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NEWSLETTER

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INCENTIVES BULLETIN

Financial Reporting Council research on remuneration reporting

FCA consultation on a new Remuneration Code

PIRC 2021 UK Shareholder Voting Guidelines

Rio Tinto's Directors' Remuneration Report

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Welcome to the May edition of our Incentives Bulletin, updating you on the latest developments in the field of executive remuneration and share plans. In this Bulletin, we look at the Financial Reporting Council's report on directors' remuneration reporting by listed companies, the FCA's consultation on a new remuneration code for Collective Portfolio Management Investment Firms, PIRC's 2021 UK Shareholder Voting Guidelines and the vote against Rio Tinto's Directors' Remuneration Report.

FINANCIAL REPORTING COUNCIL RESEARCH ON REMUNERATION REPORTING

The Financial Reporting Council ("FRC") has published new research (undertaken by a team of academics from the University of Portsmouth) on the impact of the 2018 iteration of the UK Corporate Governance Code (the "Code") on the directors' remuneration-related disclosures of FTSE 350 companies.

Overall, the FRC found that the new requirements introduced by the updated Code have had a positive impact on the extent of remuneration disclosure, with increased reporting on the measures companies had taken to engage with their shareholders, to align directors' remuneration with long-term shareholder interests and to comply with each of the specific Principles and Provisions of the Code. The report found a particular focus on the new requirement of the Code (in Provision 40) that a company's remuneration policy and practices should display the qualities of clarity, simplicity, proportionality and predictability, as well as being designed to mitigate the company's risk profile and to align to the company's culture.

However, the FRC noted that much of the disclosure was highly formulaic, with many remuneration reports borrowing wording from the Code verbatim and relying on 'boilerplate' explanations of the company's adherence to the Code. The FRC makes clear that it expects to see detailed, tailored explanations illustrating how companies have engaged with the Principles and Provisions of the Code.

The research found a significant increase between 2017 and 2019 in the number of FTSE 350 companies reporting links between remuneration and the company's environmental, social governance ("ESG") performance, indicating the increasing importance of ESG metrics in the determination of executive pay. However, the FRC also noted that many companies which used non-financial metrics in setting performance conditions failed to adequately explain why these were chosen or how they were formulated. We anticipate that, with the continued focus on companies' ESG performance, shareholders will demand further detail on the formulation of ESG metrics and evidence of their robust assessment by remuneration committees.

FCA CONSULTATION ON A NEW REMUNERATION CODE

The FCA has published a consultation paper on the new regulatory regime for firms authorised under the Markets in Financial Instruments Directive ("MiFID"). The proposals include a new regulatory framework on employee remuneration for all MiFID-authorised investment firms, bringing many investment firms within the scope of the FCA's Remuneration Codes for the first time.

The new remuneration code has three levels of requirements, with more onerous rules applying in respect of larger, more complex investment firms. Firms designated as 'Small and Non-Interconnected' ("SNI") firms will only be subject to basic remuneration requirements, including certain minimum standards for remuneration policy design, governance and oversight and a requirement not to award variable remuneration if it would endanger the firm's capital base. Larger 'Non-SNI' firms will be subject to more onerous remuneration requirements, including detailed rules on the remuneration of material risk takers ("MRTs"). These include the introduction and operation of malus and clawback arrangements in respect of MRTs' incentive awards and the remuneration committee's discretionary adjustment of bonus and long-term incentive outcomes where this is justified looking at the company's position as a whole. This will require remuneration committees tread a fine line to balance the requirements of the regulator and management interests. The largest non-SNI companies will also be required to defer a proportion of MRTs' variable pay into shares (or equivalent instruments) for at least three years. Firms will however be relieved that the FCA has not proposed a 'bonus cap' in contrast to the Capital Requirements Directive ("CRD") regime applicable to the major banks and building societies.

The draft code is expected to be finalised later this year and the FCA has stated that firms will need to apply the new rules from the start of their next performance year beginning on or after 1 January 2022. MiFID-authorised investment firms should therefore take steps to prepare for the new remuneration code coming into effect. The experience of CRD remuneration requirements may provide a useful roadmap for MiFID-authorised firms approaching remuneration regulation for the first time. In particular, we anticipate that the FCA will focus on ensuring that remuneration outcomes are properly risk-adjusted, requiring remuneration committees to act robustly in exercising discretions available to them. Remuneration committees should also ensure that variable remuneration awards are subject to malus and clawback arrangements which are contractually enforceable and contain appropriate trigger events.

PIRC 2021 UK SHAREHOLDER VOTING GUIDELINES

PIRC has published its UK 2021 Shareholder Voting Guidelines (the "Guidelines"). The remuneration aspects of the Guidelines focus on the perceived costs and complexities of executives' variable remuneration. In particular, PIRC calls for companies to stop operating LTIPs, all executive directors' service contracts to be subject to shareholder approval, the adoption of a 'single profit pool' to be distributed across the wider workforce, and bonuses only to be awarded in recognition of exceptional performance.

While the Guidelines are further evidence of the heightened level of scrutiny on executive remuneration seen in the 2021 AGM season, they are likely to have limited influence on wider investor behaviour and expectations. PIRC's stated policy objectives have for some time differed markedly from market practice. In particular, the call for the abolition of LTIPs appears unlikely to gain traction, given investors' continued focus on long-term shareholder value over short-term outcomes in any single financial year.

RIO TINTO'S DIRECTORS' REMUNERATION REPORT

Shareholders of Rio Tinto plc have recently rejected the company's 2020 Directors' Remuneration Report at its 2021 AGM. Statements from prominent institutional investor bodies indicate that the vote was primarily driven by opposition to the perceived generosity of remuneration outcomes for executive directors following the controversial destruction of Aboriginal rock shelters at Juukan Gorge in Western Australia. The vote therefore appears to be further evidence of the growing importance of ESG performance to shareholders. It emphasises the need for remuneration committees to ensure that ESG is adequately reflected in performance conditions for annual bonuses and LTIPs, and that plan rules provide sufficient flexibility to adjust formulaic outcomes. Remuneration committees should also ensure that incentive

arrangements have appropriate malus and clawback provisions to recover value in the event of serious reputational damage to the company.

If you would like to discuss any of the issues referred to in this briefing please contact one of the individuals listed below or your usual Slaughter and May contact.

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