GOVERNANCE: KEY CONSIDERATIONS FOR EFFECTIVELY MANAGING REMUNERATION ARRANGEMENTS DURING THE PANDEMIC (AUSTRALIA)

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Legal Briefings – By **Stefanie Wilkinson and Lauren Selby**

One of the many issues companies are facing in light of the Covid-19 pandemic is how best to appropriately remunerate, incentivise and retain employee and executive talent as the pandemic continues to unfold.

This article sets out five key issues for listed companies and their remuneration arrangements. Effective management of these issues will be vital as companies look ahead to ensure they are well placed to continue responding to enduring uncertainty and to take advantage of eventual opportunities as the impact of the pandemic subsides.

ONGOING REMUNERATION – HOW MUCH TO ADJUST

In the immediate aftermath of the pandemic, a number of ASX companies announced remuneration adjustments for key management personnel – both for executives and non-executive directors. This included fixed fee reductions for non-executive directors and reductions in base remuneration and/or variable remuneration (ie STI and LTI) for executives. These adjustments were seen across a range of sectors, with those most heavily impacted by Covid-19 volunteering some of the most prominent adjustments. This has also become a heightened focus for shareholders where companies have cancelled or deferred dividends and shareholders are wishing to see executives and directors “sharing in the pain”.

As the uncertainty continues, companies are now considering remuneration for FY21 and what arrangements will be appropriate. Some companies are considering whether to scale back the proportion of fixed remuneration, vary remuneration mixes, or defer a portion of remuneration into equity (for example, a move away from the ‘usual’ annual cash bonuses to a deferred equity grant).

For companies that grant STI and LTI equity, one of the key issues to consider at this time is shareholder reactions if deferred STI or LTI grants are made using the company’s current share price (where that share price is currently significantly lower than normal as a result of the Covid-19 pandemic). Allocating equity using an unusually low share price will result in an increased number of awards. Windfall gains may arise if the level of grants expressed as a multiple of salary is maintained after a substantial fall in the share price.

As a result, careful consideration should be given to using an average share price over a longer than usual period to determine the number of awards allocated, or granting as normal but with an expectation that the Board or Remuneration Committee will use its discretion at the time of vesting to ensure that only performance-related gains are recognised in the vesting levels (to remove windfall gains). As with any adjustment in remuneration, it will be important to message any changes and bring executives and shareholders along on a shared journey.

For companies that continue to need to conserve cash, other alternative forms of remuneration for non-executive directors, executives and/or employees are being considered, including offering equity arrangements (such as shares or share rights) in lieu of a portion of their cash salaries.

For some companies, this is being used as in conjunction with employees voluntarily accepting a reduction in remuneration.

If this approach is being considered, there are obvious additional considerations from a securities law, employment law, ASX Listing Rule, tax and accounting perspective.

INCENTIVE AWARDS – MANAGING AWARDS “INFLIGHT”

The current economic circumstances are affecting many of the performance hurdles attaching to awards that are on foot and will impact future vesting outcomes.

Companies looking to amend the terms of existing awards (for example, by changing the performance hurdles, vesting date or performance period) are reminded to be cautious as certain changes are prohibited under the Listing Rules or may require shareholder approval. Also, it is important to remember that any alternations to the terms of an existing award held by a member of key management personnel requires disclosure in the Remuneration Report.

Some Boards and Remuneration Committees are considering whether to exercise discretions available to them under the terms of existing awards (as opposed to making formal 'amendments' to existing awards) to ensure appropriate vesting outcomes in the circumstances. In some instances, this has even involved considering the ability to defer vesting (where the vesting of an award during this Covid-19 pandemic period would be considered inappropriate). An exercise of discretion technically does not need to be disclosed in the Remuneration Report, depending on the circumstances. However it is in line with good practice to include a disclosure in the Remuneration Report because the exercise of discretions remains a key focus of proxy advisers, particularly where it may result in increased vesting or a perceived "gain" for executives.

It will also be important to consider ASIC's recent guidance on *Board oversight of executive pay decisions during the COVID 19 pandemic* (Infosheet 245) which encourages a robust remuneration governance framework that includes proactively considering whether to exercise discretions to ensure remuneration remains consistent with its original objectives.

"Replacement" awards are also being considered by some Boards, especially where awards may be lapsing in the ordinary course due to circumstances outside of management's control. Any replacement award should be carefully structured to ensure that options or performance rights which are on foot are not deemed to be cancelled for consideration which can trigger shareholder approval requirements.

Of course, the optics of exercising Board discretion, amending the terms of an award, or granting replacement awards will need to be carefully managed in the current environment.

NEW INCENTIVE AWARDS – SETTING PERFORMANCE TARGETS IN THE CURRENT ENVIRONMENT AND HOW TO ACCOUNT FOR ECONOMIC RECOVERY

Setting sensible short and long term performance targets for new STI and LTI awards is challenging during this period. Albeit, some may argue that determining long term performance targets is always fraught with difficulty.

We are seeing some companies seeking to defer the setting of actual performance targets and choosing to only confirm the amount of the opportunity and the form of performance targets that will apply to the award. Companies should be mindful of how the market will respond to the Board setting the targets at a later point (especially where shareholder approval will be required for the CEO's award prior to the setting of the targets). This approach will require a level of trust from shareholders and it will be prudent to engage with institutional shareholders and proxy advisers early if this approach is pursued.

Ultimately, it will be important to consider whether executives should continue to be incentivised with 'at risk' remuneration during this period of uncertainty or whether they should be incentivised in a different way. For example, should standard STI and LTI offers for FY2021 be replaced with a one-year 'transitional' grant with appropriate short term performance hurdles to lead the company through the pandemic?

MOTIVATION - RECOGNISING THE ONGOING EFFORT REQUIRED TO PUSH THROUGH THIS PANDEMIC

Many executives and employees are working harder than ever and it will be important to continue to motivate them during this challenging and uncertain period.

While "retention" awards have historically been unpopular from a proxy adviser perspective, in the current environment recognition of effort and commitment remains important. Where remuneration has been negatively adjusted in the short term, companies are considering whether deferred bonuses may offer an appropriate compensation mechanism. An increased level of deferral may also spread the cost of remuneration over the coming years rather than having a single cash hit in the near term. Careful consideration should be given to whether any performance conditions should be attached to these awards (in addition to a service condition), and you may wish to consider engaging with proxy advisers and institutional investors as well.

APRA AND BEAR REGULATED COMPANIES

As usual, companies regulated by APRA and the Banking Executive Accountability Regime have additional considerations to keep in mind to ensure that the requirements relating to remuneration continue to be met.

APRA has suspended the majority of its planned policy and supervision initiatives in response to the Covid-19 pandemic. including its release of revised CPS 511, which would have introduced another level of complexity to remuneration in the financial services sector.

On 7 April 2020 the Chairman of APRA made an announcement to all authorised deposit-taking institutions and insurers in relation to capital management. It also included a statement that “APRA also expects that Boards will appropriately limit executive cash bonuses, mindful of the current challenging environment.” The implication being that, if dividends are not being paid (or are being delayed) in order to conserve cash, it would be inappropriate to pay large cash bonuses to executives.

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KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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