Remuneration of Directors: ICGN Guidelines

Discussions about the remuneration of executive directors, management board members and other top executives (hereafter collectively “Directors”) generally focus on the ‘how much’ question, that is, on specific amounts paid rather than the principles underlying a particular package. This is not surprising because some of the details of sophisticated remuneration packages are difficult to understand. However, the principal issue for long-term shareholders regarding remuneration is whether it is adequate to recruit and retain appropriately qualified Directors and to incentivise them to deliver long-term, sustainable shareholder value. Institutional investors have generally no objections to reward truly successful Directors financially. Due to the different role and responsibility of non-executives or supervisory board members, chapter 6 contains a separate set of remuneration guidelines, which reflects these differences.

These updated guidelines set out key remuneration principles which should be applied by companies regardless of their domicile. They can not address every issue that may arise in respect of remuneration. Instead they reflect what leading institutional investors and shareholder associations expect from companies regarding remuneration. The guidelines should be applied pragmatically, taking into account the specific circumstances of each company and the economic and legal environment in which it operates.

The guidelines are primarily addressed to companies and their board of directors. They are based on the assumption that the question of ‘how much’ a particular Director can earn in a specific period should not be prescribed. Since the remuneration of Directors can create a direct conflict of interest between the company’s management and its owners, it is generally agreed that mandatory- or self-regulation is required. This concerns certain remuneration related issues: for example, which organ or body of the company should represent it vis-à-vis the Directors regarding remuneration, what process should be adopted and what information should be disclosed to shareholders by the company. Furthermore, the structure, components and level of remuneration paid to Directors whilst employed, and pension arrangements, as well as contract and notice periods, need to be regulated to some extent. The guidelines address each of these issues by setting out a set of general principles that reflect best international practice. The emphasis throughout is on ‘how’ Directors are remunerated.

The remuneration of non-executive directors has not received much attention in the past. However, with the increasing demands and risks of non-executive directorships, this has changed in recent years. Therefore, in the final section, these guidelines address important issues in respect of remuneration of non-executive directors.
1 Remuneration committee

1.1 Depending on best practice in the relevant market, a remuneration committee ('Committee') composed entirely or at least with a majority of experienced independent non-executive directors should represent the company vis-à-vis the full board of directors and individual Directors. It should consist of at least three members.

1.2 The Committee should be responsible for the company’s remuneration policy and for designing and reviewing remuneration packages of individual Directors.

1.3 The Committee should generally seek advice from independent remuneration consultants when defining the company’s remuneration policy and designing and reviewing remuneration packages of individual Directors. The Committee should be responsible for the appointment and terms of references for the consultants.

1.4 The Committee should avoid granting more than is necessary to recruit, retain and incentivise appropriately qualified Directors taking the requirements of the market and the specific circumstances of the company into account. In doing so, it should be sensitive to remuneration packages and employment conditions throughout the company and the relevant industry.

1.5 The Committee should seek and maintain a constructive dialogue with all interested shareholders.

1.6 The Committee should produce an annual remuneration report setting out the company’s remuneration policy and details of the remuneration packages of individual Directors.

1.7 The Committee should explain in this report in detail the steps taken in arriving at the remuneration policy and individual remuneration packages. This should include advice received from consultants, and set out the specific circumstances of the company and the requirements of the market it operates in into account.

2 Disclosure to shareholders

Remuneration policy

2.1 The remuneration policy should facilitate the recruitment and retention of appropriately qualified Directors and align the interests of the company’s management and its owners by establishing a clear link between reward and performance.

2.2 The remuneration policy should explain the structure and components of remuneration packages, the benchmarks against which the level of remuneration is set and how the interests of the company’s management and its owners are aligned.

2.3 Substantial direct or indirect share ownership by Directors is the best way to align the interests of the company’s management and its owners at least in markets where it is not made difficult for tax
reasons. The size of an adequate risk position by Directors should be determined on a case-by-case basis reflecting market requirements and the specific circumstances of the company.

**Remuneration report**

2.4 The remuneration committee should prepare annually a remuneration report that is approved by the board of directors, included in the annual report and, whether or not legally required, submitted to the shareholders in general meeting. As an alternative to express shareholder approval an advisory vote on the remuneration report could prove useful.

2.5 The remuneration report should contain readily understandable information about the company’s remuneration policy as well as detailed information about the remuneration of the board of directors and packages of individual Directors.

