UK EXECUTIVE COMPENSATION SERVICES

WINDFALL GAINS:

YOUR GUIDE

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ALVAREZ & MARSAL

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Windfall Gains: Your Guide

We expect "windfall gains" to be one of the key issues for UK-listed companies during this year's AGM season, an assumption supported by recent updates to shareholder guidance which again highlighted this area. Despite this, the phrase is still not well defined or understood by the market. While the underlying concept is simple (that a relatively large number of shares may have been granted under long-term incentive plan ("LTIP") awards made in early 2020 following significant COVID-induced share price declines), it is much more challenging to subsequently determine whether this has ultimately translated into a so-called "windfall gain" and, if so, what if anything should be done about it?

In addition to understanding the latest shareholder perspectives, it is important that committees also reflect on the potential management perspective, including the impact of COVID-19 on all remuneration outcomes over the period. A downward adjustment to one LTIP award at vesting can feel unfair and inconsistent if other elements of the package over the same period (including other in-flight LTIP awards) have been negatively impacted by COVID-19, without any adjustment.

In our view, a "formulaic" approach to assessing windfall gains is unlikely to be appropriate, and remuneration committees will need to use judgement. To support committees in making an informed judgment, we have therefore developed a framework of risk factors to take into account in determining whether a windfall gain may have occurred. It includes consideration of various factors related to the share price trajectory (such as the magnitude, timing, relativity, and drivers of share price recovery) as well as the broader remuneration context over the period. We also provide reference points which might be used if it is concluded that some adjustment should be made. Throughout the process, it is important to take a balanced approach, and to ensure appropriate engagement and communication with all stakeholders.

In this guide, we consider the issue which has come to be known in the UK-listed environment as "windfall gains". We explain what is specifically meant by the term in its current usage, exploring how it rose to prominence in early 2020 as a result of the equity market shock brought on by the COVID-19 pandemic. We look at the different stakeholder perspectives, outlining both the evolution of shareholder guidance up to the most recent releases, as well as considering the potential management perspective.

Finally, we then outline our suggested framework to assist remuneration committees in determining whether a windfall gain may have occurred and, if so, what type of adjustment might be made. The guide will be most relevant for those companies that granted their 2020 LTIP awards following a significant decline in the share price without making an adjustment to the size of the awards and instead deferring consideration of the impact until the point of vesting.

What is currently meant by the term “windfall gain”?

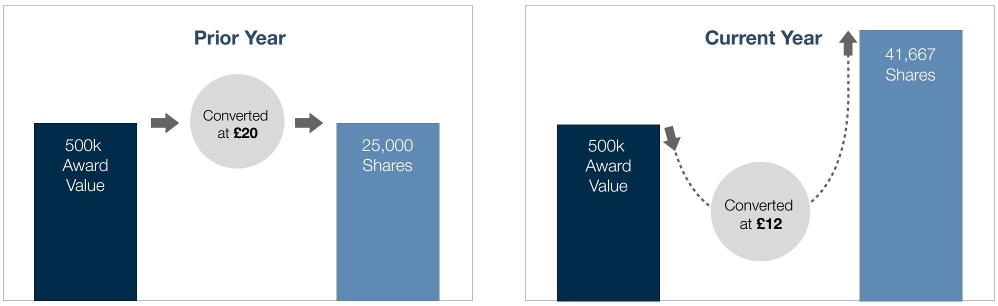
For anyone casually observing the world of executive remuneration, where the potential regularly exists for the receipt of multi-million pound payouts under incentive programmes, it may seem that the opportunity for “windfall” pay-outs is a common occurrence. But for those working in the field, the phrase has come to represent a more specific set of circumstances related to the number of LTIP shares granted following a material share price decline.

