THE PURPOSEFUL COMPANY

October 2019

The Purposeful Company Study on Deferred Shares

Key Findings Report

The Purposeful Company Steering Group

Executive Summary

Attitudes are shifting on how best to align CEO pay to performance. Companies and investors increasingly see deferred shares[1] 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 advisers 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 8):
    - Process changes to encourage innovation and adoption. As well as positive signaling from investors, we need changes to how companies, investors and proxy advisers 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 that are most effective for their circumstances.

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[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.

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 public companies we identified, mainly FTSE 350, that are currently operating deferred shares as an alternative to LTIPs using data from annual reports and voting and proxy advisor information from Proxy Insight;
- a review of the academic evidence on long term incentive design;
- interviews with asset owners, asset managers, companies, proxy advisers, 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.

This report provides a summary of the key findings and recommendations from the study. We have also produced a full report to provide open source access to the interview themes and aggregate survey data that supported these findings. It can be found here: https://www.thepurposefulcompany.org/full-report.pdf

The state of the market

The debate on alternatives to LTIPs continues to be active, not just in the UK

- Since the Report of the Investment Association Executive Remuneration Working Group in 2016, **a number of investors have publicly advocated a simpler approach to LTIPs**. In the US, the Council for Institutional Investors recently updated its guidelines to encourage greater use of deferred shares in place of LTIPs.
- However, **a spectrum of views remains within the company and investor communities** about whether deferred shares are always better than LTIPs, better in some circumstances, or generally or always a bad idea.

Academic evidence indicates that deferred shares are likely to be a good option in many cases

- Large scale studies consistently show incentive targets influence CEO behaviour, and that **executives can take action to hit targets or influence share price** close to vesting or exercise of blocks of shares **in a way that undermines long term value creation**.
- **Below the board level, use of stretching targets linked to pay can be consistent with a high performance culture**. The evidence raising concerns about targets is most acute at CEO level, given the nature of board governance oversight and the broad scope of CEO responsiblities.
- **Pay design matters**. Use of options results in higher risk taking and more volatility particularly close to the exercise price and vesting events. Conversely, use of unsecured debt as a pay vehicle is associated with lower volatility and higher credit ratings. **Lengthening the time horizon in pay results in improved innovation and long term performance. High levels of CEO share ownership lead to higher long term share price performance.**
- **The academic research, both theory and empirical, therefore supports payment of CEOs in long-dated deferred shares**, which are a comprehensive measure of the long term value of the company, with reduced focus on pay linked to short to medium term targets. Almost all models of optimal contracts, including Nobel prizewinning theories predict that **pay should vary smoothly with performance** rather than have targets and cliff-edges.
- In this context, long-dated deferred shares as supported by the academic evidence are **much longer term than restricted shares as commonly seen in the US market**, and will also involve continued holding beyond retirement.

The market appetite for deferred shares is around 5x greater than we see adopted in practice

- To date **fewer than 5% of the FTSE-350 have adopted deferred shares** in place of an LTIP.
- However, we find **investors (79%)[2] and companies (73%) believe that deferred shares are the best approach in certain companies, industries, or situations**.

[2] Numbers shown in brackets are taken from our survey of 29 investors and 52 companies carried out for this study.

- **Just under half of all 52 companies we surveyed are considering, would like to implement, or have implemented deferred shares**. Just over half have not considered or have considered and rejected the idea, usually because they believe LTIPs work well for their company and they saw no need to change. However, some also cited fears that the move would be controversial and the risk of negative impact on executive behaviour.
- Overall the data indicates that **the market considers deferred shares to be an appropriate alternative to LTIPs in around 25% of companies or more**, 5x more than we see today.