2.6 The remuneration report should cover all aspects of remuneration packages including base salary, short- and long-term bonuses, other incentives, benefits, perquisites, other cash/non-cash payments, contract- and notice periods, change of control and similar provisions and pension arrangements. Remuneration received for services to related (group) companies and benefits promised or granted by third parties should also be disclosed. The report should thus allow shareholders to calculate the minimum and maximum value of a remuneration package.

2.7 All relevant information should be set out clearly in the remuneration report rather than being scattered in notes and references to other parts or appendices of the company’s annual report.

**Performance related remuneration**

2.8 The potential and expected value of performance related remuneration components together with an explanation of how the remuneration levels are set should be disclosed.

2.9 Performance criteria applicable to long-term incentive and share option plans should be disclosed.

2.10 If commercial confidentiality makes full disclosure of specific performance criteria impractical, at least the basic parameters should be made transparent.

2.11 The costs of share-based incentives should be disclosed so that shareholders can readily assess their benefits against their costs. Such disclosure should include an explanation and justification of the valuation method(s).

2.12 The maximum dilution that may arise through the issue of shares under long-term incentive and share option plans should be disclosed.

2.13 There should also be disclosure regarding the implementation and administration of long-term incentive and share option plans.
Where the timing of the grant of shares or options is discretionary, it should be explained and justified.

3 Structure, components and level of remuneration

3.1 Fixed and performance related components of remuneration should be appropriately balanced. The appropriate ratio between base salary and short- and long-term bonuses and incentives depends on the requirements of the market and the specific circumstances of a company. Although the performance related component should be significant, a cap expressed as a proportion or multiple of the base salary could avoid excessive remuneration particularly if not entirely due to the efforts of the individual.

3.2 The remuneration level should be set by reference to relevant benchmarks taking into consideration the requirements of the market and the specific circumstances of the company.

3.3 When setting the remuneration level for individual Directors, their experience, expertise and responsibilities should be taken into account.

3.4 Paying repeatedly ‘above median’ or ‘top quartile’ could lead to ever increasing levels of remuneration (‘ratcheting up’ effect). Any such payment policy should be justified in the remuneration report.

3.5 The reasons for an increase in fixed pay beyond the rate of inflation should be set out in the remuneration report.

3.6 Share ownership by Directors may align the interests of the company’s management and its owners. Companies should therefore consider remunerating directors partly in shares. Any such shares should be granted at market value and held at least throughout the appointment period and ideally beyond.

Bonuses for transactions

3.7 Companies should not normally pay bonuses based solely on the completion of transactions, such as mergers or acquisitions, irrespective of their future financial consequences. If in exceptional circumstances bonuses are paid, they should be disclosed and justified.

Pension arrangements

3.8 Where pension arrangements for Directors are substantially different to those of other employees, the company should explain why this is the case. It should also be demonstrated how the arrangements align the interests of the company’s management and its owners.

3.9 The potential costs of pension arrangements should be clearly disclosed in the remuneration report.
Loans to Directors
3.10 Companies should not normally lend money to Directors. If in exceptional circumstances loans are made, they should be disclosed and justified.

Perquisites
3.11 As a general rule, Directors, not companies, should be responsible for paying personal expenses, such as private and family travel, financial planning and club memberships. The remuneration committee should ensure that there is a clear line between such personal and business expenses and that any perquisites are disclosed and justified.

4 Bonuses and incentive plans
4.1 The objective of performance related remuneration should be to align the interests of the company’s management and its owners as far as possible. Performance related remuneration should therefore be linked to challenging relative performance criteria which should be set out and explained in the remuneration report.
4.2 Short-term bonuses are generally awarded for the achievement of specific objectives set before the start of the year. Sometimes, these are commercially sensitive and cannot be fully disclosed. Even if the short-term performance criteria are disclosed, it is difficult for outsiders to determine whether they are the most appropriate.
4.3 Long-term incentive and share option plans generally align the interests of the company’s management and its owners. However, they may also give rise to significant conflicts of interest. Shareholders should therefore carefully consider particularly the performance criteria.
4.4 The rationale of all long-term incentive and share option plans should be fully explained in the remuneration report. Any award of multiple plans in one-year should be justified as an exceptional item.
4.5 All long-term incentive and share option plans should have a maximum annual limit on individual participation that could be expressed as a proportion or multiple of the relevant director’s base remuneration.

