Interesting Times: 2016 FTSE 100 AGM Season

Lawrence Green, Sarah Nicholson and Bernhard Gilbey at Squire Patton Boggs (UK) LLP take a look at the season now drawing to a close.

The origins of the saying "may you live in interesting times" as a traditional Chinese curse may be apocryphal, but FTSE 100 remuneration committees could be forgiven for identifying with its sentiment early on in the 2016 AGM season. In April there seemed to be a perfect storm brewing of substantial votes against remuneration resolutions fanning the flames of sensational media reporting. However, after that feisty start, things did settle down later on and as the 2016 FTSE 100 reporting and AGM season draws to an end it is worth reflecting on what we have learnt and where that might take us in 2017.

Link Between Media Reporting and Actual Votes

The season opened with a lot of publicity and some meaningful negative votes. These were mainly advisory votes on implementation policies and it has been difficult to see clear and consistent messages coming from them. However, one clear trend that emerged was the media frenzy over the "single figure" for annual remuneration. Where that figure has looked disproportionate to the circumstances of the company, the media reporting seems to have been informed directly by various groups. These include some lobbying groups with a political slant (e.g. the High Pay Centre) and some institutional shareholders, though much comment has come from proxy advisors and similar providers servicing the institutional investment sector (e.g. PIRC and ISS).

However, the way that the "single figure" remuneration numbers are made up is quite technical and covers all elements of remuneration. By far the largest and most variable element is remuneration under long-term incentive plans, usually granted about four years before the outcome of the award is disclosed in the "single figure". This means that when shareholders vote against the size of the "single figure" published in the implementation report, they are frequently objecting to something that was done a while ago under an LTIP they will have specifically approved.

So what is really going on when the media condemn high "single figure" remuneration and shareholders subsequently vote against that company's implementation report?

There is certainly more to this than the media simply reflecting public anger at the amount that FTSE 100 directors are paid, given the comments made by institutional shareholders and organisations funded by them. Taken at face value, it could be viewed as harsh to criticise in this way remuneration that was already fully approved by shareholders and equally so to vote against the paying out of that remuneration. It should not be forgotten that paying out LTIP entitlements that have already been granted is a contractual obligation on the company. Unless there is a provision in the LTIP that requires or permits downward adjustments to take account of other issues, the amount payable paid by reference to (usually) financial metrics is not open for debate, no matter how shareholders vote at that time.

The outcry may simply be explained by the changing attitudes to executive pay in recent years and, of course, it is both possible and permissible for shareholders to change their minds. However, it is equally possible that the real message is that remuneration committees' cards are being marked to ensure that overall remuneration is reined back in policies due to be renewed in 2017.

What Else Has Happened This Year?

Binding votes on forward-looking policy will normally only take place every three years, with the bulk of the policies coming up for renewal in the 2017 reporting season. However, a number of FTSE 100 companies put forward new polices for approval this year. Prior consultation seems to have ensured a relatively easy ride for most of these companies. Of the eight that have already had their AGMs, six have received at least 93 per cent support. The exceptions were CRH (40.85 per cent against) and Reckitt Benckiser (23.8 per cent against). Interestingly, CRH found that shareholders expressed a wide variety of differing views, so they could not please everybody, and Reckitt Benckiser failed to stem the tide of shareholder discontent, despite lowering the maximum LTIP awards and introducing retention periods. Several other companies have amended their policies in order to restrict directors' pay-outs but without putting the revised policy to a vote this year.

So, headlines apart, has anything really changed this year? The answer is yes, although not really in a headline-grabbing way. There are four key areas of change:

- Disclosure of annual bonus targets. Last year this was a bit of a hot potato, with many companies refusing to disclose annual bonus targets and with shareholder pressure to disclose them on a current year basis where possible. This year a far more settled pattern has emerged. While there is very little current year disclosure (due to commercial sensitivity), the great majority of companies have adopted retrospective disclosure (mostly on a prior-year basis, with a minority deciding that the information is so sensitive that a longer period is needed). There are still a few FTSE 100 companies (six so far) holding out to keep some or all of their targets completely confidential.

- Malus and claw-back. Virtually all FTSE 100 companies have now added malus and claw-back to their policies. Broadly speaking, these allow reduction of awards and potentially repayment of awards that have already paid out in event that problems (which may relate to the company or the individual) emerge that affect or would have affected the proceeds from the relevant awards had they been known of at an earlier time. There is only one company currently holding out on this one

(Fresnillo) and that may be related to its ownership structure being unusual, with a single majority shareholder. The UK Corporate Governance Code was amended to include this as a requirement on a "comply or explain" basis in 2014 so this level of compliance is not in itself too surprising, but the lack of detail in the Code initially led to significant variation in the circumstances that could give rise to these adjustments. This year has seen the completion of the shift to a very widely-drafted version of malus and claw-back. The biggest remaining departure from the norm is that some companies have excluded cash bonuses from claw-back.

