



**THE
PURPOSEFUL
COMPANY**

October 2019

The Purposeful Company Study on Deferred Shares

Full Report

The Purposeful Company Steering Group

Contents

Executive Summary	2
1. Introduction	3
2. Context	4
3. The academic evidence on incentive design	6
4. Is there market demand for greater use of deferred shares?	8
5. What are the benefits, behaviours, and risks arising from a move to deferred shares?	10
6. What are the barriers to change?	14
7. What can we learn from companies that have implemented deferred shares?	20
8. Insights and recommendations	26
9. Immediate next steps	36
Appendices	
A. About The Purposeful Company	39
B. Glossary	40
C. Companies adopting deferred shares	41
D. Participating organisations	42
E. Research methods	43
F. Desk top review of market practice	46
G. Interviews with companies and remuneration consultants	48
H. Interviews with asset owners, asset managers and their advisors	57
I. Investor survey results	67
J. Company survey results	76

Executive Summary

Attitudes are shifting on how best to align CEO pay to performance. Companies and investors increasingly see deferred shares¹ as a valid alternative to LTIPs to support long term value creation. Shareholders are supportive of companies that communicate a strong strategic rationale for implementing deferred shares. However, there remain significant barriers to adoption that prevent many companies from implementing where it might be suitable. Deferred shares are not a panacea and are not right for all companies. But they are a valid option that should be more readily available. To bring this about will require collaboration between investors, companies, and advisors to find practical ways to lower barriers to adoption.

This study finds that:

- There is widespread support amongst investors and companies for greater adoption of deferred share models than we see in the market today.
- Overall the consensus is that such plans might be appropriate for 25% of companies or more, as opposed to the c. 5% that we see in practice today.
- Investors and companies generally see behavioural and practical benefits from a move to deferred shares, including long-term alignment and encouraging long-term behaviour, as well as greater simplicity and spending less time on executive pay and target setting. The academic evidence largely supports these views.
- A minority of investors and companies also identify risks in terms of increased incidence of payment for mediocrity or failure, and reduced incentives, which could result in executives coasting or could create difficulties with recruitment.
- Despite the demand, there are significant barriers to greater adoption, with companies perceiving investors and proxy agencies as taking a strongly sceptical stance to deferred shares. The risks of adoption, in terms of low voting outcomes or severe compromises to secure support, and the work involved through the consultation process are off-putting.
- There is willingness on all sides to move the debate and practice forward, and this has led us to make recommendations in the following two areas (see page 26):
 - Process changes to encourage innovation and adoption. As well as positive signaling from investors, we need changes to how companies, investors and proxy advisors engage on and evaluate the implementation of deferred share plans.
 - Design changes to address concerns from investors about payment for mediocrity and company concerns about performance incentives and the attractiveness of the package to executives.
- If this is achieved, more companies will be able to take advantage of simplified pay designs where they are most effective for their circumstances.

¹ In the report we use the phrase 'deferred shares' to refer to any replacement to an LTIP that involves the award of long-dated share awards, including: restricted shares, performance-on-grant plans, and deferred bonuses – see Glossary.

1. Introduction

The Purposeful Company has reviewed the state of the market in relation to deferred share alternatives to LTIPs. Given the level and profile of debate on this issue, we are particularly interested in why there has been so little uptake by companies. Is this because companies and their investors continue to think the LTIP model is a better way to support long term value creation? Or is it because there are barriers to adoption that are leading to sub-optimal rates of implementation of simplified plans?

This study therefore addresses the following questions:

- Is there market demand for greater adoption of deferred shares in place of LTIPs?
- What are the benefits, behaviours, and risks arising from a move to deferred shares?
- What are the barriers to change?
- What can we learn from companies that have implemented deferred shares?
- What are the recommendations for action?

We undertook a number of activities to support our conclusions:

- a desk-top review of 19, mainly FTSE 350, public companies we identified that are currently operating deferred shares as an alternative to LTIPs;
- a review of the academic evidence on long term incentive design;
- interviews with asset owners, asset managers, companies, proxy advisors, and remuneration consultants; and
- a market-wide survey of investors and companies.

Overall, we engaged with over 100 organisations as part of this study. We would like to thank them all for their contribution.

A Key Findings Report summarising our findings and recommendations can be found here:

<https://www.thepurposefulcompany.org/key-findings-report.pdf>

The purpose of this Full Report is to provide further discussion but also full open source transparency of the data on which our conclusions were based, including interview themes and survey results. The appendices report this raw data without interpretation to enable market participants to scrutinise our evidence base and test our conclusions.

2. Context

Long term incentive plans (LTIPs) started to become widespread in the UK in the late 1990s following the 1995 Greenbury Report. The next 20 years saw the LTIP gradually displace share options as the incentive vehicle of choice. By the 2010s UK pay design had settled into a normal model that comprised salary and benefits, bonus (partly deferred into shares) and an LTIP.

However, two decades of experience has led a growing number of market participants to raise a range of concerns about the LTIP model, including:

- excessive complexity, meaning that pay plans are not properly understood by executives and shareholders;
- volatile, unjustified, or seemingly arbitrary outcomes that undermine public and shareholder confidence in pay-for performance; or
- a tendency to encourage short term behaviour as executives seek to hit targets in ways that are not consistent with long term value creation.

This has led some to propose alternative models. In 2013, Hermes EOS and the Pensions and Lifetime Savings Association, in conjunction with Railpen Investments, the BT Pensions Scheme, and USS Investment Management published '[Remuneration Principles for building and reinforcing long term business success](#)'. These principles advocated long term shareholding as the best route to alignment between executive and investor interests, and advocated consideration of simpler deferred share plans in place of LTIPs.

The Investment Association's [Executive Remuneration Working Group](#) produced a report in 2016, which suggested that restricted stock and deferred bonus plans might each be valid alternatives to LTIPs in the right circumstances. At around the same time, The Purposeful Company assembled the available academic evidence on pay in '[The Purposeful Company Executive Remuneration Report](#)' published in January 2017. This advocated use of deferred shares in place of LTIPs in many cases, in particular because of the risk that LTIP targets incentivise short term behaviour.

Hermes Investment Management provided a practical development of their pay principles in the paper '[Clarifying Expectations](#)' in 2016. Noting that '*the prevailing model of executive pay has significant problems*', the paper supported the concept of higher fixed pay partly delivered in shares, with a simplified incentive awarded in the form of long-dated deferred shares with an underpin. In early 2017 Norges published [remuneration principles](#) that supported the replacement of LTIPs with deferred share awards on grounds of simplicity, alignment, and incentivising long term behaviour.

Policymakers have also shown interest in deferred share alternatives to LTIPs. In particular, the UK Parliamentary [BEIS Committee](#) has on a number of occasions advocated the replacement of LTIPs by deferred share awards. The primary motivation has been the view that overly complex pay can lead to outsize awards and that simplification could result in a reduction in pay levels, as well as stronger incentive for long term performance.

Given all of the debate and discussion about pay alternatives, it's perhaps surprising that we were only able in our research to identify 19 current cases of deferred shares being used as an alternative to LTIPs in the UK.

In part this is because the debate has not all been one way, and some market participants continue to prefer the LTIP model. For example, BMO Asset Management expressed considerable scepticism about the deferred shares model in their paper '[All carrot no stick](#)' published in November 2017. Although not ruling out restricted shares as a concept, BMO concluded that:

'Our assessment is that, in practice, the current implementation of [restricted shares] has achieved few of its intended goals and made pay structures worse in some cases.'

As we will see in the study, a significant number of market participants believe that pay for performance, as expressed through the LTIP model, is essential for attracting risk taking executives, incentivising them to perform, and justifying pay-outs to stakeholders.

The debate on LTIPs is not limited to the UK. Following a push in recent years by asset managers and proxy agencies to get US companies to introduce LTIPs, the influential Council of Institutional Investors has recently raised a note of caution in its [updated governance guidelines](#). While not advocating a one-size-fits-all model, they state:

For some companies, emphasis on restricted stock with extended, time-based vesting requirements—for example, those that might begin to vest after five years and fully vest over 10 (including beyond employment termination)—may provide an appropriate balance of risk and reward, while providing particularly strong alignment between shareholders and executives.

...the [remuneration] committee should consider whether long-vesting restricted shares or share units would better achieve the company's long term compensation and performance objectives, versus routinely awarding a majority of executives' pay in the form of performance shares.

So the debate on LTIPs is not limited to the UK and is gaining traction. But is it justified?

3. The academic evidence on incentive design

[‘The Purposeful Company Executive Remuneration Report’](#) published in January 2017 provides a thorough review of the best academic evidence into long term incentive plan design, and the relevant original academic references may be found in that report. This section provides a short summary of the findings.

The academic evidence can never be precise enough to point specifically to a particular pay design as optimal in all cases. The authors of the review were careful to note that there could not be a one-size-fits all model and there were reasons to expect different models to be best fit in different cases. But overall the research findings did lead the authors to conclude the pay models based on long term share ownership with awards of long-dated deferred shares should be a more prevalent, and possibly the most prevalent, pay model. This was based both on negative findings relating to the current LTIP model and positive findings relating to a simplified pay model.

Negative findings about the current LTIP model can be summarised as:

- Large scale studies consistently show that *incentive targets themselves* influence executive behaviour, and that **executives can take action to hit targets or influence share price close to vesting of blocks of shares in a way that undermines long term value creation**. This is not a conclusion that is accepted by the corporate participants in our study, 62% of whom maintained that LTIPs are not a key driver of behaviour. However, over 70% of investors did expect behaviour changes as a result of changing LTIP design.
- Other research points to concerns that **CEOs have significant influence over target setting and evaluation** and partly as a result of information asymmetry, Remuneration Committees can find it difficult to set targets at the appropriate level of challenge.
- Practitioner-based evidence suggests that **complexity in long term incentive plans results in their value and relevance being discounted** relative to more immediate incentives, thereby reducing their efficacy as drivers of long term value creation. The impact of this is harder to prove, and this evidence meets a lower standard than the econometric evidence referred to above.

Taken together, this research suggests that over-reliance on performance targets for CEOs over relatively short periods of one-to-three years carries *significant behavioural risks*.

Problems with the current LTIP pay model have led some commentators to suggest that incentives should be abandoned altogether for CEOs. However, the authors of [The Purposeful Company Executive Remuneration Report](#) concluded that the research they reviewed did not support this suggestion. They found strong evidence that incentives do influence executive behaviour, and that, **correctly designed, incentives can play an important role in supporting long term value creation**. In deciding what features to embrace, the authors considered other research relevant for executive pay design:

- Some of this research points to **the importance of a lengthened time horizon for pay**. Research that identifies a causal link (rather than just correlation) has indicated that

replacing shorter-term with longer-term pay plans leads to improved company value and to investment in long term strategies such as innovation and stakeholder relationships.

- Other research suggests **placing greater emphasis on pay *design* rather than focusing on performance targets**. For instance, research has shown that payment in equity and debt has a clear, and generally positive, impact on behaviour. A rigorous study has identified a causal relationship between significant stock ownership by CEOs and long term out-performance by a margin of more than 4% per annum. A collection of studies has shown that higher levels of debt-like pay (unfunded pensions or deferred compensation) are associated with lower corporate bond yields, lower bankruptcy risk and leverage, lower stock return volatility, and higher asset liquidity.

This research suggests that **for CEOs it is better to use *comprehensive measures of performance, such as the stock price or debt value, measured after long periods***, as opposed to *specific targets* especially when those targets are financially driven and measured over the relatively short term.

A level of humility is required in interpreting academic research. Sample sizes and real-world constraints do not allow us to say that a particular incentive design will definitely be effective in a particular company. Situational considerations would always need to be taken into account, and the authors identify a number of circumstances where a conventional LTIP could be a better approach. But the evidence provides a coherent and compelling picture. The vast majority of empirical and theoretical academic research points to a pay model for CEOs based on cash and long-dated equity. **Based on the totality of this research, the authors of the report concluded that share awards combined with lengthened vesting and holding periods and phased release, had the potential to create positive incentives for CEOs to create long term value while avoiding the negative unintended consequences of the current LTIP model with its emphasis on awards with performance targets over three years.**

As a practical example, Amazon cite strikingly similar reasons to those highlighted in the academic research for avoiding conventional bonus and LTIP models. Unlike many US companies, the restricted stock used by Amazon is truly long term, vesting over a period of five or six years with no acceleration of vesting on termination of employment or change of control. Consistent with the academic evidence they explain their compensation philosophy as follows:

As stated in the Company's 1997 letter to shareholders, we believe that a fundamental measure of our success will be the shareholder value we create over the long term. As a result, we may make decisions and weigh tradeoffs differently than some companies. For example, under our compensation philosophy, we have prioritized stock-based compensation that vests over an extended period of time...we do not provide cash or equity incentives tied to performance criteria, which could cause employees to focus solely on short term returns at the expense of long term growth and innovation. We believe that investing in the creation of long term value, without the use of performance measures or specific indices, is optimal for Amazon employees, particularly at the executive level, and for shareholders.

4. Is there market demand for greater use of deferred shares?

Coming into this study, the authors were of the view that the debate on LTIP alternatives was running out of steam. The number of companies bringing forward proposals to 2019 AGMs was no more than a trickle. The pervasive view in the corporate world seemed to be that investors weren't interested and other than for the truly committed it was just too hard. We were therefore surprised by how much attitudes seem to have evolved, particularly amongst investors.

The table below shows the results from our survey on general attitudes to deferred shares amongst the investor and corporate communities.

Question: What is your general attitude to deferred shares as alternatives to LTIPs?

	Investors	Companies
Generally superior to LTIPs	24%	12%
A good idea for some companies and industries	34%	39%
Can be good for specific phases of a company's lifecycle	21%	22%
Generally sceptical – can support them when an LTIP doesn't work	17%	25%
Generally do not support them	3%	2%

An overwhelming majority of investors and companies (over 70% in both cases) and all remuneration consultants are supportive of deferred shares as an alternative to LTIPs, at least in some circumstances. Investors seem to be slightly more supportive than companies, but the difference is within the margin for error of the results. Only 20% of investors and 27% of companies are generally sceptical or unsupportive.

The generally supportive stance was reinforced in the face to face investor interviews, which indicated that **a number of asset managers have come to view deferred shares more favourably over the last two years.** Moreover, many **companies have adopted deferred shares for executives below the main board,** showing that they view it as the preferred pay structure, where they are unconstrained.

When asked what proportion of companies deferred shares might be suitable for, investor responses varied widely. The median response was 25% to 50%, and three quarters said that it would be appropriate for at least 10% of companies. Remuneration Consultants also generally agreed that deferred shares could be appropriate for 20% to 25% of companies, with one putting it as high as 50%.

This was consistent with the company responses. **Around 28% of companies have concluded that deferred shares are right for them and a further 18% are considering it. Yet relatively small numbers have implemented** (around 10% of our sample, and only around 5% of the FTSE-350).

Question: Have you considered deferred shares as an alternative to LTIPs? [Question to companies – select one only]

No	35%
Yes, but we rejected the idea as being unsuitable for our company	20%
Yes, but we're still considering whether it is the right thing for us	18%
Yes, we would like to implement, but currently view the barriers as being too high	18%
Yes we are planning to implement as part of our next remuneration policy	0%
Yes, we have already implemented	10%

Just over half of companies (55%) have either not considered deferred shares as an alternative to LTIPs (35%) or have rejected the idea as being unsuitable for their company (20%). The most common reason given was that **they simply felt that LTIPs work well for them and they see no need for change.**

While investors do not think that deferred shares are the right option for all companies, **investors do want companies to consider a range of options, rather than defaulting to a traditional LTIP.**

“The Remuneration Committee should be starting from first principles and asking what is right for the business” – Asset Manager

The overall view of investors, companies, and remuneration consultants suggests that deferred shares may be an appropriate alternative to LTIPs in 25% of companies or more, 5x more than we see today.

5. What are the benefits, behaviours, and risks arising from a move to deferred shares?

Our market survey and interviews showed that companies and investors both see similar potential benefits in deferred shares as an option.

Question: What do you see as the biggest potential BENEFITS of replacing LTIPs by deferred shares? [Only responses attracting more than 25% of respondents are shown – respondents could select up to three options]

Investors		Companies	
Simpler and more transparent pay	66%	Simpler and more transparent pay	61%
Reduced maximum levels of pay	52%	Avoid the 'boom and bust' of LTIPs	49%
Improved alignment of reward with company strategy and long term performance	34%	Avoid the difficulty of agreeing multi-year targets (internally and externally)	49%
Avoid short term of value-destroying behaviour caused by executives managing the business to hit LTIP performance conditions	28%	Improved alignment of reward with company strategy and long term performance	25%

Simplicity and transparency came top in both cases and both companies and investors highlighted the importance of alignment with long term performance. Companies also highlighted some of the practical and motivational impacts of avoiding boom and bust and avoiding the need to set targets each year. By contrast investors were more concerned about reducing pay quantum.

Both companies and investors interviewed expressed **a desire to spend less time discussing executive pay.** Companies that had adopted deferred shares noted that it had simplified and taken time out of their annual pay process. Investors also welcomed the prospect of avoiding the annual discussion and analysis of long term incentive targets. However, our research finds that **a period of additional investment in establishing the norms and frameworks for deferred shares will be required in order to attain the ultimate goal of greater simplicity.**

In our interviews with investors the desire for simplicity and reduced pay came through strongly. But avoiding short termism was also a prominent theme. Many of the investors we interviewed saw the benefits of long term share awards in supporting a long term time horizon in executives.

“[The deferred share model] creates simpler and more transparent pay, better incentivizes executives to act in the long term interests of shareholders, and avoids the boom and bust of traditional LTIPs” – Asset Manager

“By reducing the number of variables across bonus and LTIP and adding discretion you can avoid unintended consequences” – Asset Owner

However, whereas investors were generally of the view that changing to deferred shares could create positive benefits in terms of longer-term behaviour, companies generally do not consider the LTIP to be a core driver of executive behaviour, as shown by the responses to the survey question on behavioural impacts.

Question: What do you see as the likely biggest BEHAVIOURAL IMPACTS of replacing LTIPs by deferred shares? [Only responses attracting more than 25% of respondents are shown – respondents could select up to three options]

Investors		Companies	
Executives will be more likely to take decisions in the long term interests of the business	62%	Executives will continue to operate as they do today, as the LTIP is not the core driver of behaviour	59%
Executives will execute strategy more effectively because they won't be distracted by the impact on their LTIP targets	52%	Executives will be more likely to take decisions in the long term interests of the business	44%
		Executives will execute strategy more effectively because they won't be distracted by the impact on their LTIP targets	33%

Investors were generally positive about the potential behavioural impacts of removing LTIPs. Those companies that had implemented deferred shares also frequently referenced the desire to encourage long term behaviour. **But opinion across companies as a whole was more sceptical,** with most respondents believing that LTIPs are not a core driver of behaviour. Nonetheless, even **amongst companies those identifying positive behavioural impacts of replacing LTIPs outweighed those identifying negative impacts by more than two to one.** Only 15% to 17% of companies felt that the change would lead to coasting, retention problems, or less effective execution of strategy.

“Deferred shares focus executives on strategy rather than earnings and short term shareholder returns all of the time, which can be quite damaging to a company” – Asset Manager

“The traditional LTIP had greater incentives not to behave well – [deferred shares] remove the conflict of interest” – Remuneration Committee Chair

“Executives feel more connected to the value of the company” – Remuneration Committee Chair

Throughout the interviews with investors a repeated **concern was that deferred shares could increase pay for poor performers, rather than bringing pay down**. This is reflected in the two risks overwhelmingly identified by investors in the survey to the exclusion of others: that **payment for failure could become more likely, and that award (and hence average pay) levels could drift up over time**.

Companies shared the concern about the ability of remuneration committees to exercise discretion when needed. But also **a significant proportion of companies identified risks relating to recruitment and motivation**. Nearly half of companies believed that the lack of upside in deferred shares could make it harder to recruit executives, and just under three in ten feared that the model could be attractive to risk averse executives rather than value creators. On a similar theme, **just under a third of companies feared that the loss of performance incentive could lead to coasting or avoidance of tough decisions**.

