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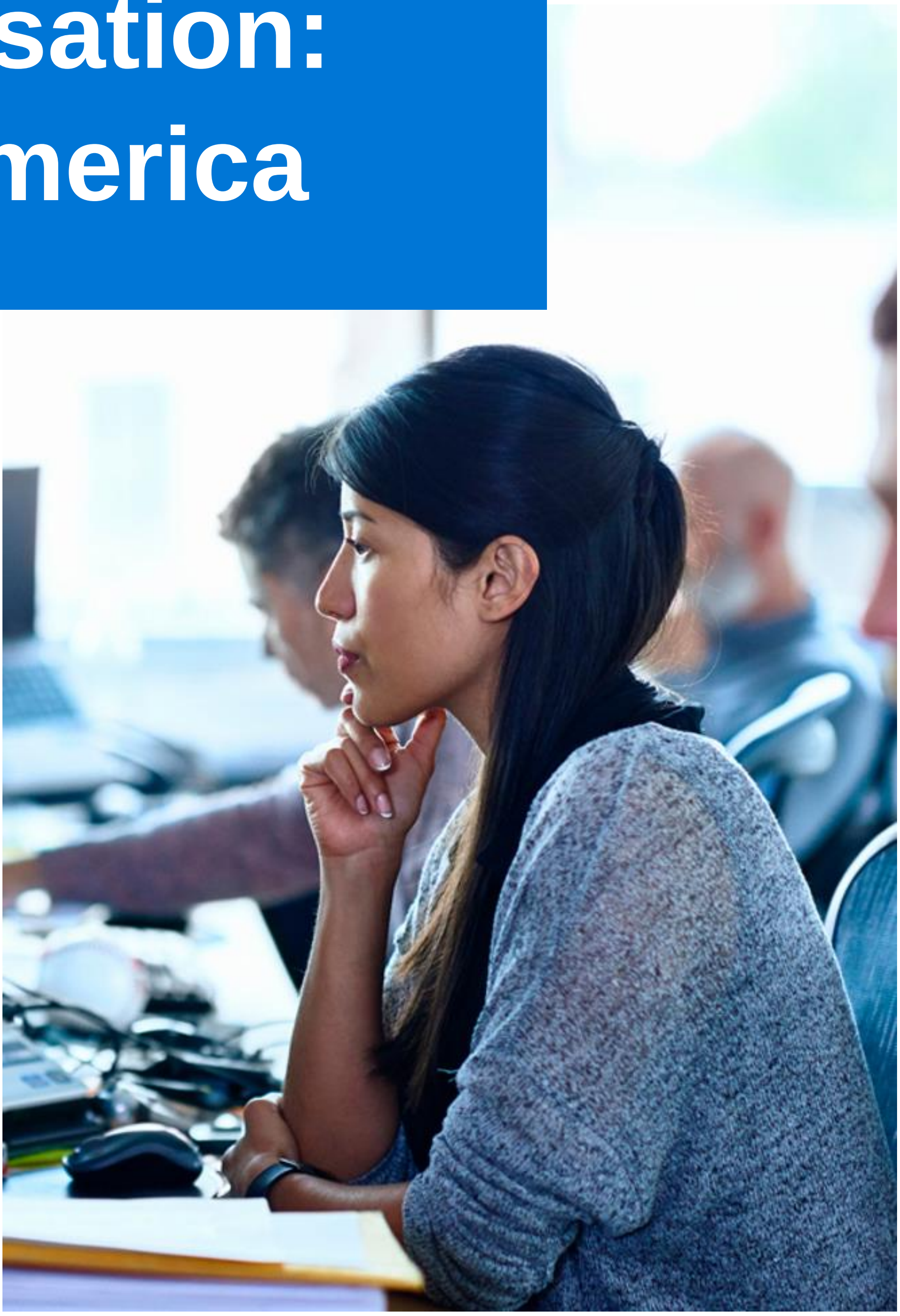
Our principles on executive compensation: North America



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Contents

Introduction

Studies conducted by Morgan Stanley[1] provide evidence of a link between failed say on pay votes and underperformance of the company's share price against the S&P 500 over the next 12 months. The study, which was 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%. Two-thirds of these companies underperformed by 34% or more. 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 for 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 tenure, diversity, compensation and to disband combined chief executive officer/chairman seats. We have also engaged on matters pertaining to climate change. Even though scrutiny on executive pay continues to grow, we have seen few changes to policies and practices to acknowledge this growing concern from shareholders.

Despite the significant impact that the Covid-19 pandemic had on many stakeholders, compensation committees continued to shield executives' compensation from lower financial performance.

The overall trend of support for say on pay hasn't changed much since 2018, tracking at around 90% support, though data suggests that support may be lower in 2021. More investors are voting against say on pay resolutions, and we believe this is set to continue post pandemic.

Last year, we produced this stand-alone document for the first time to help North American compensation committees better understand the evolving views on executive pay from a long-term shareholder perspective. This document has been updated to provide further insight into our evolving expectation on executive compensation for North American companies.

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

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

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[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 in certain cases they can be a source of valuable information to the committee's deliberations.

