

# SRD II – Say on Pay Requirements

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An Overview of Key Changes and the Glass Lewis Approach

Pursuant to the amended European Shareholder Rights Directive (“SRD II”), shareholders will have the right to vote on a company’s remuneration policy and remuneration report, which will cover both executive and non-executive directors and will have to be drawn in compliance with several structural and disclosure requirements, in all European Union (“EU”) member states.

## Remuneration Policy

While this vote is primarily designed to be binding, the directive leaves the option to member states to implement it in an advisory form. In either case, when a policy is rejected by shareholders, a revised policy must be submitted for approval at the following general meeting.

Companies must offer a vote on the remuneration policy at least every four years or any time a material amendment to the existing policy is implemented.

Companies will be allowed to temporarily deviate from the remuneration policy approved by shareholders in exceptional circumstances, provided that the policy includes a description of said circumstances and of the terms of the potential deviation.

The remuneration policy must be available on the company’s website for free for at least the duration of its validity.

## Remuneration Report

Companies will have to draw a “clear and understandable” report on the most recent fiscal year. This report will be subject to an annual advisory vote, although member states may allow small and medium enterprises to submit the report simply as a discussion item.

The remuneration report must be available on the company’s website for free for at least ten years.

In most Member States, the first vote on the remuneration report will be held in the year following the first vote on the remuneration policy – this is due to the backward-looking nature of the vote on the remuneration report.

## Structural Requirements

The remuneration policy will have to reflect a company’s strategy, long-term interests and sustainability.

Variable remuneration components must be based on clear, comprehensive and varied criteria, including corporate social responsibility criteria, where appropriate; additionally, equity-based remuneration should be subject to vesting periods.

## Disclosure Requirements

The remuneration **policy** should include a description of the following:

- How the policy contributes to a company's business strategy and long-term interests and sustainability;
- All components of the pay mix and their relative weight;
- How pay and employment conditions of a company's employees were taken into account;
- Financial and non-financial performance metrics, including CSR metrics;
- Explanation of how performance metrics contribute to the company's business strategy and long-term interests and sustainability;
- Performance assessment mechanisms;
- Deferral periods;
- Recovery provisions;
- Vesting and holding periods on equity-based remuneration;
- How equity awards contribute to a company's business strategy and long-term interests and sustainability;
- Duration of directors' contracts;
- Length of notice periods;
- Terms of supplementary pension or early retirement schemes;
- Terms of termination payments;
- Decision-making process behind the new policy (including: measures to avoid conflict of interests, role of remuneration committee);
- All significant amendments, if any;
- How latest shareholder vote was taken into account.

The remuneration **report** should include a description of the following:

- All remuneration elements awarded or due to all directors (including departing and joining directors) during the past fiscal year, on an individual basis and broken down by component;
- Relative weight of fixed and variable remuneration;
- How the total remuneration paid for the year complies with the approved remuneration policy;
- How total remuneration contributes to a company's long-term performance;
- How performance criteria were applied;
- Year-on-year change in remuneration, company performance and average remuneration of employees (i.e. non directors) on a full-time equivalent basis for the last five fiscal years, presented in a way that allows comparison;
- Any remuneration paid by entities belonging to the same group;
- Number of share instruments granted/offered;
- Main conditions for the exercise of share awards, including the exercise price and date in case of options;
- Use of recovery provisions, if applicable;
- Any deviation from the approved remuneration policy, including a description of the circumstances that triggered these deviations and of the elements from which the deviation occurred;
- How the latest shareholder vote was taken into account.

## Notable Market Changes

*Markets with no pre-existing legal requirement or established market practice in relation to shareholder votes on executive remuneration prior to SRD II implementation:*

- Austria; Croatia; Czech Republic; Estonia; Finland; Latvia; Lithuania; Luxembourg; Malta; Poland; Slovakia.

*Markets where significant changes to the Say on Pay regime will take place:*

- Denmark, Germany, Netherlands, Sweden: While each has some history of remuneration policy votes already, the vote on remuneration policy will be held at least every four years, rather than only upon the implementation of amendments. Additionally, a new vote on the remuneration report will be introduced.
- France: In addition to the current votes on remuneration policy and variable pay amounts, a binding annual vote on the remuneration report will be introduced; this vote will cover all directors on aggregate, rather than being on an individual basis as the existing votes on the remuneration policy and the variable pay amounts. Currently, the rejection of a proposal on an individual's variable pay amount results in the suspension of that individual's variable remuneration. Additionally, starting from this year, if a remuneration report is rejected, all pay will be suspended for all directors; if the report is rejected for a second time, all pay for all directors is forfeited.
- Italy: The vote on remuneration policy will be binding for all companies rather than for financial institutions only; the vote on the remuneration report will be introduced.
- Norway: A binding vote on the remuneration policy will be introduced.

