Willis Towers Watson

Executive Compensation Bulletin

Shareholders' Rights Directive launch will significantly impact governance

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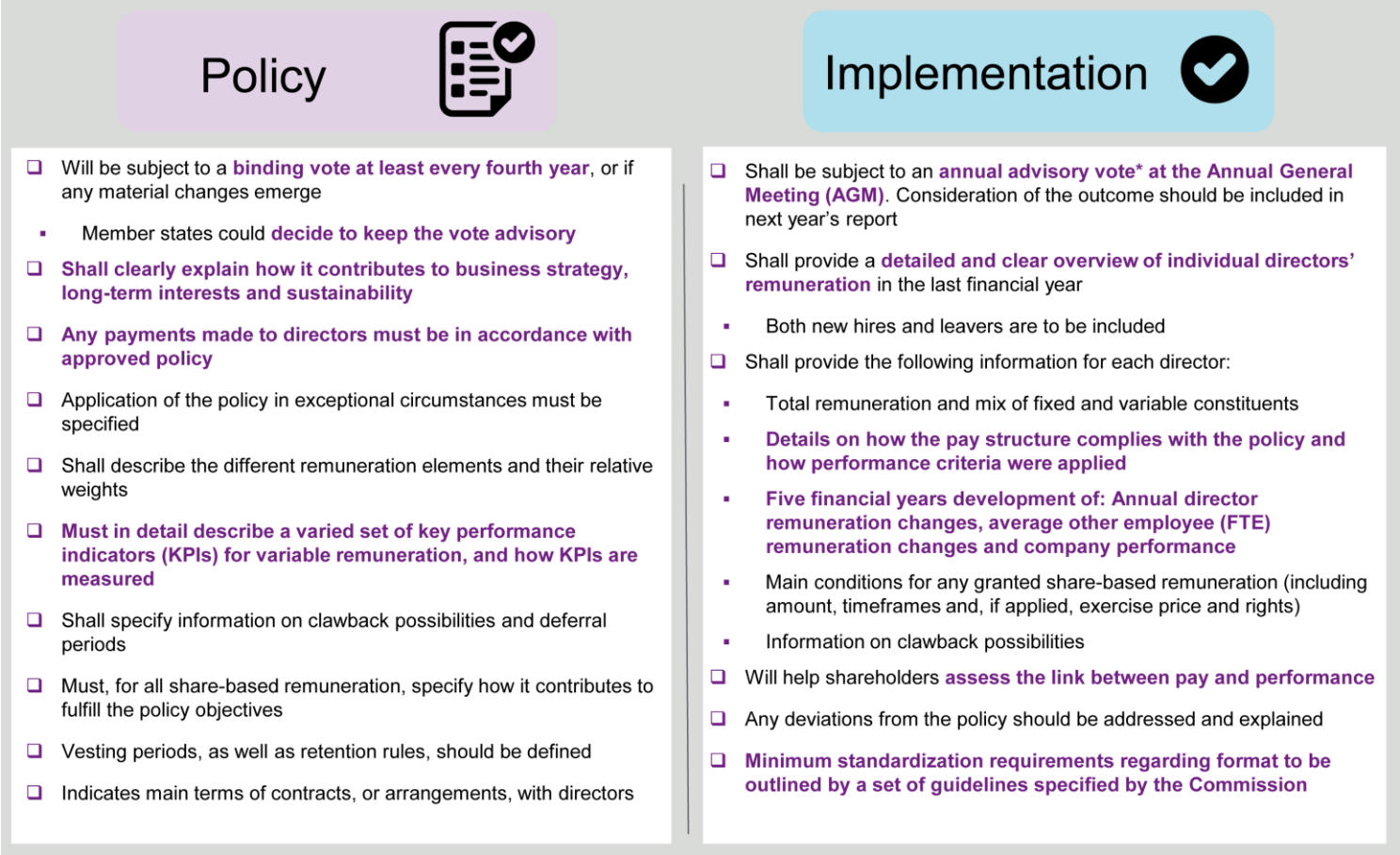
Earlier this year EU regulations on governance, known as the Shareholders' Rights Directive (SRD), were approved by the European Parliament after significant debate over SRD's content and consequences. SRD is comprised of a set of regulations meant to increase transparency and strengthen the shareholder's position.

Figure 1 provides an overview of how the SRD affects executive remuneration.

Figure 1. SRD's impact on executive remuneration



Pay ratio

One of the most important, debated considerations was whether a so-called “pay ratio” should be part of the SRD. A pay ratio is intended to show differences in pay across a company and can be defined in a number of ways, such as CEO pay divided by the lowest pay in the company, or board pay divided by median pay in the company. Many variations are possible, such as whether calculations should be country-based or broader, and should involve fixed pay or include variable pay and/or benefits (and how they should be calculated). Pay ratios will likely be part of U.S. and U.K. disclosure, as of next year, and already they’re proving potentially very troublesome to calculate.

Pay ratios did not make it into the final SRD text, but the SRD does include the obligation to disclose the “progression of director pay versus average pay” against company performance. This is not as strict as a pay ratio and, in fact, does not entail disclosing a pay ratio figure. It does, however, require careful consideration as to how to approach this disclosure and annual calculation.

Other important details

Another much debated topic was whether the shareholder should have a binding vote on pay policy (such as already exists in the U.K.), including the way base salary is annually set, workings of the bonus plan and the LTI plan and other contractual provisions. This also did not make it into the SRD.

