

Our principles on executive compensation: North America



The scrutiny on executive pay in North America is increasing year on year. In this note, we outline our stance on the issue.

Introduction

Studies conducted by Morgan Stanley¹ provide evidence of a link between failed say on pay votes and a company's share price as it relates to underperformance against the S&P 500 over the next 12 months. A study carried out in 2020 showed that companies with failed say on pay votes in 2019 underperformed the market over the next 12 months by an average of 20%. While two-thirds of these companies underperformed by 34%. Morgan Stanley has been carrying out this study since 2015, and evidence indicates that over that five year period, companies with failed say on pay votes underperformed the S&P 500 by an average of 15%.

As a long-term investor in North American companies, we believe that boards can no longer ignore the views of their investor base when setting executive pay. Although we believe that management should be rewarded for delivering a strategy that is sustainable, profitable and creates value to both its long-term shareholders and society, the quantum of total pay coupled with poor alignment with performance is leaving an increasing number of companies open to criticism, reputational damage and underperformance.

There are several aspects of governance that are important to demonstrate a well-governed and functioning board. We have been engaging with companies in North America to improve issues such as tenure, diversity, to disband combined chief executive officer/chairman seats and matters pertaining to climate change. Even though scrutiny on executive pay continues to grow, we have seen little changes to policies and practices to acknowledge this growing concern from shareholders.

We have examined the key reasons for our historic votes against pay resolutions at North American companies and this has led us to produce this stand-alone document to help North American compensation committees better understand the evolving views on executive pay from a long-term shareholder perspective.

We hope that you will find the guidance helpful when setting executive pay practices at your company.



We have a responsibility to our clients and society to ensure the companies in which their funds are invested provide sustainable long-term value for shareholders and society.

1. Say-on-Pay 2020: Raising the Red Flag, Morgan Stanley, 6 May, 2020



Compensation committee

We believe that a compensation committee should comprise entirely of independent directors. Non-independent long tenured directors should only attend meetings by invitation as they can be a source of valuable information to the committee's deliberations.

The committee should be mindful of the pay practices adopted across the organisation, its country of listing and if different where a majority of their workforce is based. The committee should consider these practices when formulating the pay policy for executive directors without over reliance on the advice of executive compensation consultants. The committee should question management on workforce pay policies if they consider them to lack alignment, be poorly structured or could be improved in some way. We expect all companies in which we invest to pay their employees at or above the living wage.²

Where a committee does use a compensation consultant, the committee should ensure that they are independent from the company and its executives, e.g. they are not used to provide other services to the company or executive. Compensation consultants should be encouraged to engage with key investors and important organisations to stay abreast of evolving best practice.

Peer groups should be selected carefully and be linked to the area of business the company operates in or a wider benchmark that is logical. We would expect the committee to explain any benchmark they use.

² The minimum income necessary for a worker to meet their basic needs. Needs are defined to include food, housing, and other essential needs such as clothing. The goal of a living wage is to allow a worker to afford a basic but decent standard of living through employment without government subsidies. It is therefore higher than the minimum wage set by US labor laws.

Our principles

We apply a simple set of pay principles while looking at remuneration structures

Structure The compensation structure and the payments awarded should be fair, balanced and understandable. This means: fair in terms of what the company has achieved; balanced in terms of total pay to the executive when compared with employees and the shareholder experience; and understandable for the recipient, the board and its shareholders.