Before we describe those specific circumstances, it is worth remembering that it is now well-established best practice for remuneration committees to consider, at the point of vesting of any incentive award, whether the “formulaic” outcome is appropriate based on a broad assessment of overall performance in context. Where the formulaic outcome is not supported by this assessment, shareholders expect awards to be subject to a discretionary downward adjustment, and we have seen examples of some companies making such adjustments in recent years. The committee’s broad assessment should consider whether the value being received by executives “feels right” in the context of a range of contextual factors, such as the underlying performance of the business, the stakeholder “experience” over the period, and the macroeconomic and trading environment. This process should naturally capture, and adjust for, situations where a “windfall”, conceived in the broadest sense of the term, might have occurred. An example might be where large pay-outs were due based on performance which had been significantly enhanced as a result of a substantial and beneficial change in government policy, which had not been anticipated when the targets were originally set.

While the phrase “windfall gain” could be thought of as one aspect of this overall assessment, in current UK discourse it is one with a very specific meaning related to the number of LTIP shares which were originally granted in certain circumstances, as set out below. It is this exact set of circumstances which we are referring to in this note by the phrase “windfall gains”.

Where a company has experienced a significant fall in its share price since the prior year’s LTIP grant, then if the next LTIP award is made on the same percentage of salary basis it will result in a material increase in the number of shares awarded to the executive. Where the share price subsequently recovers, this could create the potential for a so-called “windfall gain” as a direct result of the increased number of LTIP shares which were awarded at grant.

To illustrate this with an example, assume an executive on a salary of £500,000 is granted an LTIP award annually at a level of 100% of salary (i.e. a “face value” of £500,000 is awarded each year, converted into a number of shares to be granted at the prevailing share price at the point of grant). For the award in the prior year, assume the share price was £20 and therefore 25,000 shares were awarded (£500,000 of award value divided by £20 per share). Then assume the share price fell by 40% to £12 per share in advance of the next grant. Without any adjustment, the number of shares awarded would increase by 67% to 41,667 (£500,000 / £12).



Although the same monetary value has been awarded, it is the significant increase in the number of shares granted which creates the potential, in the eyes of shareholders, for a future “windfall gain”.

Impact of the COVID-19 pandemic and evolution of shareholder guidance

Shareholders have been cognisant of this issue for a number of years. In fact, reference to the "windfall gains" risk has been explicit in the Investment Association's Principles of Remuneration for over ten years. In our experience, however, it has historically rarely been a major area of investor focus, outside of those individual companies which had experienced exceptional and sustained periods of share price decline. This changed almost overnight following the onset of the COVID-19 pandemic.

Cast your mind back to early 2020….

Given the significant shock to equity markets in response to the impact of the pandemic on the macroeconomic outlook, a large number of companies experienced a rapid and material decline in their share price at that time. While the extent of the impact was sector dependent, across the FTSE All Share, the average level of annual share price decline to mid-March 2020 was 26%, with over a quarter of the market experiencing falls in excess of 40%.

In an immediate response to the pandemic (in late April 2020), the Investment Association ("IA") issued new guidance around executive pay, which included addressing this issue. The guidance noted that for awards which had already been granted in 2020 following the share price declines:

> **"It is important for the Remuneration Committee to confirm that they will look at the general market and share price response over the performance period to ensure that windfall gains will not be received on vesting. Shareholders will expect the Committee to use their discretion to reduce vesting outcomes where windfall gains have been received."**

The above guidance was relevant for a large number of December year-end companies where awards had been granted. For those who had not yet granted awards in 2020, the IA guidance "discouraged" remuneration committees from granting at the normal award level, and instead advised committees to "consider reducing" the award level. In practice, a substantial majority of companies granting after April 2020 continued to make awards at the normal level, but typically disclosed that they were aware of the investor view and committed to review the outcome at vesting (and included provisions in their award documentation to ensure this could be undertaken).

