FIT Remuneration Consultants

LGIM updated corporate governance policy

Legal & General Investment Management ("**LGIM**") has published an updated version of its 'Corporate Governance and Responsible Investment Policy' for UK companies. This new policy was last updated in September 2016 (see our previous briefing here) and we have set out below a summary of the most significant changes to the policy regarding executive pay.

The timing of release for the new policy (in late April), means that it is too late to have a significant impact on the 2018 AGM season for 31 December year-end companies. However, it will be a key resource for companies with AGMs taking place later in 2018 and 2019.

i) Gender diversity: For 2018, we expect FTSE 350 companies to have at least 25% women at board level.

As well as updating its corporate governance policy, LGIM has also written to the CEOs of the companies that it regularly engages with, to make it clear that it will vote against the re-election of any Board Chairman of a FTSE 350 company if the level of women on the Board is below 25%. This appears to have been part of a coordinated initiative by some investors, as on the same day that LGIM wrote to CEOs, the Investment Association and the Hampton-Alexander Review also wrote to 35 FTSE 350 companies regarding their low proportions of women at leadership level.

It is also worth noting that this target will increase to women making up 30% of the Board by the end of 2020 (for all FTSE 350 companies). For a Board with 8 directors in total, that means that at least 3 would need to be women (whereas 2 would suffice to meet the current 25% target).

Whilst this is not a matter that directly affects executive pay, it is an important issue that will influence the composition of FTSE 350 Boards and how director recruitment is approached in the future.

ii) Gender pay gap: We expect all companies to disclose a breakdown of board directors, executive directors, managers and employees by geography, main skill set and gender, along with the information on its gender pay gap and what initiatives it has in place and action it is taking in order to close any stated gap.

Gender pay gap reporting has been high on the agenda of most Boards during the last year. It is unclear whether LGIM expects gender pay gap reporting to form part of a company's annual report and accounts (or as a stand-alone report). In our experience most companies are not including the full gender pay gap report in their annual report.

iii) Shareholder dissent: A large voting opposition (>20%) to remuneration proposals should not be ignored. The Remuneration Committee should publish an explanation for the dissent including what the board is doing to address concerns and a copy of this should be sent to the Investment Association.

This statement reflects the new requirements introduced by the Investment Association in October 2017 (see our previous briefing here). However, it also appears that LGIM have removed the previous suggestion (included in the 2016 LGIM policy) that a company should re-tender its remuneration consultant contract in the event of a significant vote against.

iv) Pay ratio: All companies should produce a pay ratio of their UK employees, comparing the median employee with the CEO's single figure total pay. Global companies should also explain how this compares with the ratio when all employees are taken into account.

The 2016 LGIM policy also included a reference to the importance of the pay ratio between the CEO and median employee. The updated 2018 LGIM policy says that the comparison should be to a median UK employee. The current published UK government proposals are for the ratio to be between the CEO and an average UK employee (see our previous briefing here).

The secondary legislation implementing pay ratio analysis is yet to be published, but clearly the methodology for comparison will need to be developed to ensure consistency of disclosures.

We note that LGIM also suggests that global companies should explain the ratio if all employees (i.e. including those employees outside the UK) are included.

v) Restricted share schemes still require justification and when considering the appropriate discount rate LGIM consider 50% to be the "absolute minimum" with historic vesting rates also operating as a useful guide.

Following the recent success of Weir in gaining investor approval for a restricted share scheme, we anticipate that other companies will be exploring the possibility of introducing similar schemes.

Most of the LGIM commentary regarding restricted share schemes remains the same as set out in their 2016 policy. The significant change to note is that when LGIM is considering if a proposed discount rate is appropriate, LGIM will also consider historic vesting rates.

This suggests that LGIM will look beyond the simple mathematics and consider context. For example, why would a company with high LTIP vesting move to restricted stock? Is it calling the top of the market? Similarly, would a history of nil LTIP vesting prove the rationale for not being able to set meaningful performance targets?

vi) Re-location expenses should mirror what is being offered to employees (and any additional benefit should be limited to 2 years).

The updated LGIM policy reflects the position taken by other investor bodies, like the Investment Association and ISS, that re-location benefits should be time limited. It also goes further in that it advocates for those benefits to be brought in line with what is being offered to employees generally. This is similar to the position that investors have reached in recent years regarding pension contributions, i.e. they should be offered to directors on the same basis as to other employees.

vii) Earnings per share metrics used in incentive plans should be adjusted to strip out any enhancement that has resulted from buy back activity.

The 2016 LGIM policy made a general observation that performance targets could be adjusted for capital changes such as buy-backs. This comment in the 2018 policy is arguably more specific and prescriptive, in that it explicitly requires that the impact of share buy-backs are stripped out for the purpose of EPS performance measures.

This also reflects a concern of some investors (in both the UK and US) that executives are sometimes using share buy-backs to manipulate performance outcomes and therefore executive remuneration. Indeed, in January of this year the UK Government announced a review "*to understand how companies use share buybacks and whether any further action is needed to prevent them from being misused*". The results of the UK Government review are expected to be published later this year.

Whether valid or not, there is clearly a perception that share buyback can be used to 'game' EPS performance measures. However, we think that there is a risk that prescribed adjustments to EPS measures (albeit to address a perceived mischief) interfere with how companies manage their balance sheets.

For example, if EPS measures are adjusted to add back the shares repurchased by the company, how will the related cashflow impact of the buy-back also be taken into account? It doesn't seem right that it should be added back to earnings, but if not then there is no 'credit' for the fact that shareholders have received a return (and the company has foregone the opportunity to reinvest the funds in the business).

Consider a simple example; two companies have exactly the same earnings, issued share capital and EPS. Company A decides to carry out a buyback using surplus cash, but Company B decides to reinvest it within the business. If EPS is adjusted for the effect of a buy-back, both companies will have the same EPS. However, Company B will be at a comparative advantage for future EPS growth because it has reinvested in its business (whereas Company A has returned cash to shareholders).

The risk is that an adjustment to "strip out any enhancement" to EPS is potentially asymmetric and could create a disincentive for executives to return cash to investors.

The use of buy-backs is a complex issue that is driven by broader considerations that, we think, need to be considered in the round.

If you wish to discuss anything arising from this briefing, please ask your usual contact at FIT or call us on 020 7034 1111 or email us at Info@fit-rem.com.

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