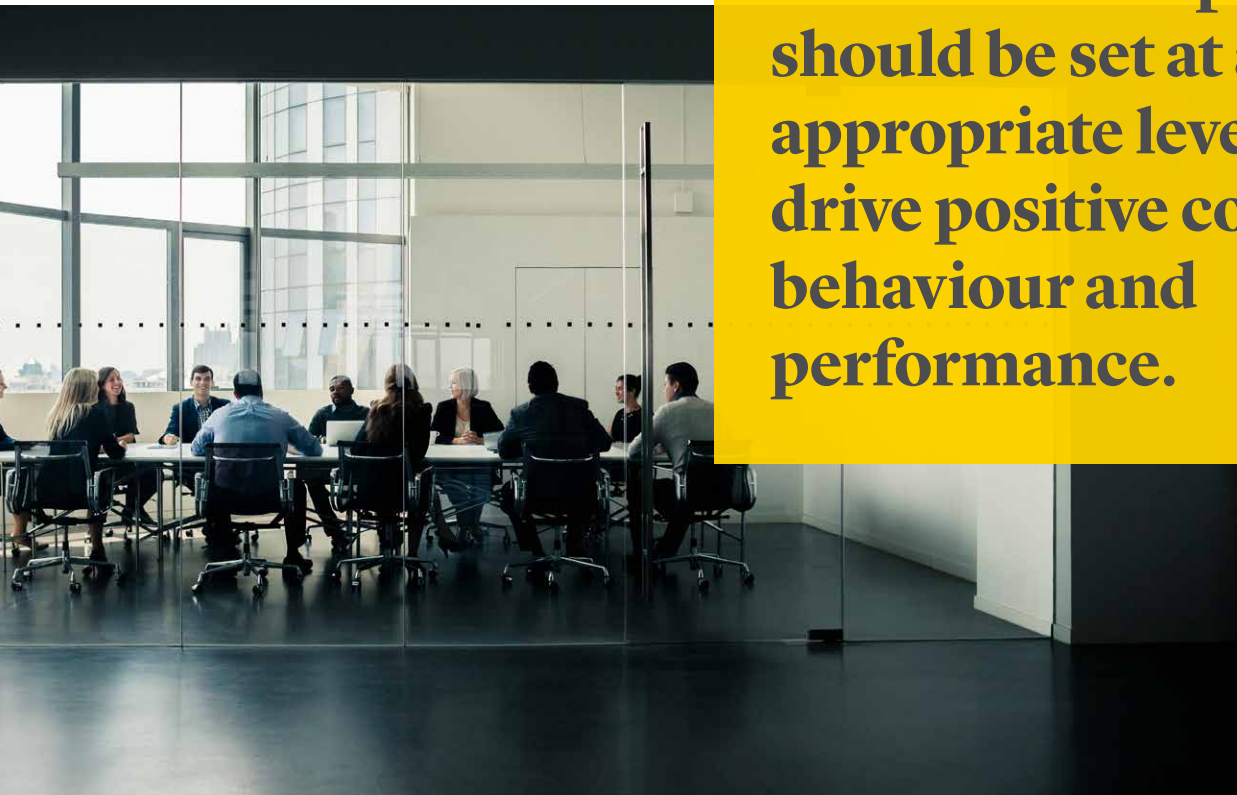
Awards Awards should promote long-term decision making and be aligned to and support the company's values and achievement of business strategy.

Transparency We expect a full explanation as to why compensation was set for that year. Why rewards were delivered, targets that were set and their relevance to meeting long-term goals, which targets were met and fully justify all adjustments made to accounting measures for remuneration purposes.

Shareholder alignment Executives should have a meaningful direct equity holding while employed and thereafter; buying shares is one of the best ways of aligning management and shareholders.

Discretion Boards should retain ultimate flexibility to apply discretion and 'sense-check' the final payments to ensure that they align with the underlying long-term performance of the business.





Executive compensation should be set at an appropriate level to drive positive corporate behaviour and performance.

Quantum

As the executive compensation landscape continues to evolve to meet the needs of modern corporations, companies must consider the current social sensitivities around pay inequality.

We entrust the current board to ensure that executive compensation is set at an appropriate level to drive positive corporate behaviour and performance. In doing so, the board should consider the wider impact of executive compensation on its stakeholders e.g. the general workforce, public perception, the economic climate. Too many companies simply take compensation benchmark data from their compensation consultants and increase pay without thinking about the wider impact or whether the increase is necessary. This has led to executive compensation packages ballooning over the last twenty years.

Therefore, the committee should not consider increases to individual elements of compensation in isolation but should consider the effect that an increase in each component will have on the total value. The committee should consider whether the total package is appropriate for a role of this nature, given the size, complexity and performance of the business preferably without solely relying on benchmark data.

The committee should set a compensation cap and ensure that all variable incentive plan rules permit the application of downward discretion to reduce the value of vested awards if the cap is reached. When setting a cap the committee should consider the potential for reputational damage that excessive compensation can cause.

We would also like to understand what changes to pay and benefits were offered to the general workforce. This will help us to understand the alignment of compensation practices within the organisation and its link to performance. It is our belief that it takes more than one person at the top of an organisation to drive value; therefore; all employees should be rewarded for the success of the company through cash and equity.