Investors and companies see significant behavioral and practical benefits from deferred shares

- Investors (66%) and companies (61%) both **see greater simplicity and transparency** as the key benefit of deferred share awards. Reduction in maximum pay levels is highlighted as an important benefit for investors (52%).[3]
- T**here is a strong desire from all parties to spend less time on executive pay** and greater use of deferred shares is viewed as a way to achieve this. While this is certainly the case, there may be a requirement to invest resources in the short term to develop consensus on the right models for using deferred shares. Greater simplicity and reduced time commitment will then follow.
- Investors highlighted two behavioural impacts above all others. Most investors believe that changing to deferred shares will **encourage executives to take decisions in the long term interests of the busines**s (62%) and to **execute strategy more effectively** because they will not be distracted by LTIP targets (52%).
- Across the market as a whole, **companies were sceptical about the behavioural impact of replacing LTIPs,** with 59% saying they are not a key driver of behaviour. However, the top two potential behavioural impacts identified by companies aligned with investors: encourage long term decision making (44%) and strategy execution (31%). **Companies were 2x to 3x more likely to identify positive than negative behavioural consequences**.
- Based on our interviews and desktop research, **the rationale for companies adopting deferred shares generally comprised one or more of**: simplification, aligning pay with performance in a very long cycle or cyclical industry, significant uncertainty or externally-driven change for the company, desire to incentivize long term behaviour, and alignment with reward structures across the organization.
- Companies also **highlighted practical benefits of deferred shares** such as avoiding boom and bust in LTIP outcomes (49%) and the difficulties of long term target setting (49%).
- A number of market participants are viewing **long term deferred shares as an effective way to integrate ESG considerations into pay**. There is now good evidence that ESG issues relating to material stakeholders are strongly linked to equity value over the long term. Use of long-term deferred shares may be a more effective way to link pay to ESG than attempts to design short-term ESG targets.

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[3] When asking survey participants about benefits, behaviours, and risks arising from deferred shares they were restricted to selecting their top three in each case so that we could identifiy the highest priority issues for participants.

But at the same time there are risks to manage with deferred shares

- The risk of **payment for failure** if remuneration committees do not exercise downwards discretion **is identified as the biggest risk** by investors (66%) and companies (49%). Beyond this, the main concern of investors was that award levels might drift upwards over time, offsetting the initial quantum reduction when deferred shares are introduced.
- Companies also highlighted three main risks created by the lack of pay variability (both upwards and downwards) on a move to deferred shares: **increased difficulty in recruiting executives** (44%), or of **attracting risk-averse executives** (29%), and the **risk of executives coasting** and avoiding tough decisions (31%).

Companies perceive significant barriers to change

- For companies wanting to introduce deferred shares, the key barrier to change is the perception that **the extent of compromises required to secure investor support makes deferred shares unattractive to executives** (58%). The biggest specific problem identified across all companies (65%) was the **required discount in award levels**.
- This is closely followed (53%) by the perceived **difficulty of getting shareholders and proxy advisors to support** deferred share plans. Those companies that had implemented deferred shares found **navigating the diversity of shareholder views was a particular challenge**.
- Investors broadly agreed. While **they remain committed to the discount**, they also accept that they need to provide a coherent and welcoming message, if change is to happen, and they also **recognize that negative proxy advisor recommendations can be a problem**.
- However, proxy advisors face **the challenge of trying to create a consensus position out of what have historically been quite varied views** on the merits of deferred shares, and have received feedback from some clients that a cautious view should be taken in the first instance.
- A **fear of unintended consequences** pervades investor thinking, and so the simple passage of time will be important – if early implementations of deferred shares are seen to be working out well, investors will naturally become more supportive.
- Turning specifically to the level of discount in award levels, investors and companies were broadly in agreement. **Half of investors said they would require a discount of at least 50%** in grant level, compared with the previous LTIP, to support a restricted share plan. Around half of companies also felt that this was appropriate. However, nearly 40% of companies said a discount less than 50% was required to make restricted shares attractive to executives (with responses evenly distributed between a 25% and 40% discount). **Equally, 43% of investors said they would consider a lower discount than 50%**.