Question: What do you see as the biggest potential RISKS of replacing LTIPs by deferred shares? [Only responses attracting more than 25% of respondents are shown – respondents could select up to three options]

Investors		Companies	
The remuneration committee will find it difficult to exercise downwards discretion when needed to payment for failure will be more likely	66%	The remuneration committee will find it difficult to exercise downwards discretion when needed to payment for failure will be more likely	49%
Award levels will drift upwards over time meaning that average pay will be higher than today	48%	Because of the reduced upside it will be harder to recruit executives	44%
		There is less incentive to perform so executives will coast and avoid tough decisions	31%
		The lack of upside will mean that the pay system will attract risk-averse executives rather than value creators	29%

Companies show persistently greater levels of concern about potential adverse behavioural risks of moving to deferred shares than investors, albeit still a minority concern.

“We will retain less ambitious executives – ambitious executives will go to private equity” – Remuneration Committee Chair

“We want to drive a performance culture. That means incentives to beat targets. Restricted stock structures just don’t carry the same level of performance demand” – HR Executive

Equally, not all investors were positive about deferred shares. **Around 20% of investors were generally sceptical or opposed to replacing LTIPs. The issues they identified were loss of performance incentive and the risk of higher pay for mediocre performance.**

“Value is being delivered regardless of value being created” – Asset Manager

“There is less incentive to perform, so executives will coast” – Assest Owner

“Restricted shares enable high quantum without appropriate targets” – Asset Owner

6. What are the barriers to change?

Appetite for change

Not all companies want to implement deferred shares. **Around half of companies have either considered and rejected deferred shares or not considered them** – generally because they were of the view that LTIPs work well for them.

Question: Why did you reject (or not consider) the idea of deferred share alternatives for LTIPs? [Question to the subset of companies (52% of the total) that have either not considered deferred shares or have considered and rejected the idea. Only responses attracting more than 25% of respondents are shown – respondents could select all that apply]

We believe LTIPs work well for our company and don't see a need to change	59%
It would be too controversial with our shareholders	28%
We would rather see how the market develops before looking seriously at this option	28%
We believe the impact on executive behaviour or motivation would be negative	25%

While 69% of these companies said it is possible they will revisit this option if the market develops so that deferred shares become more common, only 16% said this was likely. So **overall around half of companies appear to be happy with their LTIP and are in no hurry to change**. These companies are not being prevented from changing by any barrier – they have simply concluded that deferred shares are not for them. This re-emphasises the important point that deferred shares should not be considered a panacea nor the right solution for all companies. **Conversely, around a third of companies are considering deferred shares, in addition to those that have already implemented, and many of them are put off by the perceived difficulties of adoption.**

Barriers perceived by companies

Those companies considering adoption, but yet to take the plunge, perceive a number of significant barriers in getting both executive and investor support.

Question: What are the most significant barriers preventing you from implementing deferred shares in place of LTIPs? [Question to the subset of companies (34% of the total) that either want to or are considering whether to implement deferred shares, but have not yet done so. Only responses attracting more than 25% of respondents are shown – respondents could select all that apply]

The compromises required to get such a plan approved would make it unattractive to executives	58%
We don't think our shareholders would support the plan	53%
We think proxy agencies are likely to recommend against the plan	53%
The board is divided on whether it is a good idea	26%

We asked all companies in the survey to identify the most problematic (for executives) of the compromises required to get shareholder approval.

Question: Which of the following compromises often required by investors in order to support a restricted shares plan creates the biggest problem in making the package attractive to executives? [Question asked of all companies. Only responses attracting more than 25% of respondents are shown – respondents could select up to three options]

Requirement for a discount of 50% or more in maximum award level	65%
The requirement to have an underpin	44%
The requirement to extend vesting and holding for more than five years	37%
The combination of all the above	28%

Overwhelmingly the discount in maximum award level was viewed as the biggest barrier to adoption. This is understandable. Average vesting of FTSE-100 LTIPs over the last five years has been fairly consistent at 60% of the maximum, with a chance of between one-in-four and one-in-three of vesting above 90% of the maximum. Even if a board of a company with an average to strong vesting track record felt that deferred shares were a good idea from a behavioural point of view, it would be very difficult for them to sell the proposition to executives.

The requirement to have an underpin is considered to be a complicating factor by many companies, which undermines the certainty created by the move to restricted stock. However, for most investors this is an essential feature of deferred shares, and in particular restricted stock, in order to protect against payment for failure. Given that increased payment for failure was also a risk identified by companies, our experience from the study is that most market participants recognize this as a necessity in deferred share design.

Barriers experienced by companies adopting deferred shares

The interviews with companies that have adopted deferred shares suggest it is not for the faint hearted. Companies faced multiple challenges, including:

- The challenge of balancing the trade-offs required by investors (reduced quantum and so on) with a package that is attractive to executives.
- The extensive effort required in consulting with shareholders and proxy advisors.
- Dealing with the diversity of shareholder views and with proxy advisors, given their influence on the voting outcome and the difficulty of getting clear guidance on proposals.

These same themes came through in the survey responses.

Question: What do you see as the biggest challenges in introducing this type of plan? [Question to the subset of companies (10% of the total) that have implemented deferred shares. Only responses attracting more than 25% of respondents are shown – respondents could select all that apply]

Navigating the diversity of shareholder views on this type of plan	63%
Ensuring executives maintain support for the plan given the compromises required to satisfy investors	50%
Getting proxy agency support for the plan	38%
Getting a high enough level of shareholder vote to make the plan sustainable	38%
Avoiding compromises to the plan design that undermine its intent and benefits	38%
The amount of work and consultation required to get the plan approved	25%

“If you want to make a change in remuneration, you want to be in a position where you already have the investors on your side” – Remuneration Committee Chair

“You cannot concentrate on anything else” – Remuneration Committee Chair

The role of investors and proxy advisors were a prominent theme when talking to companies. It was felt that there was **not enough encouragement or coherence from investors for reform**. ISS were frequently cited as being difficult to deal with, probably reflecting their relatively high incidence of AGAINST recommendations. They were perceived by companies as taking a rules-based approach on deferred shares, lacking capacity to engage to the extent required, failing to provide clear feedback, and providing insufficient time to react to voting recommendations. **69% of companies said that proxy advisors will need to change their view and support more such plans if they are going to become more widespread** – the number one change identified by companies as being necessary to encourage more adoption.

“ISS need to ensure their commentary is more directly linked to the company strategy” – Remuneration Committee Chair

“If ISS see something simply out of line with normal practice they present it as a concern” – Remuneration Consultant

Another concern raised by some companies was that proxy advisors may have devoted the time to understanding a plan at the point of approving the policy, but **in subsequent years may have reverted to assessing it as a conventional pay policy, rather than by reference to the terms that were approved**.

We return to these themes later. Undoubtedly **the resource challenges faced by investors and proxy advisors**, and associated operating models adopted, in analyzing thousands of AGM proposals **do create tension with the considered engagement required in relation to innovative**

remuneration models. Moreover, proxy advisors have faced the significant challenge of trying to develop a consensus position on deferred shares when in practice their clients’ views of them have varied widely. It appears that ISS is becoming more accepting of deferred share proposals at more recent AGMs. Glass Lewis has more of a track record of supporting deferred share proposals.

The investor perspective

Perhaps understandably **the top fear of investors is of unseen unintended consequences.** This has created caution in the number of plans they are prepared to support. There was a concern expressed by some that a widespread move to deferred shares could lead to criticism in the future for shareholders supporting payment for failure or paymemnt for mediocrity.

Question: What other barriers have you experienced in supporting deferred share proposals?

[Asked to investors]

We are concerned about unintended consequences that we may not have identified	43%
Consistency across markets (e.g. we have been moving to add performance conditions to restricted shares in the US)	36%
Negative shareholder advisor / proxy agency recommendations	29%

But the question of consistency across markets was also relevant. **A number of UK investors commented that they had been becoming more active on pay matters in the US,** pushing companies to add performance conditions to restricted share awards. It therefore seemed **inconsistent to be supporting the opposite trend in the UK.** Of course, the US version of restricted shares has generally involved shares with no underpin vesting over three years, on occasion pro-rata. This is quite a different proposition from the UK version. The recently updated **executive pay guidelines from the Council of Institutional Investors may be helpful in creating acceptance of a long-dated version of restricted shares on both sides of the Atlantic.**

Shareholders shared some of the concerns expressed by companies about proxy advisors, but less forcefully. **Most investors view proxy advisors as providing a very important service that enables them efficiently to discharge their stewardship activities.** Several felt that company criticisms levelled at proxy advisors could be unfair, and at times simply reflect the unwillingness of companies to admit they were wrong. A number noted that it simply wasn’t feasible or efficient for investors individually to analyse proposals across hundreds or thousands of holdings. Nonetheless, **there was a recognition that proxy advisors can impose more of a ‘one-size fits all’ approach to nuanced judgements.**

“It is true that if something doesn’t fit the box they recommend against” – Asset Manager
“The attitudes of proxy advisors limits adoption [of deferred shares]” – Asset Owner

Undoubtedly there are occasions when companies object to proxy advisor recommendations simply because they do not go ‘the right way’, and companies where proxy advisors have been supportive may be more likely to view them favourably. Moreover, responsibility is at times unfairly placed on proxy advisors who are just that – advisors. **Ultimate accountability for the**

vote lies with their investor clients, and it is important to remember this fact. However, the current dynamics of AGM voting means that the large **recommendation-only proxy advisors** such as ISS and Glass Lewis **do hold significant sway over voting patterns**, particularly in the tail of a company's register. Negative proxy advisor recommendations can by themselves result in a company appearing on the Investment Association Public Register even when their top shareholders are supportive. **The guidance given by investors to proxy advisors and the engagement mechanisms between investors, advisors, and companies do both require review if we are to move practice on.**

A small number of investors questioned whether remuneration consultants were doing enough to explain the option of deferred shares to their clients. Although a minority view, they suggested that remuneration consultants could have a vested interest in complexity and so not promote simpler plans.

What needs to change?

Companies and investors are broadly agreed that investors need to develop a more coherent view of the change they want to see so that companies know what is expected. Linked to this is the need for investors to instruct proxy agencies to be more welcoming to such plans, if they do indeed want to see greater adoption.

In interviews with investors, it became clear that they felt that **some companies had been much better than others in demonstrating the strategic rationale for their proposals** and in providing supportive analytics in relation to issues such as the discount rate when moving from LTIP to deferred shares. This is also reflected in the survey, where **half of respondents say that companies just need to get on with it and accept the necessary trade-offs.** Companies themselves were not unsympathetic to this point of view.

Other points raised were that it was just a matter of time – **if things work out well for the early adopters, then investors will become more comfortable with deferred share plans.** Linked to this was a desire to see more consistently high performing companies with strong LTIP vesting come forward with deferred share proposals. The problem with this is that the level of discount required is arguably unattractive to too many companies, particularly those with strong vesting histories or prospects. A need to take a **more flexible attitude to the required level of discount** when moving from LTIP to deferred shares was **cited by nearly half of companies as a necessary change** in order to encourage more adoption.

We return to these issues in Section 8.

Question: What would need to change in order for deferred share alternatives to LTIPs to become more prevalent? [Select all that apply, ranked in order of declining combined response rate across investors and companies]

	Investors	Companies
Proxy agencies changing their views and supporting more such plans	36%	69%
Investors developing a more coherent view of the change	46%	54%
Companies need to accept the trade-offs in terms of discount, deferral, underpins	50%	42%
They will become more prevalent provided investors see early adopters working out well	39%	33%
Investors need to accept a lower discount in award levels to make it attractive to management	18%	46%
They will never become very prevalent as they are not appropriate for most companies	15%	14%

7. What can we learn from companies that have implemented deferred shares?

Types of plan

We identified **19 companies currently operating deferred shares in place of LTIPs** (see Appendix C). Eight had replaced LTIP with restricted shares, eight with performance-on-grant, and three had introduced restricted shares while retaining an LTIP in some form.

In our survey, investors emphasized that a number of key trade-offs are important in securing support for a deferred share plan. The results are shown below for restricted shares, but the findings for performance on grant plans were similar. Interviews with proxy advisors also indicated they took all of these factors into account when evaluating a proposal.

Question: In order to support a restricted shares plan in place of an LTIP, which of the following are particularly important? [Asked to investors, select all that apply. Only responses attracting more than 25% of respondents are shown.]

Strength of strategic rationale	79%
Presence of an underpin on the deferred shares	75%
The level of discount in the maximum award level	68%
Combined deferral / holding in excess of five years	68%
High shareholding requirements	68%
The quality of the consultation process and leadership shown by the Remuneration Committee Chair	61%
A remuneration committee with a strong track record of acting in shareholders' interests	50%

The eight pure restricted share proposals were quite standard in their implementation with all the companies reducing the level of award by around 50%, increasing vesting / holding to five years or more, and all but one having an underpin prior to vesting of the restricted shares. **Performance-on-grant proposals were more varied**, with pre-grant performance tests varying between 1 and 3 years, discounts varying between zero and around 40%, and underpins prior to vesting being present in just half of cases.

Sectors and strategic rationale

Three sectors dominated: natural resources, financial services, and retail. The first two of these were the two industries most commonly cited by investors in our survey (by 59% and 41% respectively) as being particularly suited to deferred shares. There was also significant commonality in strategic rationale for the change, with the following factors each identified by at least five of the companies:

- Simplification
- Industry cyclical and volatility, causing ‘boom and bust’ for LTIPs
- Significant uncertainty or externally-driven change for the company
- Desire to incentivise long term behaviour
- Alignment of reward structures across the organization

This was reinforced by the feedback we received in interviews with adopting companies. In many cases the industry context had created problematic vesting histories (see below), and the companies identified the need to retain and motivate executives as another significant motivation for introducing deferred shares. **These strategic justifications also align well with those selected by investors in our survey.**

Question: What do you view as an appropriate strategic rationale to enable you to support a deferred share arrangement [Asked to investors, select all that apply. Only responses attracting more than 25% of respondents are shown.]

Highly cyclical industries where it is difficult to set long term targets	69%
Significant change or uncertainty for the company, making it hard to set LTIP targets	62%
Very long term industry cycles and timeframes	41%
Potential for significant external factors outside the control of management (e.g. regulatory change) which can disrupt target setting in LTIPs	28%

Nearly a quarter of investors (24%) stated that they generally prefer deferred share awards and so do not need a particular strategic rationale.

The role of ESG considerations

Although not covered in the survey, the question of ESG considerations came up in a number of interviews. **There is a growing interest in how ESG factors can be incorporated into pay**, ranging from climate change through to more nuanced issues relating to employees or societal obligations.

Some participants in our study highlighted that, given the evidence about the importance for value of ESG considerations over the long term, **long-dated equity can be a simple and effective way to incorporate ESG into pay**, given that ESG factors should be reflected in the share price over the long enough term. This was a particularly prominent discussion in relation to natural resources and oil & gas industries, which face particular challenges relating to the energy transition.

Performance and LTIP vesting history

One comment made by a few investors in our interviews was a concern that restricted shares could be a refuge for underperforming companies. We did not find this to be the case. **Companies adopting deferred shares had neither systematically over or underperformed their TSR benchmarks** (as identified in their TSR chart in the remuneration report) over the short to medium term prior to adoption. Broadly half of companies had outperformed their benchmarks and half had performed below the benchmarks.

This finding counters the accusation that underperforming companies are the only ones adopting deferred shares. However, the average LTIP vesting over the five years prior to adoption of deferred shares was 35% of the maximum, with a range up to 61%, which is a little over half the 60% average level of vesting in FTSE companies over the last five (and ten) years.

On closer inspection we found the situation to be nuanced, as a number of companies were adopting deferred shares to counter extreme cyclicity of LTIP payouts, and introduced deferred share awards during a phase in the cycle when LTIP pay-outs were increasing. For example, the LTIP maturing after adoption of restricted shares at The Weir Group vested at 75% of the maximum (and in their remuneration report when the new plan was approved they noted the ten year average vesting was 61%). The LTIPs maturing since RBS redesigned their LTIP have vested on average at 65% of the maximum. And BHP, in their recent remuneration report in which they are proposing a shift in balance towards deferred shares, note that the next three LTIP cycles are projected to vest at 90% of maximum on average. **So at least in a number of cases the driver of the change in design is not a persistently low level of LTIP pay-outs but a feast or famine profile.**

Of course there is a risk of an element of self-fulfilling prophesy in this regard: if investors impose rigid guidelines that, for example, restricted shares must be discounted by 50% relative to LTIP grant levels, then any company with a *consistently* strong history and near-term prospects of LTIP vesting is going to find it difficult to sell that proposition to its executives. Therefore, the companies for whom this is going to be most attractive are inevitably those for whom LTIP pay-outs have been more erratic.

Voting outcome and shareholder context

The average vote across all the proposals was a little under 90%, although three were below 70%. This does not particularly suggest widespread investor opposition to the proposals. However, according to data from Proxy Insight ISS recommended AGAINST eight out of the 19 proposals, far above their rate of opposition for proposals across the market as a whole (less than 10%). Glass Lewis were much more welcoming of the proposals, recommending in favour of all but one. We would note, however, that **since the implementation of The Weir Group's restricted share plan in 2018, ISS appears more inclined to support deferred share implementations.**

Companies acknowledged the difficulty of securing the support of all proxy agencies and calibrated their aspirations accordingly. In our survey, **while 62% of companies that had implemented deferred shares targeted a vote of 90%+, 38% would have been content with a vote of 70%+.**

Given the large proportion of negative ISS recommendations, it is perhaps surprising that the average vote was so high. **This can be explained by the make-up of the investor bases of the companies: they are unusually concentrated.** For those adopting restricted shares to replace an

LTIP entirely, the top five shareholders held on average over 50% of the issued share capital. For those adopting performance-on-grant the average was lower, at 35%, but still above the more typical level of around 25%. These companies were therefore **better placed to secure support of a small number of anchor shareholders, which could insulate them against the effects of negative proxy recommendations**. It is notable that all three companies with voting support below 70% received an AGAINST recommendation from ISS but also had a conventionally dispersed shareholder base without strong concentration at the top of the register.

In the interviews with companies that had implemented deferred shares, the importance of a concentrated investor base and the importance of conducting a thorough consultation process were widely recognized.

Performance-on-grant proposals were opposed by ISS when either:

- There was no discount in quantum and no underpin on deferred shares; or
- The pre-grant performance test operated over only one year, rather than a mix of one and three years

When asked about the factors important to supporting performance-on-grant plans, the discount in award levels and underpin on the deferred shares were cited as being particularly important by, respectively, 54% and 50% of investor respondents to our survey. Added to the 11% of investors who said they never support performance on grant, **the ISS recommendations on these elements seem to be following the preferences of close to two-thirds of investors**.

The length of the pre-grant test is less clearly a red-line issue for investors. Only just over one-third (36%) specified pre-grant performance metrics measured over three years or more as being a particularly important factor in securing their support for performance-on-grant plans, so **it is less clear that AGAINST recommendations based on this factor are aligned with investor views**.

Restricted share plan implementations tended more closely to follow the rule book. It was less clear in this case what discriminated between positive and negative proxy adviser recommendations. It appeared that their assessment of the strength of the strategic rationale was the determining factor. **Recent evidence suggests that ISS is starting to look more favourably on restricted share plans or companies are better understanding what is required to get ISS support, as rates of support appear to be increasing**.

Recommendation-based proxy advisors have faced a particular challenge in relation to the evolving attitudes on deferred shares. Client perspectives on the change have been mixed and, certainly shortly after the publication of the report of the Investment Association's Executive Remuneration Working Group, were on balance cautious to negative. Recommendation-based advisors are required to recommend FOR or AGAINST each proposal, but against a backdrop of little consensus. Some areas of apparent consensus have emerged, for example around the level of discount for restricted shares, but **more work is required to give guidance to proxy advisors as to how these plans should be evaluated**. At the same time, **investors need to take particular responsibility for individually evaluating deferred share proposals** during the period of transition, rather than defaulting to following proxy advisor recommendations.