*Other market-specific implementation notes:*

- Netherlands: A remuneration policy will need the support of at least 75% of votes cast to be approved. Companies will have to explain how the board accounted for "social acceptance" and the advice of work councils when formulating the remuneration policy.

## Glass Lewis Approach

### Policy vs. Report

Glass Lewis will assess the remuneration policy and the remuneration reports differently, according to the different time-frame and significance of the two votes.

When assessing a remuneration policy, Glass Lewis will focus on the structural elements of the remuneration system, including: appropriateness of the pay mix (determination of base salary levels; adequate weight on long-term components), link with strategy and long-term success, presence of safeguards (payout limits, recovery provisions, deferral), appropriateness of the performance metric sets, presence of equity-based instruments, appropriateness of severance agreements, and authority to use board discretion.

Since this vote is forward looking, our assessment will be based solely on the terms of the proposed policy and on the effect of the proposed amendments over the existing policy (where applicable). In this regard, while on one hand we will evaluate a company's overall "direction of travel", on the other hand we will be mindful of the fact that, if approved, the new policy will remain in place for up to four fiscal years or until a material change is proposed.

When assessing a remuneration report, Glass Lewis will focus on the implementation of the existing policy and any relevant decision taken by the board during the past fiscal year, including: any adjustment in the pay mix (increase in base salary; change in the at-target value of variable components), any deviation from the remuneration policy and rationale thereof, exercise of the board's discretion, appropriateness of performance targets, use of safeguards (payout limits, recovery provisions, appropriateness of payouts with respect to actual performance). Additionally, we will assess the overall quality of the disclosure provided in the remuneration report, its readability and completeness against the local legal requirements and recommendations. Where we identify an issue that is covered both by the remuneration policy and the remuneration report, and both votes are offered at the same general meeting, unless the gravity of the issue does prompt a negative recommendation on both proposals, we would generally recommend shareholders to withhold support from the advisory vote on the remuneration report. Should this issue not be resolved, we would then recommend shareholders to extend their dissent to the binding vote on the remuneration policy at the following opportunity. Notably, this approach is reversed in France, given the different implications of binding remuneration report votes in that country.

### Changes Due to New Structural and Disclosure Requirements

The SRD II requirements related to the remuneration framework are largely focused on the link between pay and the long-term success of the company. As our guidelines also emphasise this link, our policies in this regard will not change. However, as a response to increasing interest in the link between pay and long-term sustainability, we explicitly note the presence of ESG metrics in incentive plans for large- and mid-cap companies.

Similarly, while SRD II disclosure requirements (and their national transpositions) include a variety of data points, we note that most of these elements were already included in our Continental Europe and market guidelines and will therefore not entail a material change in policy at this time. Nonetheless, we note companies in most markets will be required to provide the following disclosure for the first time:

- How pay and employment conditions of a company's employees were taken into account;
- Year-on-year change in remuneration, company performance and average remuneration of employees (i.e. non directors) on a full-time equivalent basis for the last five fiscal years, presented in a way that allows comparison.

We believe the inclusion of the above disclosure elements will represent a valuable tool for shareholders to assess the appropriateness of a company's remuneration scheme. However, since these requirements are new, we will observe companies' interpretation of each data point, as well as stakeholders' reactions to companies' disclosure in the first year of implementation, before considering amending our guidelines to account explicitly for the new disclosure. Such disclosure may, however, help inform our analysis of the link between pay and performance and the change in average workforce pay compared to executive pay, the latter of which is particularly relevant where a company is seeking to increase executive pay levels.

Additionally, for most markets, we expect to see significant improvements in the disclosure of the following elements:

- Amendments to a remuneration policy and rationale thereof;
- Company's response to shareholder dissent and shareholder engagement;
- Link between remuneration and strategy and sustainability.

Finally, we note that while the full disclosure of performance hurdles (i.e. threshold, target, maximum) is envisaged by the [European Commission's remuneration report guidelines](#), SRD II does not contain such an explicit requirement.

### **First Year of Implementation**

We note that in some markets there was no legal requirement for or established practice on a vote on executive remuneration until the transposition of SRD II (see Market-Specific Highlights above). Many companies in these markets will likely have to compile a formal remuneration policy and report for the first time. As such, absent egregious practices, we reserve the opportunity to take a case-by-case approach in instances that would normally otherwise prompt a negative recommendation, in order to allow some leeway to the board in the first year of implementation of the new requirements.

*Note: This document is not intended as, and should not be relied upon, as legal advice. Investment advisers should consult legal counsel on any questions about their particular legal responsibilities.*