Lessons can be learned from companies that have succeeded in implementing deferred shares

- Implementations of deferred shares to date are **broadly equally divided between restricted shares and performance on grant plans**.
- Plans have generally reflected shareholder desires for lengthened deferral, underpins (on restricted shares), and other features such as enhanced shareholding requirements. **Discounts in award levels have typically been applied at 50% for restricted shares and 20% to 33% for performance on grant plans**.
- UK implementations are concentrated in natural resources, financial services, and retail, which broadly aligns with the sectors deemed most appropriate by investors. **The motivations differed by sector**. In natural resources dealing with the **cyclicality and volatility** of a long term industry cycle and avoiding boom and bust in LTIP outcomes was a common theme, as well as aligment with the **very long term effects of executive decision-making**. Retailers often identified **rapid industry change** and uncertainty over medium term target setting. In financial services, the motivation was often to **encourage prudent risk taking over the long term**. In the US technology sector there are notable implementations of restricted stock plans, to support **growth and innovation**.[4]
- **Average historic vesting for companies adopting deferred shares is 35% to 40% over 5 and 10 years, with a range up to 61%**. This compares with a market average of 60%.
- However, companies adopting deferred shares **have neither systematically outperformed nor underperformed their TSR benchmarks prior to implementation**, so the concern of some investors that only underperforming companies adopt deferred shares is not well founded. To the extent that vesting was below market norms **this appears to have been due to difficulty in selecting or calibrating performance measures**. Indeed some companies, such as The Weir Group, were **seeking approval for deferred shares in an upcycle as projected LTIP vesting levels were increasing**, in an effort to secure shareholder support. It is too early to judge the performance impact of deferred shares since implementation – as recent as 2017 or 2018 for most companies – with no statistically significant under or outperformance overall.
- A number of companies adopting deferred shares had **average or better long term vesting levels compared to the market, but experienced extreme 'boom or bust'** in those LTIP outcomes. Whatever the precise manifestation, **difficulties in setting and calibrating LTIP measures, and ensuring LTIP outcomes that reflect performance**, were common factors in the history of companies adopting deferred shares.
- **ISS recommended AGAINST over 40% of the current implementations of deferred shares. Glass Lewis supported all but one.** For performance-on-grant plans there were design features that were associated with lack of ISS support, in particular: lack of discount and underpin, or pre-grant performance conditions operating over one year only. For

[4] See for example Amazon's description in their proxy statement: "…*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."*

restricted shares, it more commonly seemed to be strength of the strategic rationale that was cited as being the reason for support (or not) as opposed to specific design features. **Since the approval of The Weir Group plan in 2018 it has become clearer what is required to secure proxy adviser support, and ISS appear to be approving an increasing proportion of such plans.**

- Notwithstanding the high rate of AGAINST recommendations, average votes in favour have been just under 90%. This is because most companies that have implemented deferred shares have **higher than normal levels of concentration at the top of their share register**, enabling a strong voting outcome even if proxy advisers recommended AGAINST.
- **Strength of strategic rationale** was highlighted by almost all investors as **key to securing their support**. Companies that were particularly commended by investors had put the most effort into articulating this rationale, providing supporting analysis on issues such as the discount, and investing in the consultation process.
- Some market participants raised **the importance of annual incentives with robust targets while confidence is being developed in using deferred shares**. This has the potential to keep stretch targets in place over the short term whilst using share-price growth as the mechanism for exposing executives to the long term performance of the company.
- **Companies that have adopted deferred shares feel that they are working well**, including some who have long experience of operating deferred shares below board. However, all felt that the effort involved was very significant and potentially offputting to other companies. A few companies also highlighted a potential problem with implementation of non-standard policies. While the policy might have been approved by a high percentage, **the implementation reports were sometimes challenged by proxy advisors who continued to judge the policy through a conventional lens**, rather than on the basis of what was approved.