Fast forward to 2023… shareholders provide a timely reminder

Most awards made in 2020 will be due to vest in 2023. In their recent letter to remuneration committee chairs, the Investment Association provided a timely reminder that this remains a key area of shareholder focus:

> **"In 2023, many Remuneration Committees will be making those vesting decisions, assessing executive's performance against performance measures of long-term incentive grants made in 2020. These 2020 grants were made in the midst of the pandemic following significant share price falls, so a greater number of shares were granted compared to previous years. To ensure that participants do not benefit from being granted significantly more shares, it is important that Remuneration Committees consider if vesting outcomes need to be reduced. Committees should clearly articulate to shareholders how they have considered the impact of any potential windfall gains when determining vesting outcomes and why any reduction is appropriate. If the Committee has decided not to adjust for windfall gains it should explain and disclose its rationale for doing so."**

Other prominent institutions have issued similar guidance on this issue (LGIM). While the proxy advisors, most notably ISS, have not issued any updated guidance on the windfall gains issue, we understand that their thinking is broadly aligned with that described above.

We draw three main conclusions from these latest guidance releases:

- Shareholders and proxy advisors have not "forgotten" about this issue. The updates provided a deliberate and timely reminder that it will be one of the main areas of focus during the 2023 AGM season. For those who deferred their decision-making on this issue until the point of vesting, we expect shareholder scrutiny;
- While shareholders recognise the concept of a "windfall gain" in principle, it is notable that they do not provide any specific guidance on how remuneration committees might determine whether a "windfall gain" has occurred. This puts the onus on remuneration committees to use their judgment to make such a determination;
- Disclosure will be critical. Whatever the decision made, remuneration committees must utilise their DRR to fully articulate and explain their rationale. We believe that if the disclosure ignores the issue, or takes a "boilerplate" approach, greater levels of shareholder scrutiny can be expected.

As ever, it will be very challenging to fully "quantify" the level of risk to the Directors' Remuneration Report ("DRR") vote as it will depend on the circumstances of the business and its shareholder base. However, if shareholders identify what they perceive to be an egregious "windfall gain" outcome, which is not adequately explained by a compelling rationale in engagement and in the DRR, then it could well be sufficient to become a voting issue for shareholders and proxy agencies (and particularly if there are other prevailing concerns in respect of the DRR or broader investor sentiment).

As a final word on the latest shareholder perspective, perhaps in recognition of the challenges which might arise when trying to assess windfall gains at the point of vesting, last year (November 2021) the IA strengthened its guidance "to reflect investor preference for companies to reduce awards at grant where share prices have fallen rather than relying on discretion when awards vest".

Making an adjustment at grant is therefore now considered best practice in the UK market where there has been a significant share price decline prior to grant, although it has yet to become established market practice. The IA guidance indicates that a 30% decline in the share price might be the threshold to review whether an adjustment at grant is required (although LGIM state a lower threshold of 20%). No specific guidance has been provided on what the adjustment to award levels at grant should be in these circumstances, but a potential "rule of thumb" might be that the award level should be reduced by a factor of around half the share price decline (e.g. if the share price had declined by 40%, the award level might be reduced by c.20%). It is of course always important for the remuneration committee to consider the level of such adjustment in the broader context of other remuneration outcomes and decisions, and whether the reduction in share price is considered to be a short-term one or more of a permanent re-rating.

Ensuring a balanced view – understanding the management viewpoint

As with many aspects of life for a remuneration committee, it is important to ensure a balanced view of the perspectives of all key stakeholders. While the content of the note above highlights the expectations of shareholders, remuneration committees will also want to reflect on the potential management perspective. This can be a sensitive and challenging issue for a variety of reasons.

Executives may perceive a discretionary downward adjustment at vesting to be “penalising” them for high levels of vesting and share price growth, which executives would normally expect to be rewarded for in accordance with well-established principles of “pay for performance” and alignment with shareholders.

There is a further potential perception that downward adjustments for windfall gains is simply another example of an increasingly “asymmetric”, and arguably inconsistent, approach to managing executive director remuneration in the UK. By asymmetric, we mean that the application of a particular principle is perceived to be typically applied in favour of the shareholder perspective, rather than consistently to all stakeholders (for example, one often hears the observation that the principle of using discretionary adjustments to adjust a formulaic outcome is typically only ever applied negatively, and hence rarely in management’s favour).

