European Policy - Non-Executive Director Remuneration

Background and Overview

Grants of performance-based compensation to non-executive directors – meaning cash bonuses, stock options, performance shares, or other forms of performance-based cash or equity compensation -- are relatively rare among publicly listed companies in most continental European markets, as these practices are viewed by many investors and corporate issuers as being potentially compromising of director independence.

The International Corporate Governance Network and a number of prominent European codes of best practice also recommend against performance-based pay for non-executive directors: of the 15 continental European markets in the Governance Quick Score (GQS) universe, nine contain recommendations against the grant of any performance-based compensation to executive directors – in one case, with the possible exception of insignificant amounts – while a further three local codes recommend against grants of performance-based stock or stock options to non-executive directors.

Additionally, many ISS clients based in continental Europe have customized voting policies that oppose the grant of performance-based compensation of all forms to non-executive directors. Results of the 2015-16 policy survey also indicate that a majority of institutional investors believe the grant of stock options or performance-based equity are inappropriate forms of compensation for non-executive directors.

Key Changes Under Consideration

The current European policy states that ISS may recommend against proposals regarding non-executive director compensation where proposals provide for the grant of "stock options, or similarly structured equity compensation."

The proposed amendment would extend negative recommendations to all forms of performance-based compensation for non-executive directors. The proposed wording would state that a negative recommendation would generally be applied for proposals providing for the grant of "stock options, performance-based equity compensation (including stock appreciation rights and performance-vesting stock), and performance-based cash" to non-executive directors.

Intent and Impact

The proposed changes are intended to reflect local best practice and market trends in continental Europe.

The amendment regarding performance-based equity is expected to have a minimal impact on voting recommendations, due to the fact that the practice is relatively rare in most European markets, as well as the fact that the current policy already calls for recommendations against the grant of "stock options or similarly-structured equity compensation." The new recommendation against performance-based cash is expected to have a more significant impact on voting recommendations, particularly in Germany, which is unique among large European markets in that the local corporate governance code takes an explicitly neutral stance toward performance-based remuneration for non-executive directors as long as such remuneration is geared toward sustainable growth (many German companies have however moved away from this practice in the last several years following a May 2012 code amendment, which toned down the code's support for performance-based pay for supervisory board members)[1]. Approx. 24 percent of German companies in the GQS universe grant performance-based remuneration to non-executive directors, whereas in the rest of continental Europe, about 7 percent of GQS companies engage in this practice (this includes companies that grant performance-based equity).

It is difficult to gauge the anticipated increase in voting recommendations however, since resolutions on non-executive compensation are not proposed annually in Germany and many other European markets, in addition to the fact that the practice is falling out of favor in Germany and remains rare elsewhere.

Request for Comment

- In your organization's view, are there particular circumstances when granting performance-based cash or equity (incl. stock options) to non-executive directors may merit support on an exceptional basis? If so, please explain.

- In light of the abovementioned circumstances in the German market, would your organization favor a carve-out or delay on the implementation of the new policy on performance-based cash for German companies?

[1] Prior to May 15, 2012, the German Code of Best Practice stated that members of the supervisory board "shall receive fixed as well as performance related remuneration. Performance-related compensation should also contain components based on the long-term components of the enterprise." The version amended May 15, 2012 changed this to the following: "If members of the Supervisory Board are promised performance-related compensation, it shall be oriented toward the sustainable growth of the enterprise."