Historically, workforce pay was not part of the remit of the compensation committee. However, the tide has turned and investors such as LGIM believe that executive compensation should not be decided in isolation of workforce practices.

Therefore, 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.

LGIM would expect the committee to hold the CEO to account for the workforce pay policies introduced. The committee should question management on workforce pay policies if they consider them to lack alignment, be poorly structured or if they could be improved upon.

We expect all companies in which we invest to pay their employees at or above the living wage.[2]

Although the Federal Minimum Wage is still US$7.25, some states have set their own minimum wage levels. Despite these levels being higher than the federal rate, many remain less than the living wage needed to ease levels of poverty. This living wage calculator provides more information.

LGIM would therefore ask the remuneration committee to make themselves aware of the living wage rates for key regions in which they have employees and to hold management to account for non-payment of a living wage.

When using a compensation consultant to assist with the process of setting executive compensation, the committee should ensure that they are independent of 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 relevant organisations to stay abreast of evolving best practices.

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

Transparency
We expect a full explanation as to how compensation was set for that year. Information on why rewards were delivered, how targets were set, what sorts of adjustments were made to accounting measures, and the relevance of those targets to meeting long-term goals of the company is vital.

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 and the economic climate. Too many companies simply take compensation benchmark data from their compensation consultants and increase pay without considering the wider impact or whether the increase is justified. This has led to executive compensation packages ballooning over the past 20 years. The pandemic has increased investor awareness of this issue. The 2021 proxy season highlighted that shareholders are increasingly reluctant to support excessive compensation packages.

The committee should not consider increases to individual elements of compensation in isolation, but should instead consider the effect that an increase in each component will have on the total value of the package. 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 downward discretion to reduce the value of vested awards if the cap is reached. When setting a cap the committee should consider the pay ratio and the potential for reputational damage that excessive compensation can create.

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 their 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.

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 underperformance. 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 be capped. In addition, its weighting within total compensation should be around one-third of total compensation.

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

Measures such as health and safety should be used as a reducing feature rather than a compensating feature, because ensuring the health and 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.

Disclosures should explain whether the company currently pays the living wage to all employees in all states. The committee should explain why they consider a bonus should be paid in the absence of a clear target date to pay the living wage.

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

We would expect 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 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 increases in bonus opportunity from year to year
- The delivery of annual compensation is not linked to the delivery of financial performance in line with the strategy
- From 2022, where the bonus is paid entirely in cash

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 that 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; we would expect most of the performance conditions to be disclosed prospectively
- Retrospective changes to performance targets that were previously set are not supported

Quantum

Long-term incentives should be capped in terms of overall value 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 compared with prior years. 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 (RSUs)

We would expect these to be held for a minimum 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 that are not restricted to being held for a minimum period of five years.

The ultimate vesting of RSUs should be subject to compensation committee discretion based on management and company performance over the preceding five years.

Incentive stock options

Although the delivery of value from stock options requires share-price appreciation, we do not consider share-price appreciation on its own, particularly short-term increases, to reflect management performance. That is because share-price changes can be driven by market factors rather than management action. We also do not support incentive plans that rely on just one metric to justify performance as it may promote the wrong behaviours.

In order for us to consider incentive stock options as a form of performance-based incentive, we would require an additional financial underpin such as return on capital employed (ROCE), profit before tax (PBT) or another metric that is linked to strategy and demonstrates the long-term financial viability of the company.

We do not support the annual release of stock options for executive directors. Stock options should be held by the companyfor three years before they are released to the director.   We expect the annual release of stock options to be phased out by the end of 2022.

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.

Stock incentive options 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 2023 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 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.

Although our current expectation is that PSUs will form at least 50% of the total long-term compensation package, from 2022, our expectation is that PSUs should form 65% of the total package. From January 2022 this will become a voting issue.

We expect a company to select performance conditions that drive their own strategy and to ensure that management action takes account of the business’s impact on all relevant stakeholders. Therefore, performance conditions should be a mix of financial and non-financial measures that capture the positive impact of the business on society. All measures should be measurable.

Many companies use total shareholder return as a metric to demonstrate alignment with shareholder interests. Yet, many of these companies chose to reward management for delivering a performance that is below the median of their chosen peer/benchmark group. LGIM does not support this practice, and we will vote against such policies from January 2022.

One-time awards

Golden parachutes/handshakes/sign-on bonuses

Acceptance of these practices by shareholders has changed. Shareholders no longer believe this to be an 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 that is not linked to the delivery of future performance.

Retention awards (shares or cash bonuses)

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 have 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 early?

Severance compensation

Change of control compensation (CIC)
We expect any payments to be triggered only if change of control results in termination (double trigger). Compensation should be limited to two times 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 with a maximum of two years.

The use of ‘golden hello’/sign-on bonus payments is not supported (see above on 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 should 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 to 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 by the director 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 are 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 organisation.

Equity considerations

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 those of 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 recognise 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 shares purchased 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 capitalisation of US$75 million and over to disclose the ratio of CEO compensation to that of the median employee at that company[3]. 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 US$1.07 billion in revenue and smaller companies with less than US$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.

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[3] https://www.sec.gov/rules/final/2015/33-9877.pdf

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