We may periodically select a sector and assess pay relative to performance, and where there is a misalignment we will vote against the say on pay resolution and compensation committee chair. We will then review compensation practices in the following year and if no changes have been made, we may vote against the re-election of the entire compensation committee.

Fixed compensation

Fixed compensation practices vary by company, are valued by the executives and can form a significant part of the overall compensation package. Therefore, base pay decisions should be explained. Executives should not expect to get increases each year. Increases should not be awarded in years of under-performance. When performance justifies an increase, these should be commensurate with increases offered to the rest of the workforce.

Potential benefits

- Tax gross ups

We will not support the provision of tax gross up benefits for bonuses or other one-time payments such as severance. We believe that individuals should be responsible for meeting their own tax expenses. We do not consider this a good use of shareholder funds. Tax gross-ups to meet re-location expenses will only be supported for a maximum of two years if a similar benefit is offered to all employees.

We will vote against any compensation policy that allows tax gross up payments, excluding re-location (see above).

- Re-location packages

These should be for a limited period of two years.

- Use of company aircraft

We generally do not support the use/ownership of private aircraft and would encourage companies to stop or reduce their use. However, where companies have a legitimate business reason for their use, the use should not be extended to executives as a perk.

Variable compensation

Annual incentives

We expect companies to focus on the delivery of long-term performance, therefore the level of compensation offered for the delivery of short-term performance should not only be capped but its weighting within total compensation should be significantly less than what is offered as long-term compensation.

The delivery of the annual incentive should be linked to quantitative financial/non-financial targets that are geared to the delivery of corporate strategy.

Measures such as health & safety should be used as a reducing feature rather than a compensating feature because ensuring the health & safety of employees should be embedded in the philosophy and values of the company and a normal expectation of running a successful business.

Achieving a threshold level of financial performance should be a pre-requisite for the delivery of any bonus including the delivery of personal performance objectives. The exception being in a turnaround situation when changes to non-financial strategic targets may take priority for a few years.

The performance targets set and what is achieved should be disclosed to investors.

We would encourage at least one third of any annual incentive payment or any payment that exceeds one year's salary to be delivered in the form of equity shares and deferred for a minimum period of two years.

These shares should be subject to clawback/malus being applied to reduce the number of shares that are eventually delivered under certain circumstances, e.g. accounting irregularities, profit warnings etc.

We will vote against compensation policy where:

- The bonus is not capped
- There is no explanation for changes in bonus opportunity from year to year
- The delivery of annual compensation is not linked to the delivery of financial performance
- From 2022 where any bonus exceeding one year's salary is not delivered in the form of shares deferred for two years.

Long-term incentives

We believe that a company should motivate and reward executives by granting long-term equity incentives that will align their interests with those of long-term investors. Incentives should be structured to motivate management to build a sustainable business which will generate positive returns to investors and makes a positive contribution to society.

In general:

- The policy requires that at least 50% of the value of long-term compensation is subject to performance
 - From January 2022, this threshold will be raised to 65%
- Performance conditions should be explained in terms of the delivery of strategy and the targets to be achieved
- Retrospective changes to performance targets that were previously set are not generally supported

Quantum

Long-term incentives should be capped in terms of overall value and or as a percentage of salary. Annual shareholder disclosures should provide an explanation for any variation in the value of long-term incentives that were awarded during the year. Increasing compensation purely based on a benchmarking exercise is no longer acceptable to shareholders.

Omnibus plans

Many companies use omnibus plans that allow the company flexibility to select the type of incentive medium to offer each year e.g. restricted shares units, incentive share options, performance shares, stock appreciation rights and phantom stock.

To reduce complexity in compensation policy we would encourage companies to move away from this type of plan to one or two specific plans. However, for those companies that continue to operate omnibus plans, we expect companies to be more explicit in their approach to the type of award that is granted each year setting out the maximum size of award that is permitted under each type and the total remuneration to be granted each year.

Time based remuneration - restricted stock units (RSU)

We would expect these to be held for a minimum period of five years before they become transferable. We would expect these to form a smaller proportion of the total long-term incentive proposition.

We will vote against a compensation plan that offers multiple types of reward and RSUs offered are not held for a minimum period of five years.