Looking specifically at the windfall gains issue, one could reasonably argue that if it is the case that award outcomes for a 2020 LTIP award should be adjusted to remove the beneficial impact of an external event which was outside of the control of management (COVID-19), why was it not also the case that the outcomes for other LTIP awards (e.g. 2018 and 2019) should similarly have been adjusted to remove the detrimental impact of the same external and uncontrollable event? In practice, very few companies adjusted in-flight LTIP awards or used positive discretion at vesting (and those that did generally received very negative reactions from shareholders and proxy agencies). Indeed, many companies reduced executive salaries and incentive outcomes to reflect the pandemic.

An alternative strategy here would be to say that where an event occurs which is outside of management’s control but to which management is not to be “insulated from” via adjustments, then this should apply consistently to all aspects of their remuneration, including the full suite of relevant LTIP awards.

This would imply, in principle, that where no adjustment was made to in-flight LTIP awards (from 2018 and 2019) to reflect the impact of COVID on performance targets, then no adjustment should be made for windfall gains to reflect the impact of COVID on the number of shares originally granted under the 2020 LTIP award.

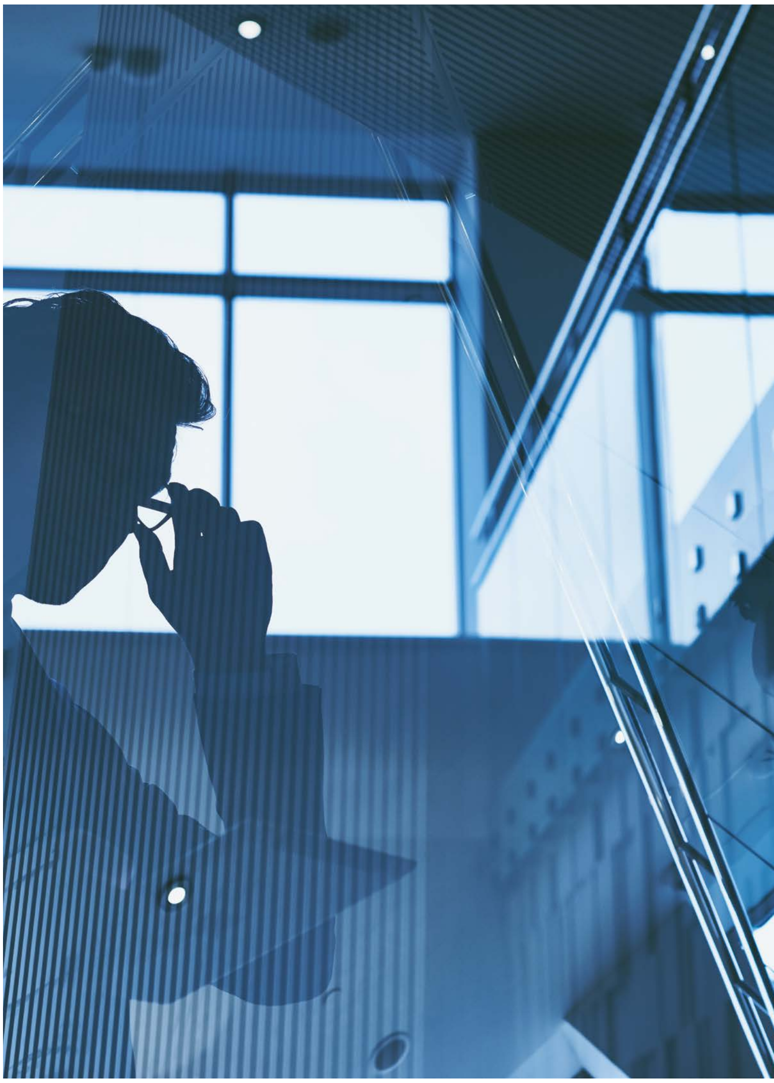
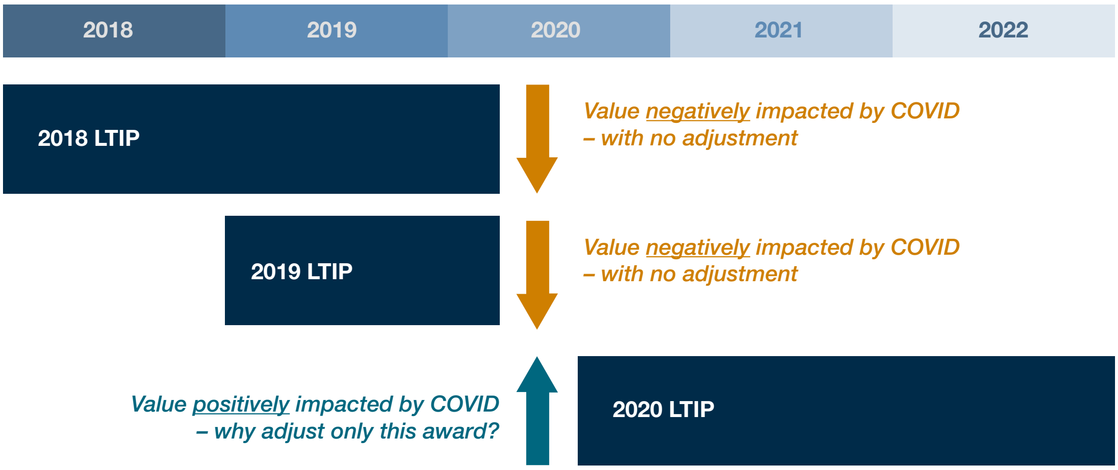