Alignment across the company

Most companies extended the deferred share plan beyond the Executive Directors.

Question: How far does your new policy cascade down through the organization? [Asked to companies that had implemented deferred shares, select one.]

Executive Committee	38%
A wider group of up to 50 executives	13%
A wider group of up to 500 executives	25%
The whole company	25%

Similarly, most companies were using the opportunity of the design change for senior executives to introduce or reinvigorate all-employee share plans.

Question: While introducing a deferred share plan for senior executives are you also looking at share ownership across the company? [Asked to companies that had implemented deferred shares, select one.]

Yes we are introducing a new all-employee share plan	50%
Yes we are reinvigorating communication of an existing all-employee share plan	13%
We already have an all-employee share plan with high levels of participation	25%
No we are not looking at this	13%

We heard consistently in our interviews that **adoption of deferred shares for a senior group in the company was generally part of a broader strategic alignment across the company** around share ownership.

Which companies do investors believe have implemented deferred shares well?

Investor respondents to the survey were presented with a list of the current deferred share implementations and were asked to highlight cases that they were top of mind as representing particularly good implementations. There was a spread of responses, but the clear leader was The Weir Group, identified by 34% of respondents. It is worth noting that Weir may benefit from familiarity bias as it has been a high profile case that most investors will have heard of and many will have been actively involved with. As a point of disclosure, the Remuneration Committee Chair of Weir is on the Steering Committee of The Purposeful Company and is one of the authors of the report.

However, this was supported in the interviews, where a number of investors noted that the Weir Group case study met a number of the criteria for a strong implementation, in particular:

- **a clearly communicated strategic rationale** that went beyond difficulty in setting targets or retention concerns, but instead spoke to alignment with strategy and value creation;

- the **compliance with design requirements** on discount, deferral, shareholding requirements and underpin;
- a **strong and timely consultation process** led by the Chair of the Remuneration Committee, leaving plenty of time for iteration and feedback;
- **clear disclosure in the remuneration report** of the consultation process, how feedback was incorporated, and the other options considered and rejected.

Rather than reproducing a case study in this report, we refer the interested reader to [The Weir Group's 2017 Remuneration Report](#), which lays out the rationale for the new policy.

8. Insights and recommendations

We have reviewed in depth the motivations, hopes and fears, and experiences of market participants in relation to deferred shares. We outline in this section **two areas where we believe it is critical for change to occur if momentum for change is to be built**. If investors and companies want to see more deferred share plans, and it appears that they do, then they will need to engage in open dialogue around these issues. We provided some ideas for debate, which doubtless contain flaws and need stress testing. But we believe they form a meaningful starting point for dialogue, if market participants truly do want to see change. They are:

- **Process changes to encourage innovation and adoption.** As well as positive signaling from investors, we need changes to how companies, investors and proxy advisors engage on and evaluate deferred share proposals and their subsequent implementation.
- **Design changes** to address concerns from investors about **payment for mediocrity** and company concerns about **performance incentives and the attractiveness of the package to executives**.

To make progress in these areas requires a period of **investment in dialogue** by investors and companies to enable new solutions and design norms to emerge. This will require a **willingness by investors and companies to devote more resources** to the pay question in the short term, both directly and via their respective service providers. However, in the long term, simplification should lead to reduced time commitments. **Without specific effort on these issues, the pace of change will remain very slow.**

8.1 Process changes to encourage innovation and adoption

Many companies we spoke to and surveyed highlighted the **perception of a resistant and disjointed investor and proxy advisor community as a major barrier to change**. Analysis of the implementations to date provided some evidence for this, showing **that ISS had recommended AGAINST nearly half of implementations** (Glass Lewis supported all but one). Those companies that had implemented deferred share plans largely (but not exclusively) had significantly concentrated registers allowing them to secure a strong vote through support of a small number of anchor shareholders, notwithstanding proxy advisor views.

Investors we spoke to and surveyed also identified **the need to present a more coherent view of the desired change and a more welcoming stance**. They also recognized the need for clear guidance to be given to proxy advisors. Even though deferred shares are mentioned in the Investment Association Guidelines and other shareholder voting policies, to date, companies perceive most investors and proxy advisors as merely tolerating deferred share implementations. Active supporters within the investor community are viewed as being in a minority.

As well as being more openly encouraging of appropriate deferred share implementations, **investors will also need to instruct proxy advisors to approach these schemes differently**. We recognize that standardized approaches to analysis are important in creating efficiency at scale, given the thousands of meetings that investors have to vote. However, too rigid a rubric has been implemented too quickly. We also observed that on occasion a proxy advisor had recommended AGAINST a number of implementations that met the requirements of discount, underpin and

deferral, because they did not find the rationale compelling. **We believe that strategic rationale should be a matter for investor judgment**, as proxy advisors are not equipped to assess the fit with a company's strategic context or the particular circumstances of the management team. In this context the recommendation-only model can inhibit innovation.

A period of time is required during which there is greater dialogue, a more explicit role for investor judgement, and sharing of lessons learned, in order to inform the optimal design parameters. This will also be required to build trust. After a period of time, these can then be converted into a more structured rule-set about what is acceptable in this area.

A number of companies interviewed felt that **The Investment Association Public Register makes adoption of deferred share plans particularly high risk**, given the perceived lack of consensus on the issue and the risk of negative proxy advisor recommendations. We do not see an easy way to address this. It is not realistic to withdraw the register in the current environment. However, the risk of being tipped onto the register purely because of a negative proxy agency recommendation could be reduced, and this is the basis of our recommendations.

- First, it would help encourage companies to come forward with appropriate proposals for change if **The Investment Association made it clear that members welcome deferred share plans in the right circumstances, that investors encourage companies to consider whether they are right for their business, and that they are ready to engage with companies on this topic.**
- Second, **Investors need to provide clear guidance to their proxy advisors.** Proxy advisors are service providers, fulfilling a critical and high quality service to investors. Investors are responsible for how they use their recommendations. However, **the practical influence of the large recommendation-based proxy advisors is undeniable** (and causal influence on voting has been demonstrated by academic research). Their methodologies for evaluating deferred share plans are therefore an important part of enabling reform.

We cannot expect proxy advisors to lead the debate on what constitutes appropriate design in long term incentives – indeed that would be inappropriate. Therefore, it is particularly important that **investors provide clear guidance to their service providers on how they would like to see deferred share plans evaluated.** However, it is also important that proxy advisors appropriately identify proposals as being for strategic judgement.

This will require investors to identify the design features that they wish to see evaluated. **Features should be divided into red-line issues, where no alternatives will be countenanced and those where investors may accept a range of outcomes**, if appropriately justified, for example including:

- Core design: restricted shares, performance-on-grant, deferred bonus, bonus bank, other designs as discussed later in this paper.
- Discount (depending on type of plan), deferral and holding periods.
- Underpin – presence and nature (e.g. formulaic vs discretionary).
- Pre-grant performance tests – measures and duration.
- Treatment for joiners and leavers.

- Evidence of the quality and authenticity of the consultation process.

Having identified the criteria, and which are red-line issues, we therefore recommend that until we have completed the 2021 AGM season, **investors should work with ISS and Glass Lewis** – as the largest recommendation-based proxy advisors in the UK market - **to implement the following approach** in relation to deferred share proposals:

- **Proxy advisors should clearly highlight deferred share proposals** to clients as an item worth of tailored consideration.
- The proposal should be analysed by the proxy advisors in terms of the issues identified by investors. Breach of red-line issues could justifiably lead to an AGAINST recommendation. However, **failure to adopt the ‘best practice’ provisions outlined by investors should be clearly identified, but should not automatically lead to an AGAINST recommendation**, but instead, provided not egregious, should lead to a FOR recommendation, but with a clear flag that the proposal is for shareholder judgement and that there are critical issues for the shareholder to consider.
- Advisors **should not recommend AGAINST on the basis of strategic rationale**, as this is a matter for shareholders not advisors.
- The proxy advisors should offer an **extra engagement meeting** to the company to enable appropriate iteration and full understanding of the proposal.
- If ISS or Glass Lewis recommend AGAINST such a proposal, **the timeframe for response should increase ideally to one week** and provide genuine opportunity for engagement and mutual understanding.
- If a company could persuade **major shareholders publicly to express their support** for the plan, the proxy agencies should **take this into account** in their own voting recommendation, for example if a company could demonstrate that its anchor shareholders were supportive.
- **Investors should be prepared to analyse for themselves proposals flagged as deferred share plans (whether proxy advisors recommend FOR or AGAINST)** to determine whether they support the proposal or not, so that investor preferences can be revealed to the market. If they are supportive should state this support and feedback to the proxy advisors to inform their own analysis process.
- **Implementation of non-standard approaches should be assessed against the policy that was approved** rather than through the lens of a standard LTIP or incentive design template.
- In the event of an AGAINST recommendation on a deferred share proposal, or on the implementation of a previously approved policy, **the proxy advisor should offer a ‘review of learnings’ meeting after the AGM season** to enable mutual understanding with the issuer.

Following the 2021 AGM season, investors and proxy advisors, via the Investment Association, should review implementations to date and seek to **update guidance so that companies and**

proxy advisors understand how to assess deferred share proposals in a more standardized way, without the need for bespoke engagement on every occasion.

We do recognize that this process will impose greater resource demands on investors as well as ISS and Glass Lewis. We have focused on the role of these two advisors recognizing their dominant market share, which brings with it stewardship responsibilities in terms of allocation of resource to issues identified by the market as being systemically important. We understand that this is challenging in an environment where thousands of AGMs must be analysed. However, this is also the stewardship responsibility. **We will not move from debate into practice in the area of executive pay design without effort.**

At the same time companies need to recognize their responsibility to enable high quality, informed dialogue. **Remuneration Committee chairs seeking to drive reform need to take the time fully to understand the evidence, issues, and trade-offs to be in the position to convince investors about the quality of their stewardship of the Committee's decisions.** The rationale for the pay design must be well articulated and tightly aligned with the strategy, and not based purely on poor experience with LTIP vesting history.

Supporting this effort, we believe that there is a case for a forum in which investors and companies come together to **discuss the best academic research and leading current practice in remuneration** so as to build capability across the market in the investor, remuneration committee, and advisory spheres.

Ideas should be developed to address concerns from some investors and companies about the attractiveness and variability of pay under deferred share proposals

The 50% discount for restricted shares (which is in the Investment Association Guidelines) has been treated as a red line issue by proxy advisors. Yet nearly **two-thirds of companies identify the discount as a big problem** in making deferred shares attractive to executives.

Considering implementation of deferred shares purely as an LTIP replacement, with a consequent 50% discount, may be creating too many constraints. **To create the desired total pay variability with deferred shares while achieving a package that is attractive to executives may require more substantial package restructuring.** Over two-thirds of investors were prepared to consider more fundamental changes in the fixed-variable package mix in exchange for payment in shares (68%) or to consider awards of restricted shares in exchange for investment in shares by the executive (72%). Companies were less keen with 52% and 28%, respectively, supporting these options. However, we believe there are potential approaches that meet the needs of all parties.

A significant proportion, albeit minority, of investors (up to 24%) and companies (up to 44%) see a **risk that deferred shares may lead to insufficiently variable pay outcomes.** Although not all investors we spoke to shared the view – many felt that the large shareholding built up with deferred shares itself created enough performance alignment.

Insufficient variability may create issues on the downside, in terms of the **risk of payment for mediocrity**, and on the upside, in terms of **lack of attractiveness to executives and incentive for exceptional performance.**

These concerns, although a minority view, were sufficiently pervasive that the underlying issues should be explored and options considered to create the desired performance variability

through deferred shares without undermining the objective of simplicity. **The academic research tends to point towards simple packages consisting of cash and shares as being optimal**, and so the question may be as much one of the package mix between cash and shares as the design of the incentive components.

Below we summarise some approaches to implementing deferred shares that could address some of the concerns raised.

The academic research strongly points to optimal executive contracts generally consisting of a mix of cash and deferred shares. Ways of implementing this include:

- **Wider package restructuring** which could create greater variability in total pay by using deferred shares in place of part of bonus, pension, or even salary, but therefore with a lower overall discount in pay levels. The increased long term equity component of the package provides the desired pay variability. Replacing part of the bonus with deferred shares also reflects some investor concerns expressed about the rigour of bonus target setting and assessment, particularly non-financial measures.
- **Accelerated executive investment** – using shares purchased from cash income (salary, cash bonus, or other savings) would create skin in the game and increase both the upwards and downwards wealth impact of performance compared with a pure restricted stock plan. Increased and accelerated share purchase creates a justification for a discount less than 50% (depending on the amounts invested).

To the extent that **bonus is retained, it could be reduced and based on clear leading indicators of performance linked to the strategy.**

If the deferred share alternative is introduced just as a replacement for LTIP without wider package restructuring, then there are several approaches to create a share-based incentive structure that, like deferred shares, **depends only on the evolution of the long term share price**, but which creates greater sensitivity to the share price, comparable to that of an LTIP and which may unlock some of the issues created by the application of a 50% discount on making a direct switch from LTIP to restricted shares:

- **Mix of deferred shares and options** – for example if the value of a restricted share award was delivered half in shares and half in options (fixed term, without performance conditions), the value of the award would be halved compared with pure restricted shares if no share price appreciation were delivered, but the pay-out would be nearly doubled if the share price doubled. Note, however, that there is **significant academic evidence that use of options can distort behaviour close to exercise dates or when the share price is close to the exercise price, so this option should be treated with caution.** Moreover, while options address the question of pay variability, they give rise to many of the same problems as LTIPs in cyclical industries.
- Modelling shows that an **explicit relative or absolute underpin** (e.g. relative performance above the 33rd percentile or share price at vesting no more than 20% below the grant price) could justify a lower discount in the award level – say 40% rather than 50%, so providing more upside in exchange for greater clarity for investors about when award levels would be reduced.

- **Performance on grant.** To date performance on grant plans have been less favoured by investors and have on occasion become excessively complex during design negotiations. However, an intelligent performance-on-grant framework, allowing some element of controlled award variability could address both the investor and executive concerns about pure restricted share plans.

Note that all of these proposals – other than performance on grant – have the benefit of creating **simplicity by taking any performance evaluation out of the equation and creating structures that depend only on the long term share price** and can be awarded in like fashion each year. To avoid complexity, a framework of structured judgement rather than formula should be used in the performance-on-grant options.

In reviewing designs **the findings from the academic evidence should be reflected:**

- Incentive mechanisms that **vary continuously in value with the share price** (such as deferred shares, shares bought by executives, or options) are **less prone to adverse consequences than fixed-period targets.**
- **Block release or vesting should be avoided** – phased release / exercise over fixed long term periods (including for options) are superior to block release and plans should void vesting or release being at the point of an executive’s choosing.
- **Simplicity should be retained** to enable pay to be understood and valued by investors and executives.

Developing workable frameworks and guidelines for such models **requires open dialogue between companies and investors** to come up with a range of approaches that could meet the objectives of both parties.

Practical examples show how these ideas could be implemented

To illustrate the ideas outlined above, we consider a company with a conventional FTSE-100 CEO package as follows:

Element	Value
Base salary	£900,000 pa
Pension (% of base)	10%
Bonus maximum (% of base)	200% - half cash, half deferred into shares
LTIP maximum (% of base)	300%

We now show how this package could be translated into a packages of comparable assessed value to the executive using each of the models above. It should be noted that there are many variations for implementing each type of approach, and these alternatives are therefore purely illustrative.

Traditional restricted share award

Element	Value
Base salary	£900,000 pa
Pension (% of base)	10%
Bonus maximum (% of base)	200% - half cash, half deferred into shares
Restricted Shares	150% - with an underpin
The LTIP award of 300% of salary is replaced by a restricted share award of 150%, a discount of 50%. An underpin applies prior to vesting of the restricted share award to avoid payment for failure. Deferral and holding on the restricted shares is extended beyond five years	

Wider package restructuring: simple cash and restricted shares package

Element	Value
Base salary	£900,000 pa
Pension (% of base)	N/A
Bonus maximum (% of base)	N/A
Restricted Shares	365%
Bonus and pension are removed, leaving an extremely simple package of just cash and restricted shares. The greater risk of replacing cash pension and bonus by shares results in a reduced discount of 30% on conversion of pension bonus and LTIP to restricted shares (510% vs 365%). A variation could retain the cash element of the bonus.	

Accelerated investment

Element	Value
Base salary	£900,000 pa
Pension (% of base)	10%
Bonus maximum (% of base)	100% - all cash
Matching award	Any bonus invested into shares and held is matched on a 0.5 to 1 basis (pre-tax)
Restricted Shares	200%
If the bonus is entirely invested into shares then the effective discount is 40%. Executives are thereby compensated for taking additional and accelerated equity risk. Shareholding requirements would increase corresponding to the increased investment.	

Restricted shares and options

Element	Value
Base salary	£900,000 pa
Pension (% of base)	10%
Bonus maximum (% of base)	100% all cash
Restricted Shares / Options	Value 267% delivered: <ul style="list-style-type: none"> • 75% in restricted shares → 200% of salary • 25% in options → 335% face value Assumes 20% option valuation
<p>Bonus is simplified to a cash-only bonus and halved in value. Share award is split between restricted shares and options. Overall discount on exchanging 400% of incentives (LTIP plus bonus) to shares is around one-third given higher risk in option package.</p> <p>Options and restricted shares would vest after five years, with options being exercisable within a one-year window after vesting, to avoid the build up of block option exercises. The restricted shares would have a discretionary underpin.</p>	

Restricted share award with relative or absolute underpin

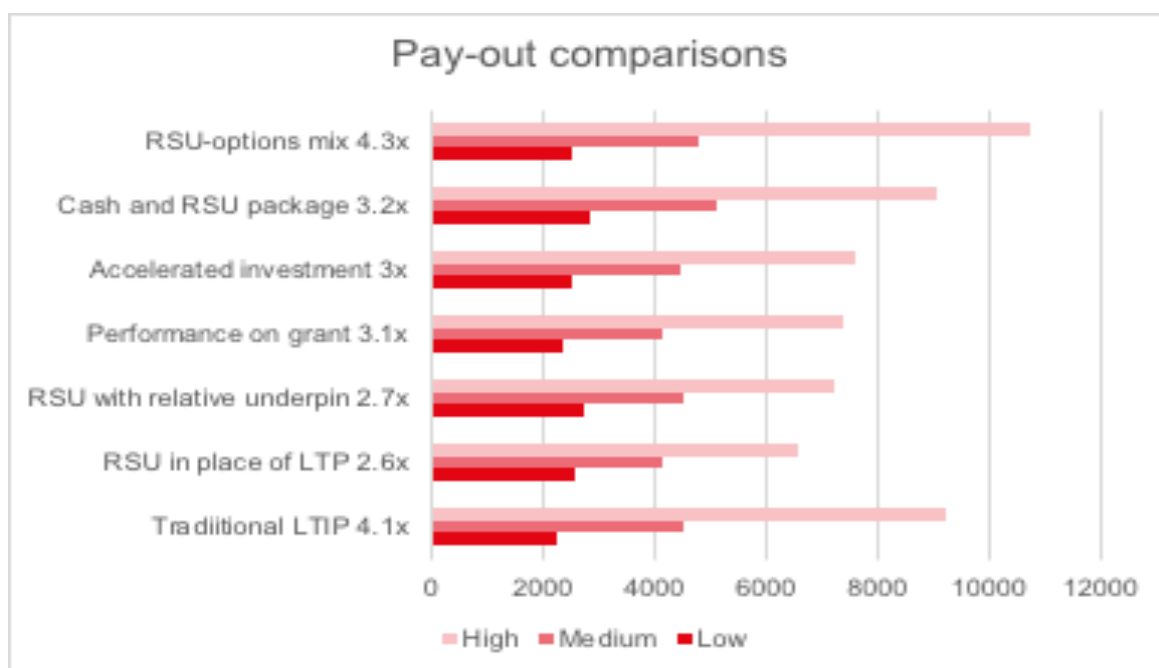
Element	Value
Base salary	£900,000 pa
Pension (% of base)	10%
Bonus maximum (% of base)	200% - half cash, half deferred into shares
Restricted Shares	180% - with a relative underpin
<p>The LTIP award of 300% of salary is replaced by a restricted share award of 180%, being a discount of 40%. The restricted share award has a relative underpin so that no value is delivered if relative TSR performance over the period is below the 33rd percentile.</p>	

Performance-on-grant

Element	Value
Base salary	£900,000 pa
Pension (% of base)	10%
Bonus maximum (% of base)	200% - half cash, half deferred into shares
Restricted Shares	150% A multiplier of 0.8x – 1.2 applies to the award on grant based on performance
The LTIP award of 300% of salary is replaced by a target restricted share award of 150%, being a default discount of 50%. However, based on an 'in the round' performance evaluation the Remuneration Committee may increase or decrease the award by 20% leading to a range of discounts of 40% to 60% depending on performance.	