Countries can choose to, at least once every four years, have a binding or an advisory vote on pay policies.

It’s also worth mentioning that with SRD, an annual advisory vote will determine whether the policy has been implemented satisfactorily in the past year (again, similar to U.K. legislation).

The last point to mention is that key performance indicator (KPIs) that can or will be used in STI plans will need to be specified and disclosed (i.e. the definition and measurement, as opposed to the actual targets).

The regulation, as set out by SRD, will result in increased disclosure and stricter governance for almost every country in the EU, even though local corporate governance and external pressures have already increased disclosures in previous years.

A summary of the current governance provisions in European countries is provided in *Figure 2*.

Figure 2. Current governance throughout Europe

Country	Binding vote	Advisory vote	Proxy/voting/investor influence	Disclosure
Belgium		Annual vote on remuneration report each year (NOT on remuneration policy specifically)	Increased influence of ISS - more attention to disclosure and ISS guiding principles are not always aligned with shareholders' proposed approaches (e.g. options, absence of bonus deferral). Specific focus on ISS P4P model as well	Remuneration paid in the prior year (individual disclosure for the CEO and collective disclosure for other Executive Committee Members) and overview of proposed changes for the next three years.
Denmark	Non-annual binding vote on incentive-based pay on introduction and in case of amendments (Companies Act)	Recommended vote on policy (introduction and amendments) and annual justification and explanation in Chairman's statement at AGM (Corporate Governance Code)	• Large pension funds like ATP have influence and are taking a more active view on compensation. • Overall, it is important to explain the compensation package clearly and its link to the compensation philosophy and business strategy. • Proxy advisors like ISS have had limited influence on pay practices in Denmark to date, but that may change with SRD.	Legislation and recommendations around pay and disclosure are less stringent than other Nordic countries and fairly "relaxed" in comparison to large European markets. Level of disclosure varies greatly among companies.
France	Annual on policy (2017) and remuneration paid (2018)	On remuneration paid until 2017 (former regulation, applicable last time in 2017).	ISS (increasing) and Proxinvest (decreasing) influence.	Standardized reports for remuneration paid following French governance recommendations. Description of remuneration policy varying level of disclosure.
Germany		On shareholder request on remuneration policy (usually proactively in case of policy change)	Increased influence of ISS and other shareholder representatives	Standardized tables showing realized pay and min/target /max policy levels

Italy	For banks - annual on policy and remuneration paid	For listed companies excluding financial sector - annual on remuneration policy.	ISS, Glass Lewis, Frontis Governance, Georgeson	Individual disclosure for board members (executive and non-executive) Aggregate disclosure for top managers
Netherlands	Introduction of new policy and significant material changes of the existing policy	No advisory vote yet. However, the implementation of the remuneration policy is a discussion item at the AGM	ISS and Glass Lewis have influence	Remuneration report fairly detailed – pressure for improvement in particular equity payments and pay-for-performance
Spain	Policy every three years	Annual on remuneration paid	ISS, Glass Lewis, ECGS (less influential)	Provides description of remuneration paid in the prior year and overview of proposed implementation for forthcoming year - restrictive
Sweden	Annual on policy	None	Large investors, mainly some pension funds. Limited influence from proxy/voting agencies.	No formal remuneration report – provides details on remuneration paid in the year and prior year for CEO and executive committee (on an aggregate basis)
UK	Policy every three years	Annual on implementation/ remuneration paid (proposal to make binding)	Strong – ISS, the IA, Glass Lewis and institutional investors	Strictest requirements in Europe with 2013 reporting regulations

We can conclude that in many countries, some form of shareholder vote on policy already exists, as well as advisory votes on (elements of) policy implementation. Furthermore, the influence of investors and proxy agencies has already increased, along with more detailed disclosures. This suggests that the impact of SRD will not be revolutionary in most markets, but rather, continue the existing trend.

However, don't be fooled into underestimating the SRD's likely impact. The U.K. introduced governance rules in 2014, still the strictest in Europe, and investors, proxy advisors and the media were:

- Helped by the consistency of reporting created by the new governance rules. It became substantially easier to compare, analyze and judge pay levels, leading to a greater appetite of external stakeholders to opine on pay levels as well as pay design
- Able to collaborate to drive changes in specific areas (e.g., longer holding periods, contract periods and levels of pension provision)

Consequently, remuneration committees have greatly increased the time spent on reporting and disclosure and are very actively involved in communicating and explaining remuneration policies and outcomes, especially the way in which performance is reflected in remuneration paid. The degree of active shareholder consultation has also increased.

Is this a bad thing? No, not really, in a time that places greater weight on transparency. But it does increase pressure on those in charge, the management and non-execs or supervisory board of the company, to devote attention to communicating and justifying their decisions.

What to expect

We wouldn't be surprised if the SRD replicates what happened in the U.K. in other countries, since SRD will result in much more consistency in types of votes, reporting and disclosure. So, increased public scrutiny, shareholder influence and proxy advisor influence is to be expected. That means that there is great value in being ready to explain pay for performance processes and outcomes, increased remuneration committee involvement and increased intensity of discussions.

SRD implementation needs to be in place in all EU countries by 2019, the first reporting year (earlier in some countries). It will be a substantial change, and we will write more over the next year or so as the direction of local legislation starts to become clearer.

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