Insights and recommendations

If investors and companies want greater adoption of deferred shares, work is required in two areas to address barriers to change, which will require investment of time and resources

1. **Process changes to encourage innovation and adoption**. As well as positive signaling from investors, we need changes to how companies, investors and proxy advisers engage on and evaluate deferred share proposals and their subsequent implementation.
2. **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 two areas requires a period of **investment in collaborative 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, in order to gain long term benefits. **Without specific effort on these issues, the pace of change will remain very slow.**

Investors want companies to consider whether deferred shares are right for them

- Investors do not believe that deferred share awards are right for all or even most companies. However, **investors do want companies actively to consider whether deferred shares are right for them and to be clear, if not, why not**. It should not be assumed that a conventional LTIP is an unchallenged default – the strategic case should be made for whatever incentive plan is adopted.
- **Investors and the Investment Association are already considering how they can support more companies to adopt deferred shares.** Based on our research across the market, we believe there are some enhancements to the engagement process that would help enable appropriate adoption.
- **It is therefore appropriate for companies and their consultants to consider these alternatives seriously** as part of policy reviews, even if they ultimately reject them.
- Companies seeking to adopt deferred shares will be more successful if they do so from the **starting point of strategic alignment and encouraging long term behaviour**, rather than simply to fix a problem with recent vesting outcomes.
- At least in the short term, companies need to **invest more in the consultation process and supporting analysis** than is the case for conventional plans, taking time to ensure that the proposed design, rationale, and parameters are fully explained and justified.
- **It is particularly important that companies commence engagements on deferred share proposals early in the cycle** (i.e. the second half of the calendar year). This enables an iterative approach to consultation, but also enables proxy advisers to undertake outreach with clients if appropriate, which in practical terms becomes challenging once the peak reporting season starts in March each year.

- In engagement meetings, companies should provide **a candid analysis of where their proposal sits against the Investment Association Guidelines**, highlighting any deviation from best practice provisions, with full rationale and supporting analysis, and with a **full articulation of the motivation and strategic rationale** for introducing the plan. Investors and proxy advisers welcome a description of the options considered and rejected.
- Investors highlighted the importance of **visible leadership and knowledge from the Remuneration Committee Chair**, who should be seen to be owning the process and genuinely listening to shareholders. Companies will help investors and proxy advisers support proposals if they **explain in the annual report the consultation process** they followed and the changes that they made to the proposal as a result.
- **An additional round of engagement is typically required** compared with a conventional consultation, and extra effort needed in the communication materials and disclosures. Remuneration committees adopting deferred shares in the near term will **need to be aware of the additional resource requirements** ahead of embarking on the change. Once norms become more established, then deferred shares should be no more complex to implement than conventional designs.

In the short term we need a process for engagement on deferred share proposals that creates more opportunity for dialogue and explicitly pushes decision making up to investors

- **Proxy advisers need clear guidance from investors**. Proxy advisers are service providers, fulfilling a critical and high quality service to investors. Investors are responsible for how they use their recommendations. Proxy advisers have faced a **difficult challenge in reconciling divergent investor views into a single recommendation.**
- However, **the practical influence of the large recommendation-based proxy advisers 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 advisers to lead the debate on what constitutes appropriate design in long term incentives – they do not wish to be put in this position and 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 advisers appropriately identify propsals as being for strategic judgement.
- This will require investors to identify the design features that they wish to see evaluated. **Features could 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 work with the major recommendation-based proxy advisors in the UK market** – **ISS and Glass Lewis**[5] – **to implement the following approach** in relation to deferred share proposals and recommendations:
   - **ISS and Glass Lewis to clearly highlight deferred share proposals** to clients.
   - The proposal should be analysed by the proxy advisers in terms of the issues identifiyed 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.
   - Advisers **should not recommend AGAINST purely on the basis of strategic rationale**, as this is a matter for shareholders not advisers, particularly during this period of transition.
   - The proxy advisers should offer an **extra engagement meeting** to the company to enable appropriate iteration and full understanding of the proposal. Companies need to realise that this can only happen before the peak AGM season commences.
   - If ISS or Glass Lewis recommend AGAINST such a proposal, **the timeframe for response should be extended ideally to one week** and provide genuine opportunity for engagement and mutual understanding. We understand the constraints that proxy advisers face on timing, and recognize that this would require investors to ask advisers to prioritise analysis of deferred share proposals for a time. This adds to the importance of the consultation process so that the advisors are aware that a deferred share plan is being brought forward.
   - 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 will need to analyse for themselves proposals flagged as deferred share plans (whether proxy advisers recommend FOR or AGAINST)** to determine whether they support the proposal or not, so that investor preferences can be revealed to the

