SLAUGHTER AND MAY

Slaughter and May Podcast
The impact of COVID-19 on Executive Remuneration

Gillian Fairfield	Hello my name is Gillian Fairfield and I am joined on this podcast by my colleague Ian Brown, where we will be focusing on all things to do with remuneration in the current COVID crisis. Ian, I think that it's fair to say that furloughing staff has if anything increased the focus on executive pay, which was pretty high in any event. What have we seen in the market on this generally?
Ian Brown	It's certainly true that furloughing staff and the consequent reductions in peoples' wages is going to sharpen the focus on what's going on in the boardroom. In response to that, what we've seen is a number of boards either defer or waive some part of their fixed or variable remuneration. Now, where a company has been furloughing employees, most commonly directors have taken a 20% pay cut to align with the 20% pay reduction that has been borne by employees under the government's job retention scheme. Now, some companies in the transport sector have gone further than that, some companies have gone less, and there's no absolute cut-out-and-keep approach. What each company is trying to do is weigh up a couple of factors, retain and motivate employees through some pretty exceptional times, keep shareholders and other stakeholders onside, and of course ensure that the business is in a good place and crucially has enough cash to come out the other side.
Gillian Fairfield	Yeh, I mean it's a tough balancing act to do isn't it, because you are almost talking about doing a balancing act between on the one hand incentivising top management during what are unprecedented challenging times I would say, but at the same time needing to ensure that executive pay doesn't stray out of kilter *vis à vis* other shareholders. Now I know that the IA have put out guidance recently which actually was in response to demands from remuneration committees, and their guidance set out what they believe shareholders expect to see with regards exec remuneration during COVID. Can we start with dividends, so where companies have cancelled or slashed or deferred their dividend, what's the expectation as regards executive pay and those situations where shareholders are clearly not seeing the returns that they would otherwise be getting?
Ian Brown	Well, there's no blanket ban on bonuses from the IA in any event. What the IA is very clear about is that companies should consider their own circumstances and its very much a case by case judgement, but the headline is that where the company has taken what I call other people's money, whether that be through pay reductions of employees, through the coronavirus job retention scheme or from shareholders through a rights issue, then shareholders expect to see that reflected in executive pay decisions as well.

Gillian Fairfield	Um, but what about performance conditions for annual bonuses, now inevitably the IA uses the term 'discretion' – I mean, is the expectation here there that there is discretion but that it should always be exercised downwards?
Ian Brown	Well, shareholders are always going to want the direction of travel to be one way, but it doesn't have to be the case. Conceptually, a discretion that's properly framed and drafted could be used to alter outcomes in either direction to deliver the "right result". I'd say there are two absolutely key points to bear in mind, firstly, I think shareholders are going to be initially nervous about upwards adjustment so companies need to be very sure of their rationale for an upwards adjustment and be prepared to justify that approach in public, and secondly, whichever way discretion is applied up or down, it's going to run the risk of legal challenge, either by shareholders or by management. So RemCos really need to be careful that they have the full picture in front of them before making any substantive decision.
Gillian Fairfield	Yeh, well RemCos as ever they have a tough job ahead of them, but isn't it also the case that depressed share prices could actually mean that some execs get an absolute windfall where 20/20 LTIPs have already been granted. I mean what do you think Remcos should be doing in response to that issue?
Ian Brown	Well I mean, that's actually been a major concern of a number of RemCos that we've been talking to but I think there are ways to address that. You will recall that when the UK Corporate Governance Code was revised back in 2018, the new Code introduced a new requirement to introduce a discretion in the plan rules that allowed RemCos to override the formulaic outcome of long term incentive awards. So committees will commonly have the discretion to tweak the vesting level where there have been supposed windfall gains and we have seen a number of companies explicitly refer to that discretion in the stock market announcement that they've put out when they announce the awards to shareholders. Now again, you've got the same issues with the legal challenges to discretion, so it's good practice I think to have a solid audit trail that the exercise of that discretion was countenanced right at the outside when the awards were first being considered.
Gillian Fairfield	But also, I mean I think it's too easy in the current circumstances to assume that everybody who is suffering share price underperformance would attribute it to COVID, but presumably there are still companies who partially would be able to attribute a share price fall to COVID but there are other factors as well. Does that make a difference?
Ian Brown	Absolutely. We've actually been back to the IA to discuss that and they are quite relaxed about share prices which have solely been affected by COVID. Their real concern is where the share price instead reflects some other form of share price underperformance for which management might be considered to bear responsibility.
Gillian Fairfield	Yeh, that makes sense, absolutely. An awful lot of companies are due to be refreshing their policy at the moment, but do you think it's fair to say, I mean does COVID make it too difficult to set meaningful three year targets, and if companies