Where a company is only offering RSUs we would expect the total value of the award to be significantly less than the value of long-term incentive awards granted by peer companies. These units should be held for a minimum of five years. The ultimate vesting of which should be subject to compensation committee discretion based on management and company performance over the preceding three years.

Incentive stock options

Although the delivery of value under stock options requires share price appreciation, we do not consider share price appreciation on its own, to reflect underlying company performance. That is because shares price changes can be driven by market factors rather than management action.

In order for us to consider incentive stock options as a form of performance-based incentive, we would require an additional financial under-pin such as return on capital employed (ROCE), profit before tax (PBT) or other metric that is linked to strategy and demonstrates the sustainable health of the company. We also expect options to be held for a minimum period of three years before they can become exercisable.

We do not support the annual release of stock options for executive directors. Where companies have adopted this approach, we would like to understand in annual disclosures how this supports the delivery of long-term performance. We expect this practice of annual release of stock options to be phased out over the next two years.

The absence of a financial underpin and the current practice of annual release of stock options does not align with the delivery of long-term performance. Therefore, we do not consider stock options as performance related pay.

Stock incentive options if offered, should be market priced options and there should be no scope for re-pricing, replacing or buy-out for cash once issued.

We will vote against compensation policies that allow or create flexibility to issue non-market priced options and/or repricing.

From 2022 we will vote against compensation plans that allow for annual release of options.



Performance shares - performance shares units (PSU)

We expect performance to be assessed over a minimum period of three years. Delivery of awards should be in the form of shares and not cash settled. The performance conditions should be aligned to the delivery of the long-term strategy of the business.

Performance conditions should be transparent and based on generally accepted accounting principles (GAAP) measures/ key performance indicators (KPIs) that drive the business performance. If non-GAAP adjusted measures are used, we would expect a full reconciliation to GAAP so that we can understand how the adjustments have impacted compensation. This should include an explanation of why an adjusted measure was used in the compensation plan.

We support the use of non-financial measures; however, if used, the committee must explain how they are integrated into the company's purpose and/or strategy.

We expect PSUs to form at least 50% of the total long-term compensation package. However, we expect companies to increase their weighting to 65% of the total long-term incentive by 2022.

One time awards

- Golden parachutes/handshakes

Acceptance of these practices by shareholders has changed. Shareholders no longer believe this to be appropriate use of shareholder funds. There is no guarantee that the new appointment is going to deliver the right cultural values, strategy or performance.

We will not support any recruitment award that is excessive, without explanation and is not linked to the delivery of future performance.

- Retention awards (shares or cash bonus)

There is no guarantee that any retention awards will deliver value to stakeholders. Offering retention awards will be damaging to the reputation of the executive. Often these have not been effective in retaining the individual or has led to their departure at the end of the retention period. We believe that the agreed compensation package and reputation for delivering good/outstanding performance should be sufficient reward.

We will vote against the payment of retention awards.

Departing directors

We expect the compensation committee to ensure that there have been no rewards for failure.

Except with dismissal for cause and/or poor performance where awards should be lapsed, any outstanding awards of leavers should be time pro-rated and allowed to run their course subject to the same vesting conditions that applied at grant.

Change of control should not automatically accelerate vesting of all equity awards not yet earned/vested. Allowing for this in compensation plans may create conflicts of interest in senior management/executives. *Why work hard and create shareholder value if I can sell the business and be paid up early.*

Severance compensation

- Change of control compensation (CIC)

We expect any payments only to be triggered if change of control results in termination, (double trigger). Compensation should be limited to 2 x salary and average bonus paid over the past two years.

We will vote against any compensation policy that allows CIC compensation without a double trigger.

- Non-CIC compensation

The multiples of salary offered to an executive as compensation to leave their post raises concern. In most cases, departure is as a direct result of an orderly succession plan or poor performance. We believe that the current practice of paying millions of dollars is no longer acceptable.

Compensation should be limited contractually to salary, benefits, and estimated bonus for the year. Anything larger should be subject to a shareholder vote.

Newly-appointed directors

When setting remuneration of a new executive who lacks experience of the company and/or the role, we would encourage the compensation committee to consider placing the individual on a lower salary than their predecessor; with a view to increasing their pay over an extended period (subject to performance).