[5] The recommendations here are most relevant to large recommendation-based advisors, which have been shown to have causal impact on voting outcomes, which is why we focus here on Glass Lewis and ISS.

market. If they are supportive investors should feedback to the proxy advisers to inform their own analysis process.

    - **It is important that implementation of non-standard approaches is 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 adviser should offer a 'review of learnings' meeting after the AGM season** to enable mutual understanding with the issuer.

- Following the 2021 AGM season, the Investment Association could facilitate a process of review of implementations to date and seek to **update guidance so that companies and proxy advisers understand how to assess deferred share proposals in a more standardised way**, without the need for bespoke engagement on every occasion.

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 advisers. 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 achiving 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**. 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. **More detailed illustrations of the approaches are provided in the in depth report.**
- **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 then 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 addresss 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 mechansims 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.

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 advisers, 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 consquences 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 adviser 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.

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 G4S, Heidrick & Struggles , Kingfisher, and The Weir Group; 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
- Professor Colin Mayer MBE, Saïd Business School and The British Academy

Primary accountability for oversight and authoring of the report is held by Clare Chapman and Tom Gosling. All Steering Group members are acting in their personal capacity, not representing the organsiations 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 support 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.

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 including holding beyond retirement.
- **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.

Companies adopting deferred shares

We identified the following 19 companeis that had adopted deferred shares as a 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

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

Allianz Global Investors

Aon Hewitt

Artemis Investment Management LLP

Aviva Investors Global Services Ltd

Aviva plc

BHP

BlackRock Inc.

BMO Global Asset Management

BP plc

Brunel

Burberry Group plc

Capital & Regional plc

Card Factory plc

Centrica plc

Church Commissioners

Compass Group plc

Deloitte

Experian plc

Ferguson plc

Fit Remuneration Consultants

Glass Lewis

Hermes Investment Management

HSBC Global Asset Management

HSBC Holdings plc

InterContinental Hotels Group plc

Imperial Brands plc

Indivior plc

ISS

John Wood Group plc

J.P. Morgan Asset Management

J Sainsbury plc

Kames Capital

Kenmare Resources plc

Kingfisher plc

Korn Ferry

Legal & General Group plc

Legal & General Investment Management Ltd

LGPS Central Limited

Lloyds Banking Group plc

M&G Investments

Mercer

Merian Global Investors

Minerva

NEST Investment

Norges Bank Investment Management

Pearson plc

Pets at Home Group plc

Performance and Reward Centre (PARC)

PwC

QinetiQ plc

Railpen Investment Management

RBC Global Asset Management

RBS Group plc

Reckitt Benckiser Group plc

Rio Tinto plc

Rolls-Royce plc

Royal London Asset Management

Royal Mail plc

Sarasin & Partners

Schroders plc

Severn Trent plc

Share Plan Lawyers

Standard Chartered Bank plc

State Street Global Advisors

Subsea 7

T. Rowe Price Group Inc.

Tesco plc

The Investment Association

The FTSE Remuneration Group

The Weir Group plc

Tullow Oil plc

UBS Asset Management (UK) Ltd

Unilever plc

USS Investment Management Ltd

Vodafone Group plc

Willis Towers Watson

WPP plc

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