	are in that position, what should they do? I mean how is this going to affect, for example, performance conditions?
Ian Brown	I think to a certain extent that depends on what performance conditions you're talking about. For example, if you are looking at a relative total shareholder or return metric, you could make an argument that it is by its nature self-adjusting. Where you have financial targets, I appreciate there is going to be more uncertainty. That said, most companies in my experience are continuing to make awards. That's because they either feel that the long term targets against which performance will be judged will be assessing performance in 2022 and 2023, when hopefully things look a bit more normal, or because they feel they have the ability to get the "right" answer on vesting either because of the formulaic override discretion that we have been talking about, or because of the ability to adjust the conditions post-grant, using terms that are commonly found in long term incentive plans to address exceptional circumstances, like the times we are living through now. Of course another way round the problem is to completely revisit the idea of the long term incentive plan. Over the last couple of years we've seen a number of companies, including FTSE100 companies move away from the standard performance share plan model where awards vest subject to 3 year performance targets as you say, to more of a restricted share plan model where the receipt of the shares is subject to the directors ongoing service and some lighter touch performance underpins.
Gillian Fairfield	Ok well that's interesting I mean in terms of, one of the other things I think we've seen is the notion of shares for employees who have sacrificed salaries, you know whether that's because of furloughing, meaning that they're only getting 80% of their salary or otherwise. I think we've seen a number of other companies do this, can you tell me more about that?
Ian Brown	Yeh, it's something that a number of our clients have looked at. The idea in essence is where an individual has voluntarily taken a pay cut, they receive in lieu of that, a share award or number of shares equal to the value of that pay reduction, and these shares are newly issued so they give the company the ability to deliver value to employees with no effective cash cost to itself, which is evidently an interesting proposition to a company which is in distress so far as cash is concerned.
Gillian Fairfield	That's clearly attractive in the currently circumstances isn't it. If we are talking about employees who have sacrificed salary, of course if they were getting cash they would just get it outright, I mean is it the case that the shares are being issued outright? Or do you think we should expect them to fall under usual fair scheme rules of good leaver and bad leaver?
Ian Brown	It's basically a commercial call. You can do it either way. Some of our clients who've been looking at this have operated under employee share plans that they already have in place. Now that has the advantage of it being a relatively straightforward approach because they have all the structures in place. Now the challenge to using an employee share plan is that commonly those plans will have

	good and bad leaver events, which mean that an individual who leaves doesn't receive the value of the shares, because they haven't fulfilled the necessary service requirement but our clients have actually seen that as something of any advantage, in that it adds a retentive element into the structure. There is no getting away from the fact that if you have a share award that is subject to ongoing service conditions then it is not absolutely on all fours with receiving additional salary.
Gillian Fairfield	No, but it's a useful method of retaining people and motivating them to stay at a time when otherwise companies are facing tough circumstances.
Ian Brown	Absolutely. But if companies are minded to move away from using one of their existing share plans, or they don't have a share plan which they can use off the shelf as it were, then it is still possible to deliver those new issue shares using the company's standard disapplication from pre-emption rights authority that the company will normally have sought approval for at the last AGM.
Gillian Fairfield	Yeh so a straightforward issue is possible then, it doesn't need to be done under a share scheme.
Ian Brown	Absolutely not.
Gillian Fairfield	Thanks Ian, I think that's all we wanted to cover today. So thank you for listening and if you've got any questions, please don't hesitate to contact your usual Slaughter and May contact.