The chart below shows the variability in total pay-out from a single plan cycle using these different packages under simple Low, Medium, and High performance scenarios defined as follows:

	Low	Medium	High
TSR	-10% pa	5% pa	20% pa
Bonus vesting	50%	75%	90%
LTIP vesting	30%	60%	90%



The analysis immediately brings a number of points into focus:

- Simply replacing the LTIP by RSU does indeed result in a significant reduction in package variability, reducing the range from 4.1x between the High and Low scenarios to 2.6x. However, the package variability is still substantial in the restricted shares model, and would also need to be seen in the context of increasing shareholding requirements, which would enhance overall sensitivity to share price over time..
- A number of models can be used progressively to increase the pay variability back to over 3x or more.
- The academic evidence points most strongly in favour of the simple cash and restricted shares package. Under this model, the pay variability is controlled by determining the mix between cash and shares in the package. In replacing pension, bonus, and LTIP by restricted shares, our example has between 75% and 80% of the package in shares.
- Use of a mix of restricted shares and options in place of LTIP creates an overall level of pay variability that is very similar to the traditional LTIP package. However, evidence relating to options suggests that this approach should be used with caution, given the known impact that options have on risk taking behaviour.

The aim of this analysis has not been to provide firm 'answers' but simply to show that a range of options can be used to achieve the desired objectives in terms of pay variability, and the fear of loss of such variability should not be used as a reason for retaining the traditional LTIP model over restricted shares.

9. Immediate next steps

- Investors and companies, but particularly investors, need to **determine the extent to which they truly wish to see greater use of deferred shares in the market**. It appears that this appetite exists, both in the UK and the US, but it will require greater effort and stewardship resources in the short term if progress is to be made.
- Stronger signaling from the **Investment Association could highlight that investors encourage companies to consider whether deferred shares are appropriate for them** and if they are will welcome and seek to support well-thought through deferred share proposals with a strong strategic rationale.
- **We are encouraged that The Investment Association has indicated its desire to work with stakeholders** on the changes required to make deferred share implementation a more widely adopted option in companies for which it is appropriate. There should be two high level workstreams, both of which should include representation from investors and companies:
 - First, covering **the consultation process**, working with investors, proxy advisors, companies, and remuneration consultants to develop short term protocols to enable innovation and investor preferences to emerge. This process needs to be calibrated to **create more space for constructive innovation**, while having **sufficient guardrails to prevent faulty designs** being pushed through.
 - Second, covering **design alternatives** that could capture the benefits of deferred shares in terms of **simplicity and incentivization of long term behaviour**, while addressing the **concerns of investors and companies relating to pay variability and attractiveness**. This could also cover review of any unintended consequences identified in the operation of deferred share plans.
- The revised consultation process should be developed for road-testing in 2020. In practice, given where we are, **the number of deferred share implementations coming to 2020 AGMs is likely to be relatively small and manageable** for the investor community without significant additional resource allocation. Any learning could be applied to refinements for 2021.
- In practice **a full update to the Investment Association Guidelines and associated Proxy Advisor guidelines** incorporating revised approaches **will only be possible later in 2020**, but this should be done as early as possible to create clearer guidance for 2021 AGMs.
- **Following the 2021 AGM season, progress should be reviewed** to determine whether:
 - The enhanced consultation process needs to be continued for a further year.
 - Practice and investor voting preferences have become clear enough to enable a codified approach to proxy advisor recommendations on deferred share plans.
 - Any lessons can be learned from implementations to date, some of which will by then have been in place for five years.

Appendices

A. About The Purposeful Company	38
B. Glossary	39
C. Companies adopting deferred shares	40
D. Participating organisations	41
E. Research methods	42
F. Desk top review of market practice	43
G. Interviews with companies and remuneration consultants	47
H. Interviews with asset owners, asset managers and their advisors	56
I. Investor survey results	66
J. Company survey results	75

Appendix A: About The Purposeful Company

The study is being overseen by the Steering Committee of The Purposeful Company. The Purposeful Company was established in 2015 with the support of the Bank of England to identify changes to policy and practice to help transform British business with purposeful companies committed to creating long term value through serving the needs of society. The Purposeful Company has published extensively on policy matters relating to Executive Pay, Corporate Governance, and Investor Stewardship, and has liaised closely with all the main policy-making bodies during the governance reforms of recent years.

The Steering Committee comprises:

- Clare Chapman: Co-founder of The Purposeful Company; Non-executive Director at The Weir Group, Kingfisher, G4S, Heidrick & Struggles and is a Low Pay Commissioner
- Professor Alex Edmans, London Business School and Gresham College
- Tom Gosling: Partner, PwC; Executive Fellow, London Business School
- Will Hutton: Co-founder of The Purposeful Company; Principal of Hertford College, Oxford University
- Professor Colin Mayer MBE, Saïd Business School and The British Academy

Primary accountability for oversight of the report is held by Clare Chapman, with Tom Gosling leading the development of the research methods and their execution. All Steering Group members are acting in their personal capacity, not representing the organisations listed above. Any views expressed are those of the Steering Committee and cannot be attributed to any of the other organisations with which a Steering Committee member has affiliation.

The research and report production have been supported by Jean-Pierre Noël and Sarina Tsukerman. Jean-Pierre was formerly a senior HR executive at FTSE-100 organisations and Sarina has recently completed an MBA at London Business School.

HSBC Global Asset Management is supporting The Purposeful Company to undertake a review of this topic. This has enabled the recruitment of research support as outlined above. However, full control of the research design and full editorial rights on this report remain with The Purposeful Company. The Purposeful Company Steering Committee is responsible for any views expressed. Support for or participation in this study does not imply agreement with those views.

The Purposeful Company would like to express its sincere thanks to HSBC Global Asset Management for providing the support to make this study possible and to all companies and industry bodies that participated in the study or encouraged their members to do so.

Appendix B: Glossary

In this report we use the following definitions

- **LTIP:** an award of shares with stretching performance conditions attached, which are tested after, say, three years. The proportion of the award that vests (between 0% and 100%) depends on the extent to which the performance conditions are met.
- **Deferred shares:** restricted shares, deferred bonus, or performance on grant award.
- **Restricted shares:** an award of deferred shares without further performance conditions attached, other than possibly an underpin condition prior to vesting (see below). Typically the value of shares awarded will be lower than for an LTIP. For example an LTIP award with a maximum value of 200% of salary (if all performance conditions are met) might be replaced by restricted shares worth 100% of salary, vesting over a longer time period.
- **Performance-on-grant:** an award of deferred shares, similar to restricted shares, but subject to a performance condition prior to grant, often over more than one year, giving rise to a greater expectation of variability in the award level. Because performance conditions still apply, the discount in maximum value will be less than for restricted shares. For example, an LTIP award with a maximum value of 200% of salary (if all performance conditions are met) might be replaced by an award of deferred shares that could be as high as 150% of salary, but might vary between 50% and 150% of salary (or even down to zero) based on performance conditions applying over one or more years prior to the award. Once awarded, the deferred shares operate in the same way as for restricted shares.
- **Deferred bonus:** a special case of a performance-on-grant plan where LTIP is replaced by an enhanced annual bonus which includes an element deferred into shares.
- **Underpin:** a condition that must be satisfied prior to vesting of a deferred share award, but designed to represent a minimum acceptable level of performance rather than a stretch condition. The underpin may be set as an explicit test (e.g. a minimum level of ROCE) or could be more discretionary in nature.

Appendix C: Companies adopting deferred shares

We identified the following 19 companies that had adopted deferred shares in replacement for other incentives as part of their remuneration policy up to June 2019.

Company	Year of policy AGM
Restricted share implementations	
Card Factory	2018
Ei Group	2019
Hargreaves Lansdown	2017
Harworth	2019
Kenmare Resources	2017
Mears Group	2017
Pets at Home	2017
The Weir Group	2018
Performance on grant implementations	
Capital & Regional	2019
Hikma	2014
Page Group	2017
QinetiQ	2017
Rathbone Brothers	2015
RBS	2017
Standard Life Aberdeen	2018
Tullow Oil	2014
Restricted shares used as part of a wider pay restructuring	
Aveva	2017
Kingfisher	2016
Premier Oil	2017

Appendix D: Participating organisations

We would like to extend our thanks to the 100+ organisations who contributed to the study through the interviews or the survey, or through providing their views in other ways. Those who have given their permission to be named are recognised below.

Aberdeen Standard Investments	ISS	Rio Tinto plc
Allianz Global Investors	John Wood Group plc	Rolls-Royce plc
Aon Hewitt	J.P. Morgan Asset Management	Royal London Asset Management
Artemis Investment Management LLP	J Sainsbury plc	Royal Mail plc
Aviva Investors Global Services Ltd	Kames Capital	Sarasin & Partners
Aviva plc	Kenmare Resources plc	Schroders plc
BHP	Kingfisher plc	Severn Trent plc
BlackRock Inc.	Korn Ferry	Share Plan Lawyers
BMO Global Asset Management	Legal & General Group plc	Standard Chartered Bank plc
BP plc	Legal & General Investment Management Ltd	State Street Global Advisors
Brunel	LGPS Central Limited	Subsea 7
Burberry Group plc	Lloyds Banking Group plc	T. Rowe Price Group Inc.
Capital & Regional plc	M&G Investments	Tesco plc
Card Factory plc	Mercer	The Investment Association
Centrica plc	Merian Global Investors	The FTSE Remuneration Group
Church Commissioners	Minerva	The Weir Group plc
Compass Group plc	NEST Investment	Tullow Oil plc
Deloitte	Norges Bank Investment Management	UBS Asset Management (UK) Ltd
Experian plc	Pearson plc	Unilever plc
Ferguson plc	Pets at Home Group plc	USS Investment Management Ltd
Fit Remuneration Consultants	Pets at Home Group plc	Vodafone Group plc
Glass Lewis	Performance and Reward Centre (PARC)	Willis Towers Watson
Hermes Investment Management	PwC	WPP plc
HSBC Global Asset Management	QinetiQ plc	
HSBC Holdings plc	Railpen Investment Management	
InterContinental Hotels Group plc	RBC Global Asset Management	
Imperial Brands plc	RBS Group plc	
Indivior plc	Reckitt Benckiser Group plc	

Appendix E: Research methods

1. Overview

The research methods used in the study consisted of desk-top review, interviews and two surveys. These were informed by the context and purpose of the study set out in the Key Findings Report, together with practical considerations such as available resources, budget and timing. The research was conducted in a professional, ethical, and responsible manner with no predetermined conclusions.

2. Desk-top review

Desk-top review was chosen as a relatively quick, cost-effective and pragmatic way to generate relevant data and information from industry, academia, UK company implementations and international perspectives. The sources chosen were reliable, contemporary and in the public domain. The output also helped inform the format and content of the interviews and surveys.

2.1 Industry views and publications

Relevant industry views and publications were examined from a range of sources, such as: the Investment Association; major investors; and the BEIS Select Committee on executive pay.

2.2 Academic context

The Purposeful Company Executive Remuneration Report published in January 2017 provided the primary source of robust and comprehensive academic evidence.

2.3 Market practice

Relevant information on UK listed companies that have implemented deferred shares was largely obtained through each company's Directors' Remuneration Report. This was then transposed to spreadsheets to help gather and organize the results. Only those companies clearly relevant to the study were included, and some companies were excluded that operate annual and deferred bonus plans without an LTIP where incentive pay is operated at an unusually modest level, reflecting particular ownership structures or founder shareholder status. Information on voting and proxy advisor recommendations was drawn from Proxy Insight.

2.4 International observations

From an international perspective, the desk-top review primarily considered the state of the current debate on the topic in the United States, including the position of the Council of Institutional Investors, together with developments in the Australian market where implementation of deferred share awards has been a feature of the recent AGM season.

3. Interviews

Over 50 one-hour interviews took place in-person and by phone with listed companies, asset managers, asset owners, advisers and remuneration consultancies. This method of primary data collection was chosen because it enabled a deep exploration of the topic including relevant context, reasons behind the views presented, and details of processes followed (such as the consultation). It also provided an opportunity to ask supplementary questions where further detail or clarification was required.

Interviews were semi-structured to enable comparisons and common themes to be drawn out on a comprehensive range of topics including: attitudes to deferred shares as an alternative to LTIPs; potential benefits and risks; and requirements for support. Although a standard questionnaire informed each conversation, responses were not necessarily captured against each and every question in order to facilitate a free flowing discussion. Interviewees were advised at the outset any information provided was anonymous, and would inform thematic insights and conclusions. Verbatim quotes are referenced within the report, but none have been attributed. Interviews were led by independent senior executives with relevant board level experience, and subject matter expertise, in executive pay. A pilot was conducted to identify and address any potential opportunities for improvement.

4. Survey

Nearly 100 responses were received from two market-wide surveys circulated to companies and investors. The two surveys were designed to have maximum possible alignment to enable comparisons between investor and company views, and to be consistent with questions posed during the semi-structured interviews. Both surveys were estimated to take 25 minutes to complete. This research method was chosen because it provides broader coverage than the interviews, is cost effective, allows accurate and efficient data collection and delivers a consistent quantitative data set. Qualtrics was chosen as an established survey software tool with enterprise level survey data security, and strong reporting functionality.

Participants were advised the results would be presented only in aggregated form and in a manner that preserves their confidentiality. Permission was requested for their organization to be named as a contributor to the study. Further, it was explained that all market participants would have equal access to the aggregated survey results.

Both surveys were piloted with major FTSE and leading investor respondents prior to the wider launch. As part of the pilot, feedback was sought and acted upon on aspects such as: ease of completion; estimated time to complete; identification of questions that may be unclear or difficult to answer; and any other relevant comments.

Most questions were multiple choice and offered respondents a reasonable range of answers to choose from. Where relevant, an, "Other – please specify" option was available if respondents did not believe any of the other options were appropriate to them. There was also a free text field for additional comments to be captured. Participants were not required to necessarily answer all the questions as the functionality within Qualtrics meant they were only presented with questions relevant to their implementation (or lack of implementation) of deferred shares – this was informed by their earlier responses.

The survey was distributed to relevant companies and investors via the Investment Association; the FTSE 100 Remuneration Group (a membership organization of Heads of Reward); PARC (a membership organization of HR and Reward Directors); Share Plan Lawyers (a membership organization of lawyers specializing in employee share plan arrangements); major remuneration consultancies; and direct approaches from members of the study's project team. A standard template invitation was used. For the company survey, the invitation explained that responses were sought from a number of perspectives, including Remuneration Committee Chairs, HR Directors, Heads of Reward and executive directors. The investor survey was circulated to Portfolio Managers and Governance/Responsible Investing Specialists.

5. Principal limitations

The principal limitations of the research methods adopted are:

- Interviews and surveys give, by definition, self-reported attitudes rather than a rigorous measurement of outcomes.
- Sample sizes in the survey, although representing over 20% of the target audiences, are relatively small and give rise to 5% margins of error of around +/-10% points in response rates.
- Deferred share adoption amongst UK listed companies is too recent and too small a sample size to give conclusive econometric conclusions. This also means it is not yet feasible to obtain hard quantitative data on the effectiveness of such plans.
- Survey respondents may be biased towards companies and investors interested in and in favour of reform, and there was not an equal proportion of survey responses from each industry.
- In a handful of cases there was more than one survey response from the same company which means a consistent viewpoint was not necessarily expressed.
- Company respondents were typically Remuneration Committee Chairs and Heads of Reward, which may not be providing a broad company viewpoint. In particular, there was limited participation from executive directors.
- Finally, a common theme emerged from a few investors who suggested that the framing of this study may be too narrow since it just concerns LTIPs and deferred shares . They acknowledged there are practical reasons informing the study's scope, but commented that it is important to not lose sight of the broad package (including pay mix, annual incentives and shareholding) plus the wider pay strategy.

Appendix F. Desk top review of market practice

1. Introduction

We have identified 19 companies that have adopted deferred shares as part of their incentive packages as an alternative to a conventional LTIP. The companies fell broadly into three categories:

- 8 companies introduced restricted shares as a replacement for an LTIP in whole or in part;
- 8 companies introduced performance-on-grant deferred shares as a replacement for an LTIP in whole or in part; and
- 3 companies introduced restricted shares as part of a more fundamental package redesign, which also retained an element of a performance-related LTIP.

This review inevitably gives rise to subjectivity and definitional issues. Performance-on-grant tests come in different shapes and sizes. Some are expected to have comparable variability to bonus outcomes and may operate over one and three years. Others are explicitly set out to be more 'threshold' in nature, with an expectation of no more than 20% variability in the grant size year on year. Some companies adopt remuneration arrangements that do not fit comfortably in any particular category. At the same time, we have excluded some companies that operate annual and deferred bonus plans without an LTIP where incentive pay is operated at an unusually modest level, reflecting particular ownership structures or founder shareholder status. We do not consider these cases to be so relevant to the general considerations of this report. Overall, we consider the companies identified to broadly reflect the state of play as it relates to deferred share alternatives to LTIPs being considered in this report.

2. Nature and context of adopters

The implementations are not limited to small companies, although most pure restricted share plans were in the FTSE-250 or smaller. Five were in the FTSE-100 at the time their plans were approved by shareholders, and three more were just outside it. There are, however, some sector concentrations. Three quarters of the companies operated in just three sectors: natural resources (including services to the natural resources sector); financial services; and retail. The other four companies were in property, defence, pharmaceuticals, and recruitment services.

This sector concentration was reflected in the rationales given for introducing deferred share alternatives to LTIPs – all companies referred to the importance of motivating and retaining executives and achieving alignment with shareholders. Moreover, there were common themes particularly relating to the introduction of deferred shares into the context in which these companies found themselves:

- 13 companies highlighted the importance of simplifying the incentive package;
- 9 referred to a context in which strategy and plans were evolving rapidly, creating a need for a flexible remuneration policy that could adapt accordingly;
- 7 referred to industry-related volatility or cyclicalities creating difficulty in setting targets and leading to boom and bust LTIP pay-outs;

- 7 referred to the desire to better align the executive reward policy with that which operated across the wider workforce; and.
- 6 referred to the desire to support the right behaviours by moving to a structure that supported a long-term focus on the strategy, performance, and / or risk of the company, as opposed to short-term targets.

3. Design features

Restricted share plans had the more consistent design features:

- Vesting and holding typically extended to a maximum of five years (and in most cases for the entire restricted share award), although the detail of the deferral schedules varied;
- In all cases a discount was applied, being 50% in the case of replacement of LTIP with restricted shares and 33% in the case of replacement of bonus;
- All but one had an underpin prior to vesting of the deferred shares. In most cases this was based on an explicit framework or set of targets. Most allowed for remuneration committee discretion to assess the level of reduction where targets were missed. Two operated in an entirely formulaic manner.

Performance-on-grant plans were more varied:

- Vesting and holding again typically extended to a maximum of five years, although it was more common for elements of the award to vest earlier;
- In four cases the pre-grant test operated over a combination of three and one years (typically broadly comparable amounts of the award applying to each) and in three cases targets applied over one year only.
- Discounts to quantum applied in five out of the eight cases with a norm of around 25%, although two were at 40% or more, but in part this may reflect the strength of the pre-grant test applying.
- Underpins applied to the deferred shares in four cases, two being formulaic and two providing a framework for structured discretion by the remuneration committee.

