Institutional Shareholder Services (“ISS”) is pleased to have the opportunity to provide our views on what progress is considered to have been made in implementing the recommendations on executive pay by the previous Committee in its 2017 report on Corporate Governance.

ISS is a leading provider of corporate governance and responsible investment solutions to the global financial community, including corporate governance research and voting recommendations for institutional investors (also referred to as voting advisory or proxy advisory services). More than 1,700 institutional clients globally use ISS’ expertise in providing background research and voting recommendations to help them make more informed voting decisions. In the UK, ISS operates through its wholly-owned subsidiary, Institutional Shareholder Services (Europe) Limited, and has offices in London, Brussels, Paris, Berlin, Stockholm and Zurich.

Our comments below reflect our views in our capacity as a voting advisor, research and data provider and thought leader in the area of corporate governance, and not necessarily those of our clients.

- What progress has been made on implementing the recommendations on executive pay by the previous Committee in its 2017 report on Corporate Governance?

Long term incentives

Some progress has been made with the obvious point of reference being the FRC’s consultation on its proposed changes to the UK Corporate Governance Code. A key recommendation from the previous committee is that the “FRC consults with stakeholders with a view to amending the Code to establish deferred stock rather than LTIPs as best practice in terms of incentivising long-term decision making, including a simpler structure based primarily on salary plus long-term equity, to divest over a genuinely “long-term” period, normally at least five years, without large steps.”

Whilst the proposed wording in the revised Code does not discourage LTIPs, it does state that “Remuneration schemes should promote long-term shareholdings by executive directors that support alignment with long-term shareholder interests...and...In normal circumstances, shares granted or other forms of long-term incentives should be subject to a vesting and holding period of at least five years. Longer periods, including post-employment periods, may be appropriate.”. Importantly, the FRC consultation has asked respondents to suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance.

We are keenly awaiting for the new Code to be published and in the meantime, we have seen a handful of companies consulting shareholders and voting advisory firms such as ISS, on deferred stock schemes (also referred to as restricted shares schemes). In fact, The Weir Group plc, a large FTSE 250 company, obtained a high level of shareholder approval (92+%) at its 2018 AGM to introduce a restricted shares scheme. As well as including the features expected (by many shareholders) to mitigate for the reduced emphasis on performance targets and therefore the increased certainty of pay (such as a 50% reduction of awards compared to previous LTIP levels, a strong underpin and long holding periods), the Weir Group Remuneration committee made a strong and ultimately convincing case to shareholders as to why a traditional LTIP model was not appropriate for its business. It is too soon to know whether many
other companies will follow suit, and whether shareholders are going to support the introduction of further restricted share schemes if the companies don’t make a strong company-specific case for them (in addition to the more generic benefits they can bring such as simplicity, transparency and reduced quantum in face value). We would also point out that there is still some scepticism amongst investors about these types of awards as there is a risk of reward for failure i.e. the company underperforms, yet management could still walk away from the business with the shares (which is unlikely to be the case for LTIP awards because the performance targets would probably have not been met).

The ISS perception is that the vesting outcomes (and the assessment) of traditional LTIPs in UK companies is not the biggest issue with executive remuneration as vesting outcomes are, in general, seen as a fair reflection of performance, and assessing the relevant information such as performance targets is usually fairly straight-forward based on company disclosures.

**Bonuses**

In our view, annual bonus awards continue to be a larger area of concern than LTIPs, whether this be due to a lack of disclosure of performance targets (particularly for personal or strategic objectives – see below), too many metrics to assess, the complexity of the schemes, or the view that the relevant bonus outcomes are simply too generous for the performance achieved. As such, it is not evident to us that there has been meaningful progress on the previous committee’s recommendation that companies make it their policy to align bonuses with broader corporate responsibilities and company objectives and take steps to ensure that they are genuinely stretching. Annual bonus opportunity remains a significant part of remuneration arrangements, often the same percentage of salary opportunity as the LTIP, and generally resulting in higher outcomes. The Final Report of the Executive Remuneration Working Group (July 2016) stated that "There is often a suspicion regarding bonus payments which, in the past 10 years for FTSE 100 companies, have regularly paid out between 70%-80% of the maximum opportunity. There is concern that at least a proportion of annual bonuses are used to “top up” salary payments and are seeing as part of fixed pay, with a portion of annual bonus which pays out if performance is only satisfactory. Annual bonus targets are often set against budget or consensus levels which can lead to certainty in bonus outcomes." ISS would agree with this concern. As the chart below shows, on average bonuses are consistently above 100 percent of salary.
As such, it is far less clear that annual bonus awards are subject to stretching targets and strong performance, compared to LTIP awards. So far in 2018, there have already been a number of large dissent votes on company remuneration arrangements, and many of which appear to be linked to bonus outcomes. This is another indication of the lack of progress on this recommendation.

**Pay ratios and salary increases**

On the recommendation that the “FRC works with other relevant stakeholders on the detail and amends the Code to require the publication of pay ratios between the CEO and both senior executives and all UK employees”, we note and have been pleased to see that some companies have voluntarily disclosed pay ratios before the Government has introduced the requirement to do so. These disclosures should provide useful context for shareholders in engagement with companies on executive pay and company culture. However, it will be more meaningful for investors once all UK companies are providing the information, under a consistent methodology, and even more so when it is possible to assess them over multiple years.

