the importance to shareholders that remuneration committees consider the individual circumstances of the company and the impact of the coronavirus (COVID-19) pandemic on the company. There are particular concerns around the ability to set meaningful three-year targets at the current time, the appropriate grant size given recent share price movements and whether it would be more appropriate to postpone the current LTIP grant. Depending on the individual circumstances of the company, the guidance therefore suggests the following options:

- grant on the normal timeline and set performance conditions and grant size now;
- grant on the normal timeline and set the grant size now, but commit to set performance conditions within the next six months; or
- delay the grant (no later than six months from the usual date) to allow the committee to more fully assess the appropriate performance conditions and grant size. The performance period should remain three years following grant, but may be shortened by up to six months (depending on the explanation provided by the committee and adequate post-vesting holding provisions being in place) in which case grant sizes should be similarly reduced.

The remuneration committee should explain to shareholders the approach it is taking and should be clear what discretionary powers are available to it on vesting and commit to using them to ensure that outcomes will reflect company and executive performance as well as the experience of stakeholders.

5. Expectations where a company seeks additional capital from shareholders or requires government support.

As noted above, the broad expectation is that executive pay is aligned with the experience of the company, its employees and its other stakeholders. As such, remuneration outcomes should take into account where a company has sought to raise additional capital from shareholders, or has required government support such as furloughing employees. In addition, where companies are asking employees to take temporary salary reductions, it is expected that executives do so as well.

6. Expectations on proposals to change remuneration structures.

Many companies will be putting their three-year remuneration policy to shareholder vote at forthcoming AGMs. The guidance distinguishes between companies that have spent significant time consulting on new remuneration policies that will be subject to shareholder vote in the upcoming AGM season and those that are yet to consult on a new policy. Where extensive consultation has been undertaken, there is no expectation that such policies be rewritten (noting that, if companies are planning to propose variable pay increases in the current year, the appropriateness of such increases should be carefully considered). However, for companies that are yet to consult and have been significantly affected by the coronavirus (COVID-19) pandemic, the guidance notes it may be more appropriate to wait until there is greater clarity on the future market environment before bringing forward remuneration policies with substantial changes.

Conclusions

The IA's guidance asks remuneration committees to take a common sense approach to executive pay to ensure appropriate outcomes in light of the impact that the coronavirus (COVID-19) pandemic has had, and continues to have, on UK listed companies. Where discretion is used or changes are made to executive remuneration, companies should make sure that they engage with their shareholders and appropriately disclose such decision-making during this time, consistent with other advice published by investor bodies and regulators over the last few months.

Given the evolving impact of the pandemic, the IA notes that the guidance is likely to be updated as the situation evolves or new issues are identified. UK listed companies should also continue to refer to the IA's Principles of Remuneration for guidance on shareholder expectations and good practice.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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