Frequently the introduction of the policy was associated with other shareholder-friendly enhancements such as increasing shareholding requirements or introducing post-cessation holding requirements.

On the whole, then, companies implementing deferred share awards are taking account of investor desires for:

- A quantum reduction as a trade-off for greater certainty;
- Longer deferral and greater shareholder as a trade-off for the removal of performance conditions; and
- Some ability to reduce vesting of deferred shares to avoid payment for failure.

Appendix G: Interviews with Companies and Remuneration Consultancies

1. Introduction

Interviews were conducted with 18 UK listed companies and 7 leading remuneration consultancies. 10 of the companies interviewed had already implemented deferred shares as their principal long-term incentive, 6 had considered but not pursued deferred shares, and 2 were currently considering doing so. 23 company executives were interviewed – mostly Remuneration Committee Chairs (13) and Heads of Reward (7). Other company interviewees comprised of an executive director, Company Secretary and Head of Governance. The consultant interviewees were all Partners or equivalent level, involved in leading remuneration committee engagements.

2. Executive summary

- 6 of the 7 leading remuneration consultancies believe deferred shares could be appropriate for broadly 20% to 25% of FTSE companies, with one putting it as high as 50%.
- All company and consultancy interviewees identified significant barriers to adoption of deferred shares due to factors outside of a company's direct control. The principal stakeholders informing and shaping these barriers were: proxy advisors (particularly ISS) who are deemed to be unreceptive to non-standard structures; the Investment Association and investors who many argued need to be more visibly supportive of alternatives; and the UK Government who several said need to facilitate a more positively pro-executive and global playing field in executive remuneration practices.
- The two most common concerns presented by companies when considering deferred shares were the high reputational risks of not getting sufficient shareholder approval (typically at least 80% was targeted), and what they considered to be unpalatable changes/compromises required to achieve that shareholder approval which made pursuing alternate models no longer attractive.
- The lack of precedent in the UK market was considered an additional barrier by most interviewees as it meant companies were reluctant to draw attention to themselves by doing something new or different.
- 3 of the 7 consultancies commented it is possible underperforming companies with a history of low incentive awards may be those most attracted to deferred shares, and those with a strong history of high performance and high incentive awards are most likely to remain with LTIPs (this perception was also referenced in the interview with BMO Global Asset Management and covered in their November 2017 report on restricted shares titled "All carrot no stick").
- The benefits of alternatives most often cited in the interviews included: reduces LTIP volatility especially in circumstances where it is challenging to set meaningful long-term targets; enables executives to be more agile when faced with market "disrupters"; reduces complexity; facilitates strategic planning; increases motivation; supports the talent agenda (including talent attraction and retention from the US); and effectively builds long-term shareholding.

- The key risks of alternatives most often cited included: reduces pay for performance; encourages risk aversion; limits the appetite for executives to outperform; quantum may be higher than necessary in a down cycle and lower than appropriate when the sector performs well; and may require more rigour in the annual plan.
- All of the consultancies commented they can envisage numerous circumstances where deferred shares do not make compelling business sense. The companies interviewed generally evaluated deferred shares alongside other alternatives, including retaining their existing LTIP. The general consensus was that deferred shares should not be considered a panacea.

3. Themes from the interviews

3.1 Business context for the new remuneration policy

There were mixed views on whether deferred shares are solely a solution for companies within cyclical industries; in some cases, companies developed deferred shares as a scheme from a first principles approach. For examples, companies interviewed in the oil & gas, financial and retail sectors all pointed to the cyclicity of their sectors as a reason for introducing deferred shares. Others in investment management, insurance and even retail sectors cited the need to focus on the long-term goals of the company.

6 of the 18 companies interviewed described challenges in setting long-term incentive targets, and as a consequence experienced volatility in LTIP award payouts. 3 companies commented on industry specific regulations constraining what they could do. 2 companies told of macro or other factors outside of management's direct control which resulted in a recent history of low or nil LTIP awards, and 4 companies described a new strategic direction. This may imply companies who consider and/or progress with implementing deferred shares generally do so because there is an extraordinary or compelling factor within their business context driving this agenda.

3.2 Investor context for the new remuneration policy

When seeking approval for deferred shares, concentrated shareholder bases are a key consideration, particularly depending on geography. 5 of the 10 companies that interviewed that had already implemented deferred shares did so with a high investor concentration, which meant they were able to focus their consultation efforts and incorporate investor feedback effectively, even against negative proxy agency recommendations. However, other companies, particularly those with a high international investor base, were deterred from introducing deferred shares because of pushback from investors. For those companies with a more disparate shareholder base, the support of proxy agencies (particularly ISS) is a critical factor, and the remuneration consultancies said this could typically influence 20% to 30% of the vote.

It may therefore be inferred the investor conditions required to facilitate implementation of deferred shares include a concentrated shareholder base and/or an ISS recommendation FOR.

3.3 General views on deferred share alternatives to LTIPs

6 of the 7 remuneration consultancies classified themselves as “supportive of deferred shares in specific industry or company contexts where there is good justification and the right implementation.” The 7th consultancy was “generally supportive as a way of simplifying pay and improving alignment.”

The majority of consultancies said they were becoming more supportive of alternatives. However, a couple expressed concern that the way those alternatives currently need to be designed to achieve shareholder approval means they may not actually deliver the original objectives of, for example, reducing complexity or securing certainty in award level. This may also make it more challenging when it comes to securing executive support.

All companies and consultancies generally agreed the two most critical pressure points in discussing restricted shares with executives is most likely to be the underpin and discount level.

3.4 Motivations for adopting a new policy

The motivations were informed by the business context (3.1) and so common themes concerned reducing complexity and volatility of awards. This was inhibiting attraction, motivation and retention of executives and reducing trust in the remuneration arrangements. One company commented that their executives were subject to several overlapping LTIP plans, all with different measures, making it hard for them to know which measures and targets to focus on. Several also believed restricted shares are a better way of building long-term shareholding and commitment because of the certainty.

One company operating said they were “perfectly capable” of setting long-term targets, and their motivation was to “allow 3-year planning to be more strategic without management thinking the remuneration conversation comes next.” Other companies and consultancies commented that a further motivation was to free up board and executive time to focus on more impactful topics.

“We wanted to reduce the headline quantum” was a motivation cited by one company. Another believed restricted shares would enable them to better compete for talent in the US market, which despite being UK listed, was where their business principally operated. Others were motivated by adopting a remuneration construct which was more consistent with other executives.

3.5 Alternative designs

The 7 consultancies all agreed deferred shares are not necessarily a superior substitute for an LTIP – it all depends on context. The design should concern “best fit” taking all company specific factors into account. Nevertheless, in those circumstances where deferred shares may be appropriate, there was a general bias for restricted shares if quantum and/or simplicity is the primary goal, with a couple of consultancies advocating a combination of restricted shares and LTIP. One consultancy expressed particular concern with performance on grant models as it believed “they just generate a different kind of complexity.”

There are mixed views on using underpins, but they might be a means to an end to implement restricted shares. Some companies and consultancies philosophically disagree with underpins

because schemes can get just as complicated as LTIPs and therefore companies are not truly delivering on the promise of certainty. Others philosophically agree with underpins as a way to avoid pay for poor performance. Nevertheless, all agree underpins are currently an important way to get proxy advisors and investors supportive of a restricted share policy, albeit there were comments such as “this should be discretionary” or “have a strong probability of being met.”

Consultancies generally agreed that a 50% discount was appropriate when implementing restricted shares. Even in circumstances where there has been a history of strong performance, they typically pointed out past performance is no guarantee of the future. A 5-year timeframe was also generally supported, although a couple raised concerns with post-employment guidelines as executives cannot directly control the actions of their successors. If a company has a deferred bonus or performance on grant plan, the consultancies would generally expect a lower discount than for restricted shares because performance conditions still apply.

In more than half of the companies that have considered or are considering deferred shares, a key obstacle to progressing are unpalatable changes/compromises required to achieve shareholder approval. One company commented “the underpin and other requirements create a barrier to wanting to even try.” Another consultant said, “we need less rigidity – some companies won’t even look at it if you need a 50% discount and 5 years.” A common sentiment was the changes required to secure approval may mean “it just becomes an LTIP in another name.” From this, it may be inferred that for alternate designs to not just be considered, but implemented, investors will need to relax their view on the conditions that need to be imposed.

3.6 Consultation process

Of the 8 companies that stated a target level of voting support they wanted to achieve, 5 said 80%, 2 said 75% and 1 wanted at least 85%. Knowing they would not achieve at least their required level resulted in at least 2 of these companies pulling their policy before putting it to a vote. Several commented that the Investment Association’s requirement to achieve 80% approval or be put on the IA register was unhelpful as the potential damage to reputation of a vote against means some companies won’t even try to progress with a new or different policy.

Regardless of shareholder concentration, early, iterative conversations with shareholders are necessary. Successful consultations included explaining proposals clearly and compellingly, and receiving written feedback from investors. The number of consultations varied – those with a high investor concentration focused on the top 3 to 5 shareholders, while one company with diverse shareholding met with as many as 50-60 shareholders. All companies that implemented said the consultation effort required was significant. They referenced two or three rounds of meetings was typically required, and one Remuneration Committee Chair commented “you cannot concentrate on anything else.”

All the consultancies echoed the high level of shareholder consultation required, and said this should not be underestimated. They spoke of the Remuneration Committee Chair needing to passionately believe it is the right thing to do, and a pre-requisite is strong support from the Chairman and rest of the board. They reiterated the two or three rounds of meetings being required, and said this would typically be over a 6 to 9-month period.

Common themes the consultancies drew out in successful consultations were that the board needed to have a strong history and reputation for good governance, and that the board was willing to be voted against but had absolute conviction their strategic rationale was compelling enough they could weather that storm. Further, that other conditions such as equity holding, deferral, malus provisions etc. were in line with expectations, and that the company was “current” with other provisions such as those concerning pensions. Having a concentrated shareholder base (as referenced in 3.2) or doing something like this post an IPO with a loyal shareholder based were cited as useful enablers.

Overall, many companies stressed focusing on consultation with shareholders over proxy advisors. Nevertheless, an anticipation of a negative voting recommendation from proxy advisors (particularly ISS) played significantly into the decision making for those companies where there wasn’t a concentrated or loyal shareholder base. One company with dual listing shared they had to get the support from proxy agencies in multiple locations.

The companies that implemented deferred shares only progressed with a construct they felt reasonably confident would be acceptable to their shareholders. Consequently, the changes and compromises in design described after consultation started were not particularly remarkable.

3.7 The influence of proxy advisers

Consistent comments made by companies about proxy advisors was the perception amongst interviewees that they are either unavailable or do not give clear feedback in consultations and their adherence to rigid checklists. A lack of engagement from proxy agencies was referenced from most (although not all) company interviewees. As an example, in one case a proxy advisor changed their recommendation on short notice compared with what had been indicated and was not open to discussion. A general sentiment was that proxy advisors need to be more receptive to supporting non-standard structures, and to develop new methodologies to assess deferred share schemes.

Many interviewees believe proxy advisors are more focused on the wider implications of supporting deferred shares rather than concentrating on company-specific needs. In one instance, a company said ISS recommended against a policy that did not include a financial underpin because of the larger implications of supporting this type of policy publicly. There is a common view that proxy advisors are thinking about how remuneration should operate more generally, rather than focusing on the proposal as it relates to the specific company.

Some example quotations from companies that reflect the general sentiment include:

- “They want to tell rather than ask questions.”
- “They were not interested in trying to understand the scheme.”
- “ISS need to ensure their commentary is more directly linked to the company strategy.”
- “24 hours to respond to a vote against is just not fair.”

The consultancies expressed similar views:

- “If ISS see something simply out of line with normal practice they present it as a concern.”
- “There is a need to be receptive and accepting of different models.”
- “ISS need to change their model. At least give companies a directive they are receptive.”

3.8 What needs to happen to make deferred shares more widely adopted?

There is no shared consensus on who is ultimately responsible for driving forward the argument for deferred shares as an alternative where it makes business sense. Respondents pointed to investors needing to facilitate conversations with proxy advisors, companies needing sponsors from within, the Investment Association and investor community needing to educate others, and regulators needing to reconsider approval thresholds.

Nevertheless, there was still a great deal of shared views on the key barriers to change, and what needs to happen to make deferred shares more widely adopted. These may be categorized as follows:

3.8.1 Proxy advisors

As referenced in 3.7, all companies cited the attitude and actions of proxy advisors, particularly ISS, as something which needs to change. The 24-hours to respond was universally considered too short, and most believe at least a week would be more commensurate. (We note that proxy advisors explain that the constraints of the pre-AGM timetable typically prevents such long notice requirements.) Interviewees were generally of the mind that if change is to happen, it must stem from the clients of proxy advisors demanding it. A major gap in the system is companies are not convinced a material recourse to challenge proxy advisor recommendations exists. Given the consequences of a recommendation against, a common sentiment is that this situation should be of concern to those paying for their services.

3.8.2 The Investment Association (IA) and Investors

There was consensus in all the interviews that the IA and investors need to be more visibly supportive of alternatives, set out the benefits of these, and as one put it, “step up to facilitate the conversations with proxy agencies so they can change the guidelines.” One company currently considering deferred shares said, “if companies are uncertain about how investors will vote, the default will be to not change the policy.” The consultancies agreed shareholders need to be receptive to different models. A couple of additional relevant quotes include: “Investors must present a clear perspective and come off the fence” and “if big investors like Aviva and L&G become positive that would build the dynamic; at present, there is very little positive pressure.” There was general agreement the IA register needs to be abolished, and that conditions typically expected, such as the 50% reduction and underpin, need to soften.

3.8.3 UK Government

A shared sentiment predominantly from those companies operating internationally is that the UK governance environment starts from a very insular place, and the UK Government needs to facilitate a more global playing field. For example, restricted shares was cited as a typical component of the executive director package amongst US competitors. One company said, “we need to move away from demonizing executive pay and focus on the right things – no one knows enough about environment and sustainability issues.” One of the consultancies spoke about there being “too much political interference” and another about the need for an “environment which is more supportive of executives – we have fallen down the global pay scales.”

Some interviewees cited Brexit and/or a potential Labour government as factors that may impact executive pay design and quantum generally, and adoption of deferred shares in particular. It was generally recognized most stakeholders will inevitably consider how their actions may play out politically.

3.8.4 Market practice

The lack of UK market practice of alternatives was generally considered a barrier by most interviewees as it meant companies were reluctant to put their head above the parapet by presenting something new or different. As one company put it, “if more companies implemented there would be more acceptance from proxies.”

Furthermore, 3 of the consultancies commented it is possible underperforming companies with a history of low incentive awards may be those most attracted to deferred shares, and those with a strong history of high performance and high incentive awards are most likely to remain with LTIPs (this perception was also referenced in the interview with BMO Global Asset Management and covered in their November 2017 report on restricted shares titled “All carrot no stick”). Some interviewees did say that it would be helpful if there were more examples of large, high performing companies that have adopted deferred shares.

3.8.5 Other

Other comments included:

- “A lot of executives don’t want the change because it is a reduction in maximum potential.”
- “Regardless of the validity of the remuneration design, those investors that are dissatisfied with the company for other reasons, may use it as a protest vote.”
- “The risk appetite of remuneration committees needs to change.”

3.9 Executive and shareholder attitudes to implementation

Those companies that have implemented deferred shares say their executives are largely supportive, albeit some have not yet received an award under the new plan. A key take-away was the need to engage with executives throughout the process so there are no surprises.

A couple of early adopter companies commented that their shareholder base has evolved since their policy was approved, and they anticipate changes will be necessary when renewal comes e.g. around use/implementation of underpins. A few comments include:

- “People like the certainty – 90% of managers prefer the change.”
- “Landed fine with executives.”
- “Executives don’t want to change it; for them, it is understandable and simple.”

3.10 Overall effectiveness of the policy and lessons learnt

Companies said it was generally too early to identify hard, quantifiable measures of success. Several qualitative success measures were cited, and examples of these include:

- “Executives are more motivated.”
- “There is an increased appreciation of the importance of the share price movement.”
- “People believe they are measured on things more controllable, so it is fairer.”
- “The traditional LTIP had greater incentives to not behave well – removes conflict of interest.”
- “It increases the chances of successors coming from within.”
- “Encourages a collegiate approach.”
- “More effective than LTIP, but still not perfect.”
- “Working perfectly well. Working as designed.”
- “Executives feel more connected to the value of the company.”
- “The concept is perceived to be working – there has been share price growth.”

A consistent key lesson learnt from companies that implemented was the importance of an aligned board and a Remuneration Committee Chair who passionately believed this was the right thing to do for the company. As referenced previously, this will be a time-consuming process. Other messages included:

- “If you want to make a change in remuneration, you want to be in a position where you already have the investors on your side.”
- “Focus on consultation with shareholders, not rating agencies.”
- “Start board discussions early.”
- “You need a personal relationship between investors/proxy agencies and the Remuneration Committee Chair, as well as a strong Company Secretary and HR team.”
- “You need a policy that will endure. Remuneration is something you cannot change every 3 years as makes management unstable.”

3.11 Wider workforce issues

Several companies interviewed said they operated an all-employee share plan.

Long-term incentives generally only applied for more senior executives. However, even in the case of those companies that implemented deferred shares for executive directors, the exact same plan did not generally apply to other executives – for example, there were typically no underpins applied to restricted shares awarded below the board. In at least two companies, the LTIP operated only for the executive directors, and the interviewees commented that although this was unsatisfactory as far as the board were concerned, they felt forced into this situation because shareholders would not support deferred shares.

Appendix H: Interviews with Asset Managers, Asset Owners, and Proxy Advisors

1. Introduction

Interviews were conducted with 13 asset managers, 7 asset owners, and 4 proxy advisors. 26 executives were interviewed who predominantly held leadership positions in governance/responsible investing. A mixture of business models was noted amongst the asset owners with 3 predominantly appointing asset managers for delegated fund management, and the remainder either managing assets directly, or outsourcing this in part.

2. Executive summary

- All investors said they were at least somewhat supportive of deferred share alternatives to LTIPs, although there are mixed views which ranged from being, “not always opposed, though highly sceptical...we recognize the current model does not work for every company” to being, “generally supportive as a way of simplifying pay and improving alignment”.
- Most investors qualified their receptiveness to alternatives as being in specific industry or company contexts where there is good justification and the right implementation. A minority of investors expressed an opinion on the proportion of companies such arrangements could be appropriate for, and where this data was captured, it ranged widely from “less than 10%” to “50% to 75%”.
- A couple of asset owners commented that they tend to engage most deeply on the topic of executive remuneration in the context of environmental, social and governance factors. Otherwise, there wasn't a clear or remarkable differentiation between the responses of asset managers and asset owners. In fact, a variety of opinions were cited within each grouping.
- Investors identified several actions they could potentially take in order to make deferred shares more widely adopted. These might either be as a community (e.g. greater coordination, consistent guiding principles), or individually (e.g. relaxing conditions such as the discount, more visible support to alternatives, a voting policy that explicitly references deferred shares, building capacity and capability to more robustly assess alternate designs, and developing deeper trust in remuneration committees).
- Proxy advisors (particularly ISS) were widely identified as creating a barrier to adoption of alternatives because of the inherent difficulty of evaluating non-standard structures within a recommendation-only model. Other common barriers cited were: limited UK market practice; a risk averse board; companies unwilling to adopt conditions necessary to secure shareholder approval (such as the discount); and an unconvincing business case for change.
- Proxy advisors highlighted a number of the constraints they are under in relation to non-standard plans. First, as the market develops they need clear guidance from clients, yet the diversity of views on this topic amongst investors has prevented this. Second, investor views on deferred share models were initially cautious overall, and this reflected the guidance given to proxy advisors. Proxy advisors are altering how they evaluate such plans as experience develops. Third, proxy advisors and investors face severe time constraints in light of the short

timescale (and high volumes) between publication of reports from mid March and the AGM seasons starting at the end of April. This typically gives very little opportunity for issuer engagement or client-out reach beyond early March.