We would highlight that many executives continue to receive salary increases each year that are in line with the average employee increase at the company concerned. Whilst these do not change the pay ratio, many companies don’t appear to take account of how this impacts the value of overall executive pay, especially where salaries and variable pay opportunity is already competitively positioned. For example, a 3% increase to an executive’s £1m salary is more than what many employees earn a year. Further, a £30,000 increase in salary could be worth multiple times more as typically, many other elements of an executive’s pay / pay opportunity are determined as a percentage of salary. i.e. If executive directors are able to earn 400% of salary in bonus and LTIP awards, the increase could result in another £120,000 to total pay.

**Employee representation**
We have noted that a few UK companies (e.g. Mears Group and Weir Group) have already made arrangements to formally represent the views of their employees on their Boards, prior to the publication of the revised UK Corporate Governance Code which is likely to include the three options suggested in the Government’s Green Paper Consultation on Corporate Governance Reform, in order to ensure better representation of employee views. In the case of The Weir Group, a Non-Executive Director (NED) who was already on the Board has been appointed an Employee Engagement Non-Executive Director. For Mears Group, an employee has been appointed to the Board as a NED (an 'Employee Director').

**Remuneration Committee Chair**

To respond to the Government’s paper, Provision 32 of the revised UK Code includes a requirement that the remuneration committee chair will have served for at least twelve months as a member on any remuneration committee before taking on this role. Our experience is that this is generally the case already but will be of greater focus once the revised Code is published.

- What improvements have been made to reporting on executive pay in the last 12 months?

Generally, UK company disclosures on executive pay have for some time been sufficiently detailed, which is largely as a result of established regulations, guidance and positive engagement between companies and shareholders. In fact, UK company disclosures on executive pay are considered by many to be world leading. There is of course room for further improvement: some companies use boilerplate disclosures and do not sufficiently explain how their executives’ remuneration is linked to company strategy, and it is not clear in some disclosures if pay increases have been driven by anything other than benchmarking exercises. Over 2017 and 2018 to date, we have observed some improvements in bonus disclosures: most FTSE AllShare companies now report fully on the financial performance targets that determined bonus awards for the year under review - there is also generally sufficient detail in respect of performance against those targets and the resulting outcomes. However, disclosures around non-financial targets such as personal objectives and the achievement of such are generally quite vague which can be problematic when a remuneration committee has deemed these to be largely achieved, especially when the financial targets have not been met. Where the disclosure of personal performance conditions highlight that these are not largely different from what may be expected of an executive as part of their normal day-to-day role - for example, conducting investor roadshows; attending board and executive meetings; ensuring a motivated workforce - this further increases scepticism over the robustness of bonus frameworks.

- What steps have been taken by Remuneration Committees and institutional investors to combat excessive executive pay in the last 12 months.

This is a question best answered by Remuneration Committees and institutional investors, but we have observed numerous examples where prudent decisions have been made to reduce pay quantum, whether in performance-related opportunity or in using discretion to scale back awards that have met the relevant performance targets. Most UK FTSE 350 companies now have most of the best practice features in their pay structures such as malus and clawback, and deferral of bonuses and/or vested LTIP awards - although these will not generally lead to a reduction in executive pay. So far in 2018, there have already been a few large dissent votes on company remuneration arrangements and even on re-
elections of remuneration committee chairs. It would appear that many institutional investors are becoming less tolerant on pay quantum issues, and not just at the outlier companies that haven’t performed well enough to be seen to justify the pay outcomes, but also those that may have performed strongly, but where the outcomes are still considered excessive. The table below highlights this issue in respect of remuneration reports voted in 2017.

<table>
<thead>
<tr>
<th></th>
<th>Average Total Pay 2017</th>
<th>Average Level of Support% for Remuneration Report 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 5 Highest Paid UK</td>
<td>24,821,156.54</td>
<td>78.1%</td>
</tr>
<tr>
<td>Top 10 Highest Paid UK</td>
<td>16,295,806.57</td>
<td>84.1%</td>
</tr>
<tr>
<td>Top 20 Highest UK</td>
<td>10,706,798.45</td>
<td>88.1%</td>
</tr>
<tr>
<td>Median UK</td>
<td>1,572,144.00</td>
<td>93.1%</td>
</tr>
</tbody>
</table>

- What further measures should be considered?

If there is an increase in companies adopting restricted share schemes, we consider it would be helpful to look at the single figure methodology again. As most restricted shares schemes are likely to be subject to an underpin, these would not be deemed to have vested until after the assessment of that underpin has been made at the end of the performance / holding period. As such, the value of the shares will only be included in the single figure table at that time. Some may question whether this is the appropriate decision as they are effectively free shares and could be disclosed in the first year they are granted (and a restatement to be made if they are scaled back due to the underpin).

We hope that you will find our comments useful, and we are available if you would like to discuss anything in further detail.

Nathan Leclercq  
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25 May 2018