Long-term incentive plans
4.6 Long-term incentive plans generally involve the issue and conditional allocation of shares to Directors. The allocation should take place at regular (normally annual) intervals.
4.7 The vesting of the shares conditionally allocated should not only depend on the passing of time and/or continued employment, but
also be subject to the achievement of challenging relative performance criteria.

Share option plans

4.8 Share option plans should not be the only long-term incentive.

4.9 The exercise price of share options should not be at a discount to the prevailing mid-market price at grant. The setting of a premium exercise price is not of itself a substitute for the adoption of challenging relative performance criteria.

4.10 To ensure that share options adequately incentivise Directors, their exercise price should be indexed and/or challenging, relative performance criteria, which need to be met before vesting of the options, should be set.

4.11 Share options should have vesting terms of at least three years and be granted at regular (annual) intervals. This should remove any need for varying the exercise price. Repricing should only take place in exceptional circumstances and not without shareholder approval.

Performance criteria

4.12 The vesting of shares or share options should be subject to the achievement of challenging levels of performance appropriate to the company over the incentivisation period taking into consideration the prospects of its business as well as the prevailing industry and economic environment in which it operates.

4.13 The performance criteria set for Directors of a particular company should normally include a relative component that allows measurement against a peer/comparator group (or other relevant benchmark). The companies that are included in this group should be similar to the company in terms of the nature and development of their business. To make the comparison meaningful, the group should include a sufficient number of companies.

4.14 The period over which performance is measured should be at least three years in order to encourage the achievement of sustained improvements.

4.15 ‘Retesting’, that is, granting of extra time to meet, or variation of, performance criteria governing the vesting of long-term incentive awards or share options should be considered only in exceptional circumstances. Any change of performance criteria, which increases the likelihood of awards vesting, should be explained in the remuneration report and subject to shareholder approval.

4.16 Pro-rata performance criteria should apply and awards made on a change of control or equivalent corporate event. The remuneration committee should satisfy itself that the pro-rata performance criteria reflect a real measure of underlying achievement over the shorter time period.

4.17 Sliding scales that correlate the reward with the level of achievement are a way of ensuring that performance criteria are
4.18 If other performance criteria than TSR or EPS are used that are relevant to the nature and development of the company’s business, the criteria should be made transparent and measurable and reflect the creation of value for shareholders.

**Dilution**

4.19 As a general rule, shares issued and commitments to issue new shares under all employee share plans should not exceed an amount equivalent to 10 per cent of the issued ordinary share capital of the company in any rolling 10-year period.

4.20 As a general rule, shares issued and commitments to issue shares under any executive share plan should not exceed an amount equivalent to 5 per cent of the issued ordinary share capital of the company in any rolling 10-year period.

4.21 Companies should disclose in their annual reports the cumulative issue to date and the potential or actual dilution of shareholders’ interest under all incentive arrangements.

**5 Contract and notice periods**

5.1 Contracts of Directors should not normally be for periods of more than one year as longer periods reduce accountability and may lead to significant liabilities of the company, if the employment is terminated prematurely. Contractual severance pay should be limited to executive directors and not exceed the equivalent of one-year base salary and be subject to mitigation.

5.2 Initial contracts, which for recruitment purposes run for more than one year, should revert to one-year contracts after that period.

5.3 Contracts of Directors should not normally make special arrangements for a change in the control of the company or equivalent corporate event.

**6 Non-executive directors**

6.1 The remuneration packages for non-executive directors should adequately reflect their contribution to the company’s longer-term success.

6.2 The nature of the position and the work of non-executive directors is different from that of executive directors. This should be taken into account when designing remuneration packages for non-executive directors.

6.3 As a general rule, non-executive directors should not have the same performance related remuneration plans as executive directors. In particular, the use of incentive plans geared to dividend payments or other annually based measure of the company’s performance could interfere with the independent,
longer-term oversight that non-executive directors are expected to provide.

6.4 Non-executive directors should be required to invest a significant part of their annual cash remuneration in shares of the company and to hold them at least throughout their appointment period with a minimum of five years.

6.5 Non-executive directors should not be eligible for pension arrangements as such arrangements might create financial dependence on the appointment and compromise independence of thought.

Sources


*Best Practice on Executive Contracts and Severance* – A Joint Statement by the Association of British Insurers and the National Association of Pension Funds (2002)