- The benefits and risks of deferred share alternatives were generally consistent with those identified by the companies and consultancies interviewed. The investors also shared the same general perspective that deferred shares should not be considered a panacea. For example, as one asset owner said, “LTIPs still work in companies where you know the drivers of performance, and these are predictable”.

3. Themes from the interviews

3.1 Business context for a new remuneration policy

8 of the 13 asset managers suggested particular industries or strategic contexts where it is possible deferred shares may make more sense. These include: cyclical industries; companies with a volatile share price; mining; oil & gas; pharmaceutical; and utilities. One asset manager said, “we generally prefer deferred share awards, and so do not need a particular strategic rationale” and another observed that, “companies and sectors where restricted shares could be relevant is broader than we initially thought”.

3 asset owners largely concurred with the industries specified by the asset managers. Additional ones cited were: finance; insurance; commodity; and real estate. 2 asset owners did not have a particular position with one saying, “that is a fund manager question”. The final 2 were generally supportive of deferred shares.

Proxy advisors highlighted feedback from their clients that required a clear strategic rationale for a deferred share plan to be approved.

The interviews with companies implied those that consider and/or progress with implementing deferred shares often do so because of an extraordinary or compelling factor within their business context driving this agenda. This does appear to correlate with scenarios where investors may be particularly receptive to alternate models.

3.2 General views on deferred share alternatives to LTIPs

8 of the 13 asset managers may reasonably be categorized as supportive in specific industry or company contexts where there is good justification and the right implementation. 2 are in the category of generally supportive as a way of simplifying pay and improving alignment, and 3 are somewhere in between these two positions.

5 of the 7 asset owners may reasonably be categorized as supportive in specific industry or company contexts where there is good justification and the right implementation. 2 are generally supportive as a way of simplifying pay and improving alignment.

All investors said they were at least somewhat supportive of deferred share alternatives to LTIPs, although one asset manager is concerned, “some of the schemes being approved are not appropriate” and another believes, “we have voted against all proposals for deferred shares”. A couple of asset owners did not present particularly detailed perspectives which may be because

they generally use asset managers for delegated fund management, and/or have relatively limited in-house resource and expertise. One asset owner said, “executive remuneration is an area where we are more passive...we have been more active in executive remuneration alignment with climate change”, and another said they, “engage more broadly on ESG issues”.

A minority of investors offered an opinion on the proportion of companies such arrangements could be appropriate for. Where this data was captured, it ranged widely from “less than 10%” to “50% to 75%”. Similarly, there were only a few and mixed comments on whether they were becoming more or less supportive of alternatives which ranged from, “we liked it from the start” to, “we are becoming less confident in this model of pay”.

Many investors are concerned that so few companies are prepared to put forward alternatives to LTIP that may better support long term value creation in their business context. Even one of the more skeptical asset managers observed, “we are surprised at how few companies have put forward alternate models” which may imply that despite this scepticism, they still believe a wider adoption of alternatives may be appropriate.

3.2.1 The benefits of alternatives

The benefits cited by investors were generally consistent with those determined from the interviews with companies and consultancies. These include: reduces LTIP volatility especially in circumstances where it is challenging to set meaningful long-term targets; reduces complexity; facilitates strategic planning; supports the talent agenda; and effectively builds long-term shareholding. One asset manager believes that removing the performance element will make executive remuneration more directly comparable, which makes it easier to benchmark. An asset manager and an asset owner were also of the opinion that executive director tenure may increase with greater certainty in pay.

Example comments include:

- “it creates simpler and more transparent pay, better incentivizes executives to act in the long-term interests of shareholders, and avoid the boom and bust of LTIPs”. (asset manager)
- “focuses on strategy rather than earnings and short-term shareholder returns all of the time, which can be quite damaging to a company”. (asset manager)
- “they are a good idea and generally superior to conventional LTIPs”. (asset owner)
- “by reducing the number of variables across bonus and LTIP and adding discretion you can avoid unintended consequences” (asset owner)

3.2.2 The risks of alternatives

Similarly, the risks cited by investors were generally consistent with those determined from the interviews with companies and consultancies. These include: reduces pay for performance; creates risk aversion; limits the appetite for executives to outperform; quantum may be higher than necessary; and there will be greater focus on the annual bonus plan. It was also stated by a few that such plans may have a negative impact on executive director engagement as they may feel aggrieved about relinquishing a higher earnings opportunity. In addition, a couple of investors

believe a risk is that the Remuneration Committee will find it difficult to exercise downwards discretion so payment for failure will be more likely. Consequently, as one said, “the governance is key”.

Although these were, overall minority views, example comments include:

- “overall, we are hugely sceptical of alternatives”. (asset manager)
- “value is being delivered regardless of value being created”. (asset manager)
- “there is less incentive to perform so executives will coast”. (asset owner)
- “restricted shares enable high quantum without appropriate targets”. (asset owner)

3.3 Alternative designs

In circumstances where alternatives to LTIPs may be considered, views on the most appropriate form of deferred shares are mixed. 5 of the 13 asset managers expressed a preference for restricted stock with one saying, “we have a strong view that we don’t support performance on grant”. Another prefers performance on grant because, “it is cleaner”, and 2 said they were particularly attracted to deferred bonus. For the remaining 5 asset managers, the critical component is that whatever is proposed needs to be aligned with the company’s strategy. No strong preference on alternate design was observed by the asset owners. A typical response was, “all of them can work depending on circumstance” and another said that, “we would not want to restrict ourselves to one model”.

3.3.1 Underpins

Views on underpins are mixed, although most investors either require, or advocate, their adoption albeit with some differences of opinion as to how stringent the conditions attached should be.

Example asset manager comments include:

- “underpins are important but should not be over-engineered”.
- “we do understand the concern that more underpins just become performance conditions”.
- “underpins need to be business relevant”.
- “would like to see an underpin in most cases...helps prevent reward for failure”.
- “underpins should just be a defense against a payout when something has gone awfully bad”.
- “don’t think need an underpin although that may depend on the business”.

Example asset owner comments include:

- “an underpin is essential”.

- “underpins help avoid paying for failure”.
- “we do expect some kind of payment for failure protection”.
- “underpins become just as complicated as LTIP”.
- “the risk is you go back to having something that looks like performance share plan”.

3.3.2 Discount

5 of the 13 asset managers require at least a 50% discount as a condition for approving the implementation of restricted shares. Feedback from the other 8 suggest they may be receptive to a lesser discount or do not have a pre-set view:

- “50% to 60% feels like an appropriate range”.
- “arguing about level of discount is not the right argument; it misses the point of why we are trying to do this.”
- “Investment Association have been unhelpful in saying 50%”.
- “look at it case by case, but 50% is too high a discount”.
- “we would not get too hung up on quantum as long as executives have done a good job and business is doing well”.

Half of the asset owners who specified a figure require at least a 50% discount, while the others would consider the discount based on various factors.

A minority of investors expressed a view on the discount for performance-on-grant plans. For those that did comment, the general opinion was that they would likely support a lower level of discount than for restricted shares. However, the actual discount should be assessed taking account of a range of factors.

3.3.3 Hybrid schemes

There was limited discussion of plans that comprise a reduced LTIP award plus an award of deferred shares (although this was advocated by a couple of the consultancies interviewed). Of the few who commented, concerns were raised about adding complexity and generating even longer Director Remuneration Reports.

3.4 Consultation process

Common enablers that investors cited to support an effective consultation process were consistent with those identified by consultancies, and include: early and proactive communication; a compelling business case for change; a strong history and reputation for good governance; other aspects of remuneration (such as malus and clawback provisions) being in good order; and a strong Remuneration Committee Chair.

Investors typically anticipate companies will start with first principles, and assess the optimum remuneration construct to best meet the business needs; “RemCo should be starting with first principles and ask what is right for the business”. Other comments include, “we want to see a good explanation for why restricted shares makes sense” and, “it is all about long-term alignment with value creation – we will be supportive of anything that boosts that”.

The compelling business case requires a strong narrative that shows clear alignment with business strategy. Complementary views were that companies need to clearly set out what will change, how this results in something better than currently in place, identify any risks and actions to mitigate, and scenario plan for potential future outcomes. Examples cited of where investors said they have rejected proposals have been because, “the strategic rationale was so weak” or, “where the solution being proposed is not simple”. One asset manager said, “we do not have time for over-engineered pay schemes”.

A strong Remuneration Committee Chair was also identified by several as a key enabler. Strong was generally qualified as being someone who has sufficient business acumen and technical capability in remuneration to lead and shape the debate. It also means they instigate trust that they will act in the shareholders best interests even when under extreme pressure from other stakeholders. Relevant comments include: “we rely on the RemCo Chair being strong enough to stand up to management”; “a RemCo with a strong track record”; and “a good RemCo Chair is essential”. Another said they will “look at how RemCo has used discretion in the past”, and another that “the Chair must drive and own the discussion even if they bring their Head of Reward (or others) to the meeting”.

The interviews with the companies and consultancies stressed the effort that goes into successful consultations. This was acknowledged by several investors with an example observation being, “when companies do this a lot of thought goes into it; they really need to plan it”. Consequently, “strong” may also be inferred to encompass resilience and perseverance.

Interestingly, despite the recognition that considerable consultation is important, a few investors said they recognize they do not always have sufficient capacity and capability to adequately assess alternate designs. This is also an important barrier to wider adoption (see section 3.5.2).

3.5 What needs to happen to make deferred shares more widely adopted?

There were several common themes on the key barriers to change, and what needs to happen to make deferred shares more widely adopted. These may be categorized as follows:

3.5.1 Proxy advisors

A consistent concern raised about the role of proxy advisors in the company and consultancy interviews concerned whether they have the resources and processes to consult effectively, and their adherence to rigid checklists. Most investors also identified that proxy agencies need to be more receptive to, and supportive of alternatives if deferred shares are to be more widely adopted. Example comments include:

- “it is true that if something doesn’t fit the box they recommend against”. (asset manager)

- “it is not easy to have consultation discussions with ISS and Glass Lewis because the only way to react is once they have already written their reports”. (asset manager)
- “they should keep the door open to voting in favour”. (asset owner)
- “the attitudes of proxy agencies limits adoption”. (asset owner)

Other themes include: the 24-hours response time should be extended; capacity and capability to adequately assess alternate designs should be increased; and the way companies are able to engage with proxy advisors needs to improve e.g. clear and consistent feedback to be given.

Such suggestions require sufficient incentive and motivation on the part of proxy advisors to change their current operating model. Arguably this is most likely to be achieved through a sufficient number of their clients requiring it as a condition of appointment.

Proxy advisors themselves stated they do not seek to be treated as principals in the discussion on new pay models. They see that as a matter for investors and companies, with the advisor simply providing data, analysis and context. However, investors themselves recognize that the realities of resource constraints and the recommendation-based service of the major advisors means that the influence of proxy advisor recommendations is inevitably high. Investors themselves are not obliged to rely on, or follow, recommendations from their appointed proxy advisor. However, as they may need to otherwise evaluate hundreds or even thousands of different stocks in-house, insufficient resource may make this unrealistic.

3.5.2 The Investment Association (IA) and Investors

Investors interviewed generally recognize that they themselves can play a critical role in instigating change as clients of the proxy agencies. More broadly, many also recognize that as a community they may also need to be more visibly supportive to deferred share alternatives. Example comments include:

- “we need to move this debate forward, investors need to send a clear signal that the door is open in these designs, but also what the expectations are”. (asset manager)
- “as a community the asset managers are too old school thinking on pay; we say things need to change, but then reject innovation”. (asset manager)
- “asset managers need to feel at liberty to support Remuneration Committees being creative”. (asset manager)
- “if more than 75% of shareholders could be more flexible it would be better”. (asset manager)
- “there needs to be openness as companies currently expect an uphill battle”. (asset manager)

Key challenges include the fact that there appears to be little sense of a shared mind-set or impactful coordination, and no common guiding principles for acceptable alternatives. The consequence of this as one asset owner described it, is that, “proxy advisors unintentionally step in as coordinators and you can easily underestimate the significance of that”. One asset owner

believes, “we do talk to each other and are trying to get better at it”. However, other sentiments were that, “we act in a disorganized way which is unhelpful to companies”, and another said that, “investors find it hard to coordinate amongst themselves”.

Additional suggestions as to what needs to happen to make deferred shares more widely adopted include: investors relaxing the conditions they require (e.g. concerning underpins and discount); building capacity and strengthening capability to adequately assess alternate designs (either in-house or as a requirement of their proxy advisor); and the symbolic presence of an, “important player in the investor community” who has successfully implemented deferred shares for their own Group plc. Relevant comments include:

- “I am aware that some shareholders changed their position 48 hours before the AGM which is very bad practice”. (asset manager)
- “Investors need to accept a lower discount”. (asset manager)
- “very little resource has been put aside to date for considering restricted shares, there is not the capacity to do the work on design criteria in-house”. (asset manager)
- “we do not have time to analyse such bespoke arrangements in detail”. (asset owner)
- “we don’t have time so need some pro-forma requirements when there are more than 2,000 stocks to vote on”. (asset owner)

The role and impact of the IA was called out as an important body to shape and drive change. Some expressed concern that the IA Register may be creating an unnecessary barrier for change. A typical comment was that, “it is incredibly unhelpful, and creates a barrier to companies trying something new”.

3.5.3 UK Government

There were fewer comments on the impact of the UK Government compared to the interviews with companies and consultancies. Nevertheless, the political backdrop was still referenced by some, particularly in the context of quantum of executive pay which may inform the position key stakeholders are willing to take publicly.

In the broad area of regulatory reporting requirements, a few investors commented that they consider the Directors’ Remuneration Report (DRR) unnecessarily detailed. One asset manager commented, “all you need is a one-page summary of how remuneration links to strategy, and a one-page proforma of the outcomes”. Another said, “a 30 to 40-page document which may apply to just 2 or 3 executives is disproportionate”. It was not however clear how potentially relaxing DRR reporting requirements might help make deferred shares more widely adopted other than simply sending a message that greater simplification is to be encouraged.

3.5.4 Market practice

Feedback consistent with the company and consultancies interviewed, is that several investors believe that limited UK market practice means companies may be unwilling to stand out by doing something different that could damage their reputation. It also means some investors may remain

unconvinced there is sufficient evidence alternatives work. Relevant comments from 4 asset managers include:

- “it will take a few years for us to see the outcomes, and feel more comfortable with supporting alternatives”.
- “more companies need to come out and say why it is right for them”.
- “companies need to prove they work”.
- “we need role models of companies where the CEO has helped get restricted stock through”.

There was also a theme, shared with 3 of the consultancies interviewed, that it is possible alternate models may be most attractive to underperforming companies with a history of low incentive awards. To dispel this perception, one asset manager said, “we need to see some really high performing companies implement...it would be an easier sell if we saw more companies that are not on the cliff edge make the change”.

A couple of asset managers and asset owners referenced market practice in the US which may be relevant for companies who conduct significant business in the US, and compete in that talent market. This argument is consistent with some company interviews where deferred shares was cited as a benefit to support the talent agenda, including talent attraction and retention from the US. Example investor comments:

- “the US share plan dynamic should be considered; I believe there is movement to restricted stock”. (asset manager)
- “we are concerned about a quantum gap opening up between the UK and USA”. (asset manager)
- “if the total package is much less attractive then this could be suboptimal for investors and companies”. (asset owner)
- “the US have many companies with restricted stock plans”. (asset owner)

3.5.5 Other

Other comments include a suggestion that boards need to adopt a less risk averse mindset as this may be holding them back from putting forward proposals for change. There was also concern about insufficient trust between investors and companies. One asset manager commented, “the main blocker is we have lost trust in companies, we need trust in RemCo and advisors to do the right thing”. This may imply that another enabler to an effective consultation process is for the Remuneration Committee Chair to invest in strengthening personal connections and relationships with investors and proxy agencies which could build that necessary trust. In addition, there was a suggestion that companies should consider deferred share alternatives as a matter of course in any new policy deliberations. One asset manager commented, “it would be beneficial if companies said they considered all options including restricted shares”.

3.6 Overall effectiveness of new policies

The earlier observation concerning limited market practice (3.5.4) means it is generally too early to identify hard quantifiable measures of success, although several qualitative success measures were cited in the company interviews. As a couple of the asset managers said, “it is too early to say how successful the early adopters have been”, and, “as this is new for the UK market a lot will rest on these early adopters”.

Another asset manager expressed concern that some of the alternatives that have been supported by other investors have insufficient justification and, “these schemes won’t reduce pay”. That does, however, assume quantum was the primary motivation for their implementation. In fact, deferred shares is just one possible solution to the specific problem or challenge a company may be seeking to address. Deferred shares may not necessarily the best, or only, solution, and as one asset manager said, “I do hope this study can be encompassing enough to keep other options on the table”. Another asset manager suggested that whatever companies implement, they need to give the new policy time to embed, “the speed of change is massive; nothing is ever given long enough”.

3.7 The scope of the study

The study is focused on deferred share alternatives to LTIPs as a specific and bounded question that is currently topical, reasonably well understood, and can be subjected to specific research. The investors interviewed understand and acknowledged this, although a common theme to emerge was that a few deem this scope as being too narrow. Some of those interviewed said they felt they may be being pushed into taking a binary position on LTIP versus deferred shares, and instead would prefer to widen the debate to consideration of the broad package, including pay mix, annual incentives and shareholding.

Example comments include:

- “in an ideal world, scrap the annual bonus and just give shares”. (asset manager)
- “why do we also need a short-term bonus?”. (asset manager)
- “share ownership is the ultimate alignment vehicle”. (asset manager)
- “we would advocate increased salary...our real worry is with annual bonus”. (asset owner)
- “we would prefer much less performance related pay”. (asset owner)
- “we are talking far too much about what an individual gets paid, rather than the wider pay strategy”. (asset owner)

There are practical reasons informing the scope of this study. Nevertheless, this feedback is relevant and highlights the importance of executive remuneration being considered holistically, rather than for any particular design aspect evaluated in isolation. It is also possible broader remuneration questions might arise as a consequence of this study – for example, concerning deeper package reform and bolder constructs.

Appendix I: Investor survey results

Investors and asset owners were invited to participate in the survey. Distribution of the survey was via the Investment Association and The Purposeful Company's existing network of investors.

29 Asset managers and owners participated, representing many of the largest holders of shares in the UK stock market. We also sought to obtain representation in the survey from US-headquartered asset managers given their prominence in the market.

Based on sample sizes in absolute terms and relative to the target market we estimate margin for error in the response rates to be approximately +/-10% points at the 95% confidence level.

