UK Executive Pay & Governance

New ISS and Glass Lewis Voting Guidelines for 2019 AGMs

November 2018

Introduction

On 19 November ISS published details of the updates it is making to its UK & Ireland voting guidelines for 2019. The full version of the updated guidelines will be published in December and will apply to AGMs taking place on or after 1 February 2019.

The changes are limited and in most cases should not require any action from companies.

Remuneration

- Following on from a key theme of ISS reports during the 2018 AGM season, the new guidelines increase the level of focus on the detail of annual bonus schemes. ISS states that **target bonuses should be set no higher than 50% of the maximum bonus potential**. Anything above this level requires a “sufficiently robust explanation.”
- In line with the 2018 UK Corporate Governance Code, the new guidelines make it clear that **long-term share awards should be subject to a total vesting and holding period of five years or more**. The guidelines also now include a reference to the post-employment shareholding requirements recommended by the Code.
- ISS has made explicit its position that **where there has been a material fall in the share price, the remuneration committee should consider a reduction in the size of the next LTIP grant**. This reflects concerns that a grant at normal levels (as a percentage of salary) following a large share price fall results in an award over a much higher number of shares than the previous year. The excessive leverage means that the executive stands to reap windfall gains in the event of a significant price recovery.
- A new provision has been added to the effect that **fees payable to non-executive directors should not be excessive relative to similarly-sized companies in the same sector**.
- The guidelines now make it clear that the standard Investment Association (IA) dilution limits are the ones which should be incorporated into LTIP rules.

Other changes

- From 2019, **ISS may recommend a vote against a director where “egregious actions” have been identified relating to the director’s service on other boards “that raise substantial doubt about that individual’s ability to effectively oversee management and to serve the best interests of shareholders at any company.”** This is intended to align ISS’ UK & Ireland policy with the approach taken in other markets.
- ISS may recommend a vote against the reappointment of the external auditors if the lead audit partner has been linked with a significant auditing controversy at another company.
- There will be greater scope for ISS to recommend against share issuance authorities in circumstances where companies are deemed not to have followed the Pre-Emption Group guidelines in issuing new shares for cash.
- **ISS will consider the disclosures that AIM companies are now required to provide on the extent of their compliance with a recognised corporate governance code**. (This follows a change to the AIM Rules which came into effect in September.) Poor or no disclosure will be taken into account in the ISS recommendation on the resolution to approve the annual report and accounts.

P4P

Separate to the proposed policy changes, the window for companies to submit a peer group for consideration in ISS' quantitative Pay for Performance (P4P) model is open until 7 December. This group should reflect the companies used for setting pay for the current financial year, and will be taken into account by ISS when constructing the P4P peer group to be used ahead of the 2019 AGM. We believe that relatively few companies submit their own peer groups to ISS each year.

Glass Lewis

Glass Lewis, the second largest proxy adviser after ISS, has also recently published updated voting guidelines for 2019. Again, the changes are minimal.

- Glass Lewis continues to encourage the disclosure of the ratio of pay between the CEO and the average UK employee. However, it has made it clear that **for 2019 the ratio will not have a particular influence on its vote recommendations**.
- **The link between executive pay and company performance will be assessed by considering realised pay over a period of at least three years**.
- Glass Lewis may recommend a vote against the chair and members of the relevant committee in cases where there has been a failure to adequately address shareholder dissent. The question of what constitutes an adequate response will be the subject of a qualitative judgement.
- Gender pay gap data and the composition of the executive pipeline will be considered when assessing diversity concerns at the board level of FTSE 350 companies.

Our View

- The changes announced by both ISS and Glass Lewis do not represent a major step change in approach for either organisation. Crucially, it is clear that neither proxy adviser is demanding that companies report in 2019 against the new legislative and regulatory provisions which will require updated disclosures from 2020 onwards. Companies will need to wait until this time next year to discover precisely how the proxy advisers will address the new requirements once reporting is mandatory. Many investors will take a similar approach, although we are aware that one large institution (Legal & General Investment Management) will shortly update its own guidance and will be more explicit on its expectations under the new regime.
- Glass Lewis is clear that CEO pay ratio information, while helpful, will not impact its vote recommendations in 2019, and our discussions with ISS have indicated that it takes a similar view. While both proxy advisers will report the CEO pay ratio if it is available, they will not undertake their own calculations in the absence of company disclosures. Our expectation is that, while some companies will publish a ratio in 2019, others will wait until 2020 and instead spend the next year developing their accompanying narrative and monitoring the reaction to those companies which publish early.
- Although ISS makes reference to post-employment shareholding requirements in its updated guidelines, there is no insistence that companies adopt them in 2019. However, investors which have been calling for these provisions for some time may have higher expectations, and as such we recommend that those companies renewing their remuneration policies in 2019 consider introducing them. In any event, it is likely that ISS is paving the way for a stronger approach from 2020.
- The one area where ISS is getting tougher relates to LTIPs. A five-year timeframe between grant and release is now expected, which mirrors the new Code. The view from ISS is that this has been viewed as best practice by investors for a number of years and is now prevalent across the UK market. Companies which are renewing their remuneration policies in 2019 need to be aware that the lack of a post-vesting holding period could lead to ISS opposition (particularly if other issues have been identified).
- Although ISS has stated that it will not view the issue "mechanistically", annual bonus plans will need to be reviewed where the payout at target is greater than 50% of the maximum opportunity. As a minimum, a good explanation for such a structure will need to be provided. When assessing this issue, ISS will consider factors such as overall quantum, historic pay-for-performance alignment and past remuneration committee behaviour.
- The new reference in the ISS guidelines to NED pay suggests that this area is in line for greater scrutiny. Companies will need to have a good understanding of where their NED fees sit against relevant size and sector benchmarks and be able to justify the positioning if it is significantly above-market.
- Our understanding is that for 2019 there will be no change in the way in which the P4P model outcomes impact upon ISS vote recommendations. This should mean that, for most companies, the P4P results are divorced from the recommendations. However, we have observed a handful of instances over the last year or so where a "high concern" P4P result has been used to bolster the case for an ISS recommendation against the remuneration report. We expect this to continue.

Want to know more?

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