- Holding periods. Shareholders and their representatives have been pressing for some time for longer performance and/or holding periods (although the requirement for an aggregate five-year period was only added to the Investment Association principles late last year). Only a few years ago the norm was for share awards to mature after three years with the participants being free to realise the profit on those awards immediately, subject to any overall shareholding that they would be expected to maintain. This has moved rapidly and now the great majority of FTSE 100 companies have adopted longer periods in some form. Perhaps the most common form is a performance period of three years with a holding period of two years (which fits nicely with a two-year malus/claw-back period). However, there are many variations and no market standard as yet. Examples of other approaches are longer performance periods (e.g. five years) and phased release dates. Banks and other financial institutions are, for the moment at least (pending Brexit), subject to additional requirements resulting in even longer retention periods.

- Pay rises. This is a case of the dog that did not bark. The current requirements for remuneration policies put to shareholders stipulate that the policy must define the maximum opportunity for directors to receive value from each type of remuneration. The expectation was that each policy would restrict the maximum salary increases that could be awarded during its three-year duration (expressed as a monetary amount or percentage). In most cases this has not happened and remuneration committees have retained discretion to pay what they think is necessary for each position. However, even though the approved policies may not give a strict limit, it is very clear that remuneration committees are in practice acting as if they were restricted in that way. This can be seen from the way that companies are handling the required disclosure of CEO pay increases against those of the wider workforce. The increases disclosed correlate very closely and most companies explicitly state that that their policy is that normally the CEO should not receive greater increases than the wider workforce, while discretion is retained to depart from that. There is less uniformity in the group of employees against which the comparison is made. In some this is the worldwide workforce and in other cases may be restricted by location (e.g. UK or EU) or role/seniority in order to give a meaningful comparison. At this stage it is impossible to tell whether the selection is being affected by the pay increases given to the various groups against which the comparison is made, but no doubt shareholders will be on the lookout for companies chopping and changing the comparator group in case that is being done to massage the disclosed figures.

And During the 2017 AGM Season?

The first thing to remember is that next year most FTSE 100 companies will be putting their remuneration policies up to shareholders for a binding vote. There will be much consultation with shareholders as remuneration committees consider what they need to do to keep them happy.

As we have seen this year, the major issue is likely to be the reining in of total remuneration, with particular emphasis on LTIP awards. It remains to be seen how much ground will be given on this. The binding nature of the vote may appear to give the final say to shareholders, but that is not actually the case, since, if the vote is not carried, the sanction is that the previously-approved policy continues in place. So, in theory at least, shareholders cannot use a binding vote to force a company to reduce the level of remuneration offered.

However, in the real world, companies will be very keen to keep shareholders on side and the general flexing of muscles this year will have focused minds wonderfully. We will have to see whether there will be resistance from executive directors to the trimming of their existing remuneration packages, although they will need to bear in mind the way that the original shareholder spring in 2012 triggered some unexpected high-profile departures.

Normally, you would expect that uncertainty in this area would trigger movement towards the safe haven of the tried and tested formula of remuneration being made up of salary/benefits/annual bonus/LTIPs, with the two variable elements being as standard as possible (e.g. LTIP awards with a three-year performance periods only being released after a further two-year retention period). However, the Executive Remuneration Working Group (set up last year under the auspices of the Investment Association and reported in ECB) is due to upset the applecart somewhat in its eagerly-awaited report, expected this month. If the interim report is anything to go by, the ERWG will be urging companies to find the remuneration structure that most suits their business rather than just following the herd instinct. It is likely to suggest a number of possible models that could be adopted.

If, as expected, these include the current salary/benefits/annual bonus/LTIP model, then companies will at least have the option of sticking with a known structure provided that overall quantum is contained; there may nevertheless be some pressure to look at the other approaches.

Accepting that perfect balance cannot often be achieved, any company looking to shake up its remuneration structure will need to attempt to place the following items in equilibrium:

- competitive pay;
- simplicity (to enable both the executives to be motivated and shareholders to understand);
- incentivising the desired behaviours;
- quantum;
- reward arrangements geared to the specific needs of the company;
- flexibility to deal with the scale of change in the business world (for example, the implications of a post-Brexit world that is currently impossible to describe); and
- the different perspectives of its various shareholders and the proxy voting organisations (possibly the most challenging aspect).

It all ensures that 2017 will be interesting at the very least and, no doubt, FTSE 100 companies will continue to find it hard to please everybody all of the time.

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