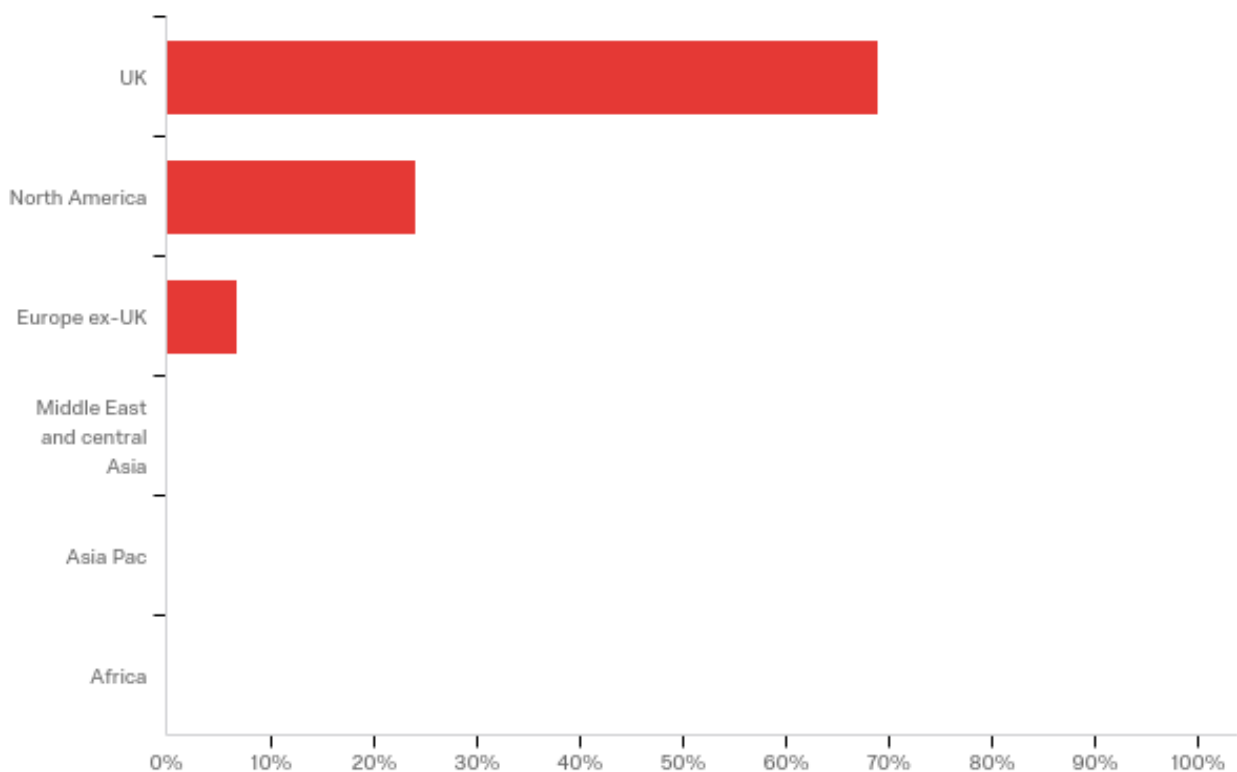
Note that certain questions, particularly relating to benefits, behaviours, and risks arising from adoption of deferred shares, required prioritization, with participants required to identify at most their top three most important issues.

Investor Survey

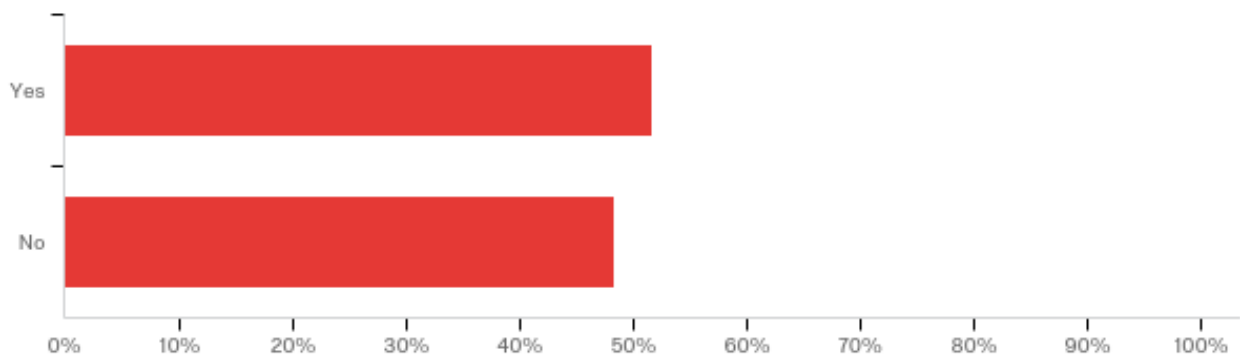
What best describes your role?

Asset owner - Portfolio manager	0%
Asset owner - Governance / responsible investing specialist	14%
Asset manager - Portfolio manager	0%
Asset manager - Governance / responsible investing specialist	69%
Shareholder advisor / proxy agent	7%
Other – please specify	10%
Total	29

Where is your headquarters based?



Do you make reference to deferred share alternatives to LTIPs in your executive pay voting policy?



What is your general attitude to deferred shares as alternatives to LTIPs?

We think they are a good idea and generally superior to conventional LTIPs	24%
We think they can be a good idea but only for some companies and industries	34%
They can be a good idea but for specific phases in the lifecycle of a company (for example during a turnaround or a period of rapid strategic change)	21%
We are generally sceptical and normally prefer a conventional LTIP but can be persuaded to support them when an LTIP clearly doesn't work	17%
We almost always oppose them – we strongly prefer a conventional LTIP	3%
Total	29

Which of the following types of deferred share award are you prepared to consider? [Select all that apply]

We tend not to support deferred shares	7%
Restricted shares	90%
Rebalanced plan (reduced LTIP award, offset by a deferred share award)	52%
Performance-on-grant	59%
Enhanced deferred bonus	66%
Bonus bank	41%
Total	29

Some companies have considered plans comprising a reduced LTIP award plus an award of deferred shares, either in the form of restricted shares or enhanced annual bonus. What is your attitude to such plans?

They just add complexity – companies should choose between LTIPs and deferred shares	48%
They may be a good idea for some companies but not for most	14%
They may be a good compromise and we would be open to companies adopting this approach	28%
Other – please specify	10%
Total	29

Some investors have expressed support for a wider restructuring of the package rather than simply replacing LTIP with deferred shares. Which of the following would you be prepared to consider? [select all that apply]

Increased salary with a significant proportion paid in shares held for the long term, with correspondingly reduced variable pay	68%
Block grant of shares when a CEO is recruited, vesting over a long period (e.g. 10 years), with a new block grant periodically (e.g. every 5 years)	52%
Co-investment / matching plan where restricted shares are awarded but only to the extent that executives invest their own funds to buy shares	72%
Loan arrangements where executives are lent funds to buy shares	16%
Other – please specify	24%
Total	25

What do you see as the biggest potential BENEFITS of replacing LTIP by deferred shares? [select up to three]

Simpler and more transparent pay	66%
Reduced maximum levels of pay	52%
Improved alignment of reward with company strategy and long-term performance	34%
Avoid the ‘boom and bust’ of LTIPs	24%
Creating strong incentives through a volatile industry cycle	21%
Increased flexibility to deal with a rapidly changing external environment	3%
Avoiding the difficulty of agreeing multi-year targets (internally and externally)	14%
Improved ability to attract and retain executives	0%
Avoid short-term or value-destroying behaviour caused by executives managing the business to hit LTIP performance conditions	28%
Better incentivise executives to act in the long-term interests of shareholders	21%
Other, please specify	7%
I don't see any potential benefits	3%
Total	29

What do you see as the biggest potential RISKS of replacing LTIPs by deferred shares? [select up to three]

This is just a fad and we'll be onto the next thing in a few years	14%
The remuneration committee will find it difficult to exercise downwards discretion when needed so payment for failure will be more likely	66%
There is less incentive to perform so executives will coast and avoid tough decisions	24%
The lack of upside will mean that the pay system will attract risk-averse executives rather than value creators	7%
Other – please specify	7%
I don't see any risks	10%
Executives will become risk-averse as there is reduced upside in the package	10%
Because of the reduced upside it will be harder to recruit executives	21%
Because it's unusual, it will be harder to recruit executives	7%
Award levels will drift upwards over time meaning that average pay will be higher than today	48%
Total	29

What do you believe are the likely biggest BEHAVIOURAL IMPACTS of replacing LTIPs by deferred shares? [select up to three]

Executives will work harder	0%
Executives will be less likely to resign (perhaps because pay is seen as fairer, or they can more easily value it)	17%
Executives will execute strategy more effectively because they won't be distracted by the impact on their LTIP targets	52%
Executives will be more likely to take decisions that are good for the long-term interests of the business	62%
Executives will coast because of the lack of performance incentive	10%
Executives will be more likely to resign (perhaps because of the loss of pay upside)	7%
Executives will execute strategy less effectively because of the loss of focus provided by LTIP targets	7%
Executives will be more likely to act against the long-term interests of the business because they won't suffer the consequences in terms of performance vesting	7%
I don't see any behavioural impacts	14%
Other – please specify	17%
Total	29

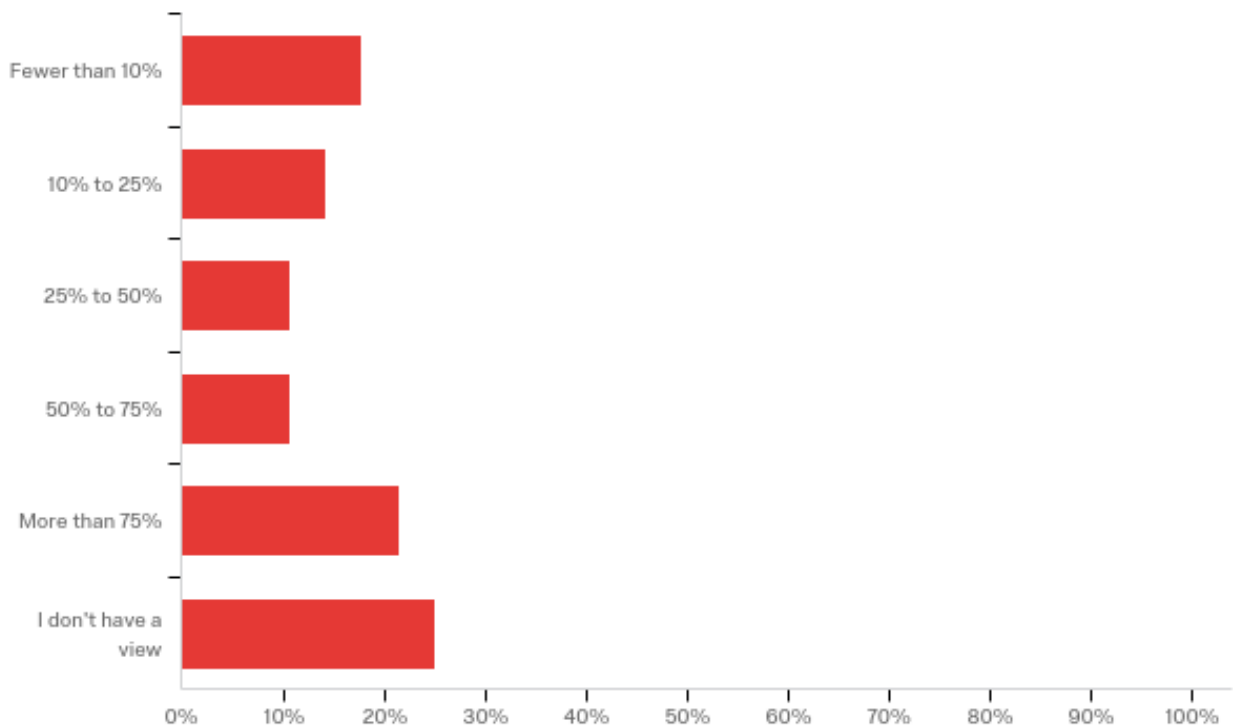
What do you view as an appropriate strategic rationale to enable you to support a deferred share arrangement? [select all that apply]

Highly cyclical industries where it is difficult to set long-term targets	69%
Significant change or uncertainty for the company, making it hard to set LTIP targets	62%
Very long-term industry cycles and timescales	41%
Potential for significant external factors outside the control of management (e.g. regulatory change) which can disrupt target setting in LTIPs	28%
We need to be convinced that it is impossible to operate a conventional LTIP effectively	21%
We generally prefer deferred share awards because of their alignment with shareholders and so do not need a particular strategic rationale	24%
Other - please specify	21%
Total	29

Are there any industries where there is a particularly strong case for adopting deferred shares in place of traditional LTIPs [Select all that apply - if you have no view move to the next question]

Wholesale trade	6%
Transportation, communications, electric, gas and sanitary services	24%
Services	12%
Retail trade	12%
Other – please specify	59%
Oil & Gas, mining	59%
Manufacturing	18%
Finance, insurance, and real estate	41%
Construction	18%
Agriculture, forestry and fishing	12%
Total	17

Over time, for what proportion of companies do you think deferred shares may be a valid or better alternative to a traditional LTIP:



In order to support a restricted shares plan in place of an LTIP, which of the following are particularly important: [select all that apply]

Strength of strategic rationale	79%
The quality of the consultation process and leadership shown by the Remuneration Committee chair	61%
The level of discount in the maximum award level (see next question for detail)	68%
Presence of an underpin on the deferred shares	75%
Combined deferral / holding in excess of five years	68%
High shareholding requirements	68%
A Remuneration Committee with a strong track record of acting in shareholders' interests	50%
We never support restricted shares so this question is not relevant to me	0%
Other – please specify	7%
Total	28

In order to support a restricted shares plan in place of an LTIP, what is the minimum level of discount you require in the maximum award level [Note: a 40% discount means that the restricted share award is 60% of the maximum LTIP award]

We will look at this on a case by case basis and could accept a discount of less than 50%	32%
We never support restricted shares so this question is not relevant to me	0%
More than 50%	11%
Don't know	7%
50%	39%
40%	4%
33%	7%
Total	28

What factors do you look at when considering the level of discount required: [select all that apply]

Historic LTIP vesting average	46%
Prospective LTIP vesting average	4%
Expected value of the LTIP	46%
How tough the LTIP performance conditions were	46%
Current level of total compensation against the market	43%
Length of deferral	46%
The strength of the underpin	43%
None of these factors matter – the discount must be at least 50% regardless	29%
Other – please specify	11%
Total	28

In order to support a performance-on-grant plan in place of an LTIP, which of the following are particularly important: [select all that apply]

Strength of strategic rationale	54%
The quality of the consultation process and leadership shown by the Remuneration Committee chair	50%
The level of discount in the maximum award level	54%
Presence of an underpin on the deferred shares	50%
Combined deferral / holding in excess of five years	57%
High shareholding requirements	46%
Pre-grant performance metrics measured over three years or more	36%
A Remuneration Committee with a strong track record of acting in shareholders' interests	46%
We never support performance-on-grant so this question is not relevant to me	11%
Other – please specify	11%
Total	28

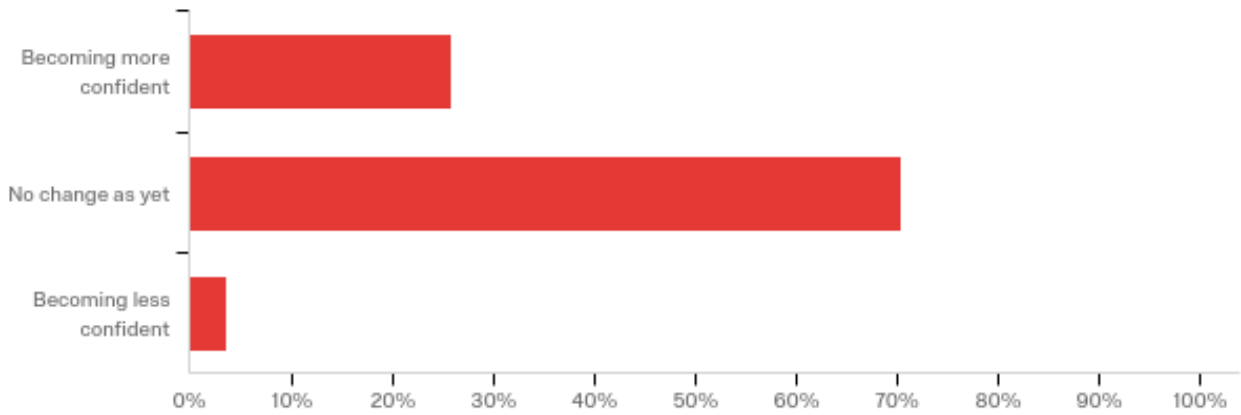
In order to support a performance-on-grant plan in place of an LTIP, what is the minimum level of discount you require in the maximum award level? [Note: a 20% discount means that the maximum award under the performance-on-grant plan is 80% of the maximum LTIP award]

No discount	10%
20%	0%
25%	5%
33%	10%
More than 33%	5%
We will look at this on a case by case basis and could accept a discount of less than 33%	57%
We never support performance-on-grant so this question is not relevant to me	14%
Total	21

What other barriers have YOU experienced in supporting deferred share proposals? [select all that apply]

We don't have time to analyse such bespoke arrangements in detail	11%
We are concerned about unintended consequences that we may not have identified	43%
We are concerned about the reputational risks of supporting something different from the norm	11%
Other - please specify	18%
Opposition from portfolio managers	14%
Negative shareholder advisor / proxy agent recommendations	29%
I have not experienced any barriers in supporting deferred share proposals	21%
Consistency across markets (e.g. we have been moving to add performance conditions to restricted shares in the US)	36%
Clients have expressed negative views of these plans	0%
Total	28

Based on how you have seen these companies operating deferred share plans, are you becoming more or less confident in this model of pay?



What would need to change in order for deferred share alternatives to LTIPs to become more prevalent: [select all that apply]

They will never become very prevalent as they are not appropriate for most companies	14%
They will become more prevalent provided investors see the early adopters working out well	39%
Proxy agencies changing their view and supporting more such plans	36%
Other – please specify	18%
Investor view developing more coherent view of the change	46%
Investors need to accept a lower discount in maximum award level in moving from LTIPs to deferred shares in order to make them attractive to management	18%
Companies need to accept the trade-offs in terms of quantum, deferral, underpins, and shareholding requirements	50%
Total	28

Appendix J: Company survey results

Companies were invited to participate in the survey with a focus on the FTSE-350. The survey was distributed via the FTSE-100 Remuneration Group, the major remuneration consultancies, and existing company networks of The Purposeful Company.

52 unique organisations participated (a small number of organisations submitted more than one response, e.g. from the Remuneration Committee Chair and the HR Director). Responses reflected a range of company sizes and sectors.

Based on sample sizes in absolute terms and relative to the target market we estimate margin for error in the response rates to be approximately +/-10% points at the 95% confidence level.

Note that certain questions, particularly relating to benefits, behaviours, and risks arising from adoption of deferred shares, required prioritization, with participants required to identify at most their top three most important issues.

Company Survey

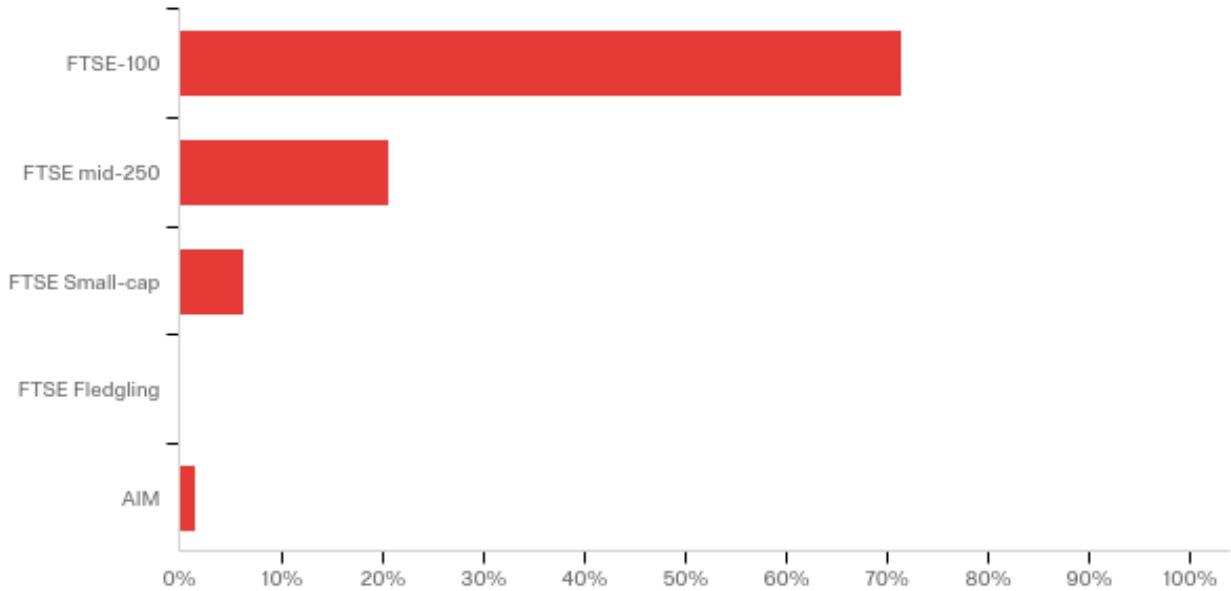
What best describes your role?