Newly-appointed executive directors should be encouraged to purchase shares in the company. Additional benefits such as assistance to re-locate, should be time limited, maximum of two years.

The use of 'golden hello' payments is not supported (see above one-time awards). Where a buy-out of existing awards from a previous employer is necessary, it should only cover the expected loss of value, and be awarded predominately in shares and subject to performance.

Malus/clawback and discretion

We expect companies to adopt appropriate policies that allow all forms of variable pay to be clawed back if over the course of the next three years evidence indicates that payments were made based on inaccurate/misleading information.

To provide clarity for all stakeholders, the compensation committee should set out the circumstances under which malus and clawback will be applied. These circumstances should not be too narrowly defined.

We define discretion as anything that alters the monetary outcome of total remuneration. We expect the compensation committee to be able to apply discretion to all forms of remuneration. The application of discretion should be possible to reduce as well as increase incentive outcomes.

These rules should be written into contracts that are agreed to participate in all forms of variable pay.

Stock ownership guidelines

Executive directors and senior executives should be encouraged to purchase shares in the company. The compensation policy should encourage its directors and senior executives to build up and to retain a meaningful interest in the shares of the company they manage. This is an essential part of aligning directors' interests with those of investors.

The level of shareholding required while employed with the company should be material. As a minimum it should mirror the value of reward under all incentive arrangements offered each fiscal year.

We encourage companies to require executives to maintain at least 80% of this shareholding for two years following their departure from the company. As a long-term shareholder, we would be comforted that the executive will continue to have a vested interest in the performance of the company following their departure. It will reduce the risk of short-term risk taking to increase exit compensation.

Any shares purchased are not required to be held post cessation. Any shares required to be held under the stock ownership guidelines should not be used for any hedging or pledging activity.

Stock ownership should be encouraged throughout the organisation. Schemes such as profit share can benefit the entire workforce offering a mixture of cash and shares and is directly linked with the performance of the business.

Pensions

Pensions are a significant cost and risk for a company as well as an element of compensation that is not linked to performance, therefore the cost of providing a pension should be considered when evaluating a compensation package.

We will not support pension enhancement payments at retirement or when a contract is terminated early. Additionally, we will not advocate an individual being compensated for changes in tax.

Companies should ensure that pension provisions are aligned throughout the organization.

Equity dilution

Equity dilution guidelines should be adhered to in relation to the issuance of shares for incentive schemes. As a rule, we expect no more than 10% of a company's equity to be used for all share schemes over a 10-year period and no more than 5% in 10 years for discretionary schemes.

Hedging of equity shares

Executives using their shares as hedging instruments severs the alignment of interests of the executive with shareholders. We believe companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company.

Pledging of equity shares

We believe investors benefit when employees, particularly senior executives, have 'skin in the game'. Therefore, we recognize the potential benefits of measures designed to encourage executives to buy shares and to retain shares that they have been granted through incentive programmes.

However, if not properly managed, the practice of pledging shares particularly to secure loans or the purchase of other assets can create a risk.

Therefore, we will only support the use of pledging if it relates to purchased shares by the individual. Once the shareholding requirement is reached any excess shares earned above this level may also be pledged.

Outside director fees

Non-employee director fees should reflect the level of responsibility and time commitment of the role. The use of share options or other performance related pay is not supported but a proportion of the fixed fees being paid in shares is encouraged.

Pay ratios

In 2015, the Securities and Exchange Commission (SEC) adopted a rule mandated by the Dodd Frank Wall Street Reform and Consumer Protection Act, 2010 that requires public companies with a fiscal year ending on or after 31 December 2017 and with a Market Capitalization of \$75 million and over to disclose the ratio of CEO compensation to that of the median employee at that company³. The company must disclose the methodology for determining the median employee and any assumptions they used. Foreign private issuers were excluded from this provision and certain exemptions were made for emerging growth companies with less than \$1.07 billion in revenue and smaller companies with less than £100 million of revenues.

We encourage companies to use their total employee population and to identify the median by using annual total compensation as determined under existing executive compensation rules. We encourage this so that the information provided is consistent and therefore comparable between companies.

2018 was the first year that all companies were required to provide such a ratio. We will use this as another tool to calculate disparity in pay for performance and inequality in pay. This may trigger future votes against.

3. <https://www.sec.gov/rules/final/2015/33-9877.pdf>



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