RemCo Chair	22%
Other – please specify	25%
Other NED or Chairman	2%
Head of Reward	43%
HR Director	3%
Executive Director	2%
Company Secretary	3%
Total	63

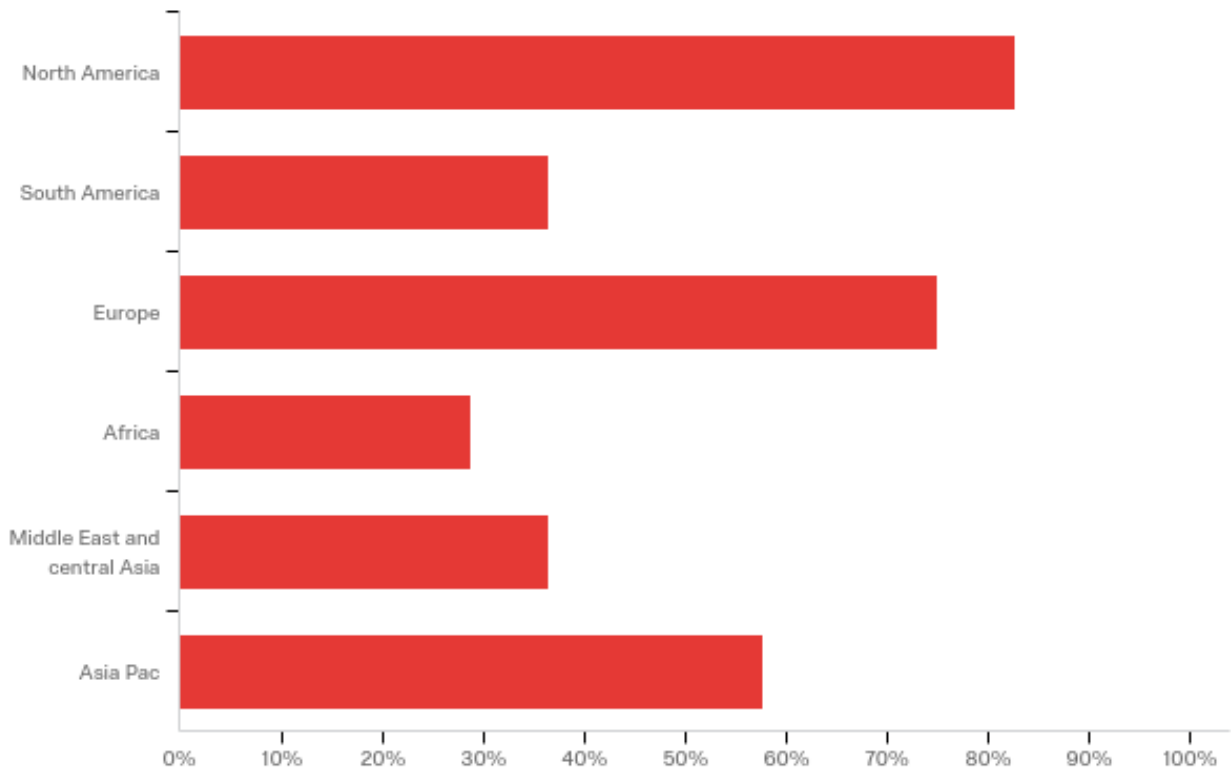
Industry sector

Agriculture, forestry and fishing	2%
Oil & Gas, mining	17%
Construction	0%
Manufacturing	8%
Transportation, communications, electric, gas and sanitary services	10%
Wholesale trade	5%
Retail trade	16%
Finance, insurance, and real estate	16%
Services	3%
Other – please specify	24%
Total	63

FTSE categorisation



Do you have senior executives (CEO-2 or above) in any of the following non-UK regions [select all that apply]:



Have you considered deferred shares as an alternative to LTIPs?

No	33%
Yes, but we rejected the idea as being unsuitable for our company	19%
Yes, we would like to implement, but currently view the barriers as being too high	17%
Yes, but we're still considering whether it is the right thing for us	17%
Yes, we are planning to implement as part of our next remuneration policy	0%
Yes, we have already implemented	13%
Total	63

Why did you reject (or not consider) the idea of deferred share alternatives for LTIPs? [select all that apply]

We believe that LTIPs work well for our company and don't see a need to change	59%
We believe that the impact on executive behaviour or motivation would be negative	25%
It would result in our pay being uncompetitive	19%
It would be too controversial with our shareholders	28%
The compromises required to get such a plan approved by investors would make it unattractive to executives	19%
It would take too much work to implement	9%
We would rather see how the market develops before looking seriously at this option	28%
Other – please specify	16%
Total	32

If the market developed so that deferred share alternatives to LTIPs became more common then do you think you might revisit this option?

Yes, it is likely that we would look seriously at this option in those circumstances	16%
No, it is unlikely that we would move away from LTIPs	16%
It is possible	69%
Total	32

Have you considered deferred shares as an alternative to LTIPs?

No	33%
Yes, but we rejected the idea as being unsuitable for our company	19%
Yes, we would like to implement, but currently view the barriers as being too high	17%
Yes, but we're still considering whether it is the right thing for us	17%
Yes, we are planning to implement as part of our next remuneration policy	0%
Yes, we have already implemented	13%
Total	63

What form of deferred shares would you like ideally like to introduce in place of your LTIP: [select all that apply]

Restricted shares	89%
Performance-on grant plan	16%
Enlarged annual bonus with deferral	32%
Bonus bank	5%
Rebalanced plan (reduced LTIP, offset by a deferred share award)	16%
I don't know	0%
Other - please specify	11%
Total	19

What are the most significant barriers preventing you from implementing deferred shares in place of LTIPs [select up to three]

The board is divided on whether it was a good idea	26%
It would take too much work to get it approved and it isn't worth it	16%
We don't think our shareholders would support the plan	53%
We think proxy agencies are likely to recommend against the plan	53%
We think we would win the vote, but want to avoid appearing on the Investment Association's Public Register	5%
The compromises required to get such a plan approved by investors would make it unattractive to executives	58%
Other – please specify	16%
Total	19

Have you considered deferred shares as an alternative to LTIPs?

No	33%
Yes, but we rejected the idea as being unsuitable for our company	19%
Yes, we would like to implement, but currently view the barriers as being too high	17%
Yes, but we're still considering whether it is the right thing for us	17%
Yes, we are planning to implement as part of our next remuneration policy	0%
Yes, we have already implemented	13%
Total	63

What form of deferred shares have you introduced / will you introduce in place of your LTIP: [select all that apply]

Restricted shares	100%
Performance-on grant plan	0%
Enlarged annual bonus with deferral	0%
Bonus bank	0%
Rebalanced plan (reduced LTIP offset by a deferred share award)	13%
I don't know	0%
Other - please specify	0%
Total	8

What do you see as the biggest challenges in introducing this type of plan? [select up to three]

The amount of work and consultation required to get the plan approved	25%
Getting a high enough level of shareholder vote to make the plan sustainable	38%
Navigating the diversity of shareholder views on this type of plan	63%
Getting proxy agency support for the plan	38%
Ensuring executives maintain support for the plan given the compromises required to satisfy investors	50%
Avoiding compromises to the plan design that undermine its intent and benefits	38%
Other – please specify	0%
Total	8

What is / was your target level of vote on the remuneration policy for introducing this new plan?

90%+	63%
80%+	0%
70%+	38%
60%+	0%
50%+	0%
Total	8

Which of the following features does your shareholder base have? [select all that apply]

We have a significant weighting (30%+) towards US investors in our Top 10	38%
We have a dispersed shareholder base with few holdings over 5%, and even those not by much	25%
Other special features – please specify	0%
Founder / family / block-holder – a single investor holds 25% or more of issued share capital	13%
Concentrated – Top 10 investors hold 50%+ of issued share capital	63%
Anchor shareholders – Our top three shareholders hold a combined 25%+ of issued share capital	38%
Total	8

How far does / will your new policy cascade down through the organisation?

The whole company	25%
More than 500 executives	0%
Just Executive Directors	0%
Executive Committee	38%
A wider group of up to 500 executives	25%
A wider group of up to 50 executives	13%
Total	8

While introducing a deferred share plan for senior executives are you also looking at share ownership across the company?

Yes we are introducing a new all-employee share plan	50%
Yes we are reinvigorating communication of an existing all-employee share plan	13%

We already have an all-employee share plan with high levels of participation	25%
No we are not looking at this	13%
Total	8

What do you think about deferred shares as an alternative to LTIPs as a general idea?

They can be a good idea but only for some companies and industries	39%
They can be a good idea but for specific phases in the lifecycle of a company (for example during a turnaround or a period of rapid strategic change)	22%
They are a good idea and generally superior to conventional LTIPs	12%
I would almost always oppose them – I strongly prefer a conventional LTIP	2%
I'm generally sceptical and normally prefer a conventional LTIP, but can be persuaded of their merits where an LTIP clearly doesn't work	25%
Total	59

Some companies have considered plans comprising a reduced LTIP award plus an award of deferred shares, either in the form of restricted shares or enhanced annual bonus. What is your attitude to such plans?

Other – please specify	20%
They are a good compromise and we would introduce one if we could	19%
They just add complexity – companies should either choose an LTIP or deferred shares	36%
They may be a good idea for some companies but wouldn't be for us	25%
Total	59

Some investors have expressed support for a wider restructuring of the package rather than simply replacing one type of LTIP with another. Which of the following would you consider if you felt it could be supported by shareholders? [select all that apply]

Other – please specify	26%
Loan arrangements where executives are lent funds to buy shares	3%
Increased salary with a significant proportion paid in shares held for the long term, with correspondingly reduced variable pay	52%
Co-investment / matching plan where restricted shares are awarded but only to the extent that executives invest their own funds to buy shares	28%
Block grant of shares when a CEO is recruited, vesting over ten years	21%
Total	58

What do you see as the biggest potential BENEFITS of replacing LTIP by deferred shares? [select up to three]

Simpler and more transparent pay	61%
Reduced maximum levels of pay	19%
Improved alignment of reward with company strategy and long-term performance	25%
Avoid the 'boom and bust' of LTIPs	49%
Creating strong incentives through a volatile industry cycle	18%
Increased flexibility to deal with a rapidly changing external environment	4%
Avoiding the difficulty of agreeing multi-year targets (internally and externally)	49%
Improved ability to attract and retain executives	7%
Avoid short-term or value-destroying behaviour caused by executives managing the business to hit LTIP performance conditions	16%
Better incentivise executives to act in the long-term interests of shareholders	19%
Other, please specify	7%
Total	57

What do you see as the biggest potential RISKS of replacing LTIPs by deferred shares? [select up to three]

Award levels will drift upwards over time meaning that average pay will be higher than today	24%
The remuneration committee will find it difficult to exercise downwards discretion when needed so payment for failure will be more likely	49%
There is less incentive to perform so executives will coast and avoid tough decisions	31%
Executives will become risk-averse as there is reduced upside in the package	16%
The lack of upside will mean that the pay system will attract risk-averse executives rather than value creators	29%
Because it's unusual, it will be harder to recruit executives	7%
Because of the reduced upside it will be harder to recruit executives	44%
This is just a fad and we'll be onto the next thing in a few years	13%
Other – please specify	13%
Total	55

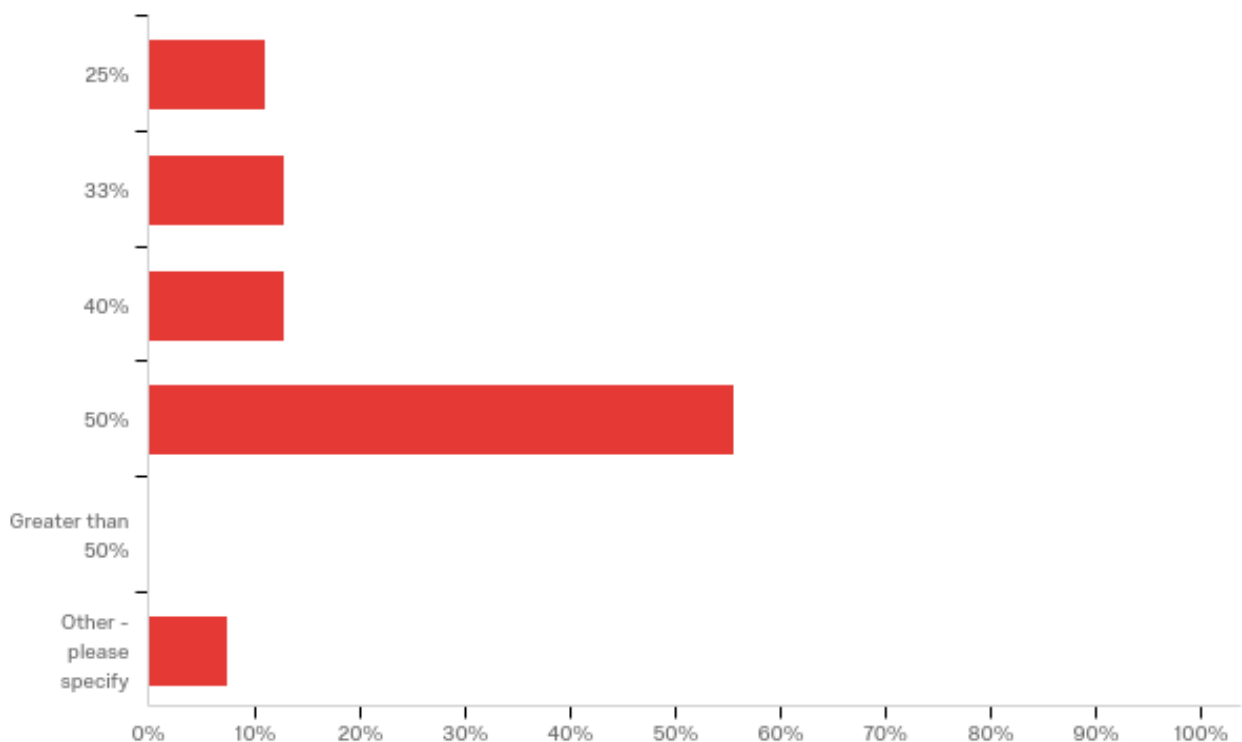
What do you believe are the likely biggest BEHAVIOURAL IMPACTS of replacing LTIPs by deferred shares? [select up to three]

Executives will work harder	4%
Executives will be less likely to resign (perhaps because pay is seen as fairer, or they can more easily value it)	9%
Executives will execute strategy more effectively because they won't be distracted by the impact on their LTIP targets	31%
Executives will be more likely to take decisions that are good for the long-term interests of the business	44%
Executives will coast because of the lack of performance incentive	15%
Executives will be more likely to resign (perhaps because of the loss of pay upside)	15%
Executives will execute strategy less effectively because of the loss of focus provided by LTIP targets	17%
Executives will be more likely to act against the long-term interests of the business because they won't suffer the consequences in terms of performance vesting	6%
Executives will continue to operate as they do today, as the LTIP form is not the core driver to behaviour	59%
Other – please specify	9%
Total	54

Which of the following compromises often required by investors in order to support a restricted shares plan create the biggest problem in making the package attractive for executives? [select up to three]

Requirement to reduce the maximum value of the LTIP award by 50% or more when replacing by a restricted share award	65%
Requirement to have an underpin prior to vesting of the restricted shares to avoid payment for failure	44%
Requirement to extend vesting / holding to more than five years	37%
Requirement to increase shareholding requirements	22%
The combination of all the above	28%
Other – please specify	0%
Total	54

Broadly what level of discount in maximum value when changing from LTIP to restricted shares do you think is reasonable in most cases, while still being attractive to executives? (Note that a discount of 25% means that restricted shares awards are made at 75% of the maximum LTIP award)

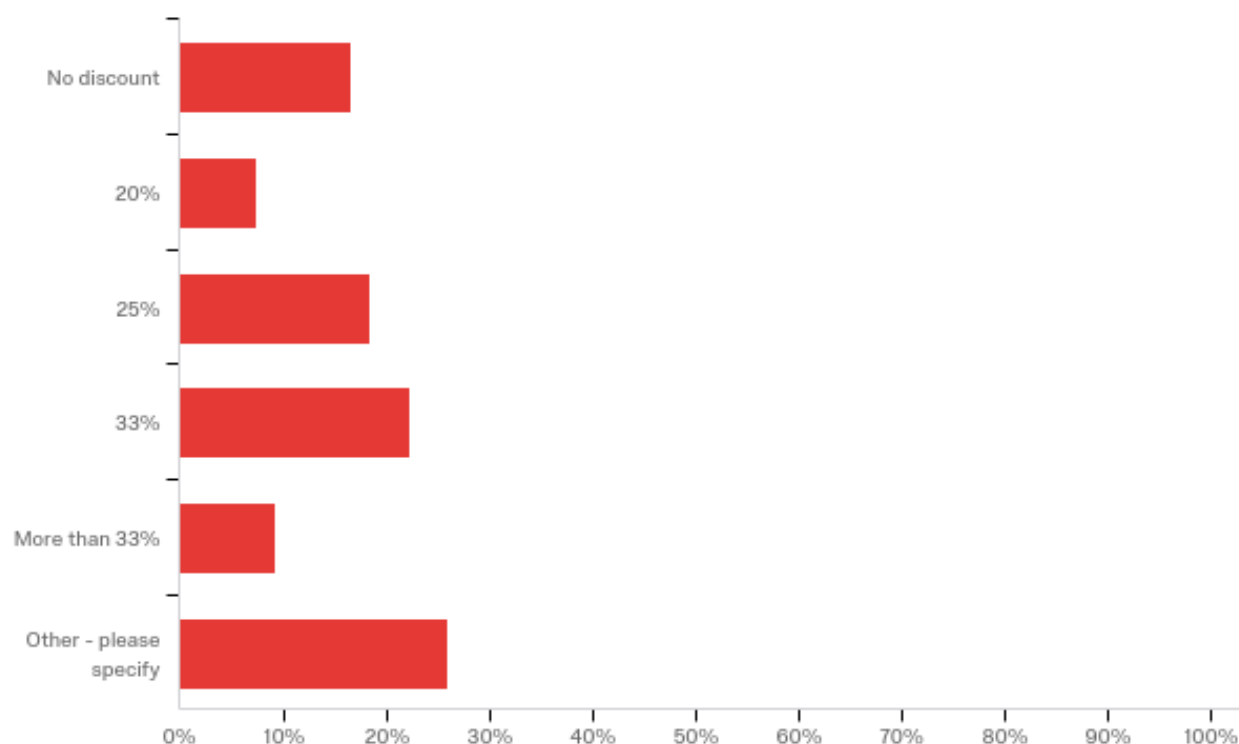


Which of the following compromises often required by investors in order to support a performance-on-grant plan create the biggest problem in making the package attractive for executives? [select up to three]

Requirement to reduce the maximum value of the LTIP award when replacing by a performance-on-grant award | 50%

Requirement to measure performance over three years prior to grant for part of the award	33%
Requirement to have an underpin prior to vesting of a portion of the deferred shares to avoid payment for failure	43%
Requirement to extend vesting / holding to five years or more	24%
Requirement to increase shareholding requirements	11%
Better disclosure of targets, retrospectively and prospectively	4%
The combination of all the above	28%
Other – please specify	6%
Total	54

Broadly what level of discount in maximum value when changing from LTIP to performance-on-grant do you think is reasonable in most cases, while still being attractive to executives? (Note that a discount of 25% means that performance-on-grant awards are made at 75% of the maximum LTIP award)



What would need to change in order for deferred shares to become more

widespread as an alternative to LTIPs? [Select all that apply]

They will never become very prevalent as they are not appropriate for most companies	15%
They will become more prevalent provided investors see the early adopters working out well	33%
Proxy agencies changing their view and supporting more such plans	69%
Other - please specify	12%
Investors need to accept a lower discount in maximum award level in moving from LTIPs to deferred shares in order to make them attractive to executives	46%
Investors developing a more coherent view of this alternative so companies know what is expected	54%
Companies need to accept the trade-offs in terms of quantum, deferral, underpins, and shareholding requirements	42%
Total	52



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