Illustration of "asymmetric" impact of COVID on multiple LTIP awards

This illustration assumes that the "in-flight" 2018 and 2019 LTIP awards were negatively impacted by the impact of the pandemic in early 2020, but no adjustment was made (i.e. value fell and performance targets became unachievable but were not re-set). The 2020 award is seen to benefit from the impact of the pandemic (lower share price at grant leading to a greater number of shares being granted), but one could reasonably argue that if no adjustment was made to the 2018 and 2019 awards, why then adjust only the 2020 award?



Finally, we also recognise that the phrase itself ("windfall gains") can be very emotive for executives, as it implies that reward has been fortunately received, or even "unearned", which is unlikely to align with how executives have perceived their workload and contribution, particularly in navigating businesses through the very challenging early days of COVID. Indeed, looking back, it may have been preferable for a different term to have been used in the investor guidance to more accurately describe the underlying fact pattern around the number of shares granted, and we are aware that some in the investment community recognise this.

There are a number of key takeaways, in practice, for a remuneration committee. First, as we shall consider below, it is critical to ensure decisions on windfall gains are taken in the context of the broader remuneration outcomes for executives over the period. Second, given the sensitivities involved, it is important to clearly and transparently communicate the background and rationale for any adjustment with the management team. Finally, while some remuneration committees may be sympathetic to the argument above that, in principle, a case can be made for making no adjustment for windfall gains on the grounds of consistency, this needs to be balanced against the practical reality of the current shareholder environment.

For all remuneration committees, we believe it is sensible to (i) consider whether a perceived windfall gain might have occurred and, if so, what level of adjustment, if any, might be appropriate; and then (ii) fully disclose the approach and the reasons behind it in the DRR.

A framework for considering windfall gains – making an informed judgment

We believe strongly that a “formulaic” approach for assessing windfall gains is not appropriate. Although it would make all our lives easier if one could develop a model to determine, unequivocally and objectively, whether a windfall gain had occurred, in reality it is likely to be a matter of judgement (like so many other decisions required of remuneration committees). But judgment means informed judgment, and therefore we have set out below our suggested framework which covers a range of factors which remuneration committees could take into account to inform their decision-making.

While it is easy to state that a decision is likely to be a matter of judgment and to provide a list of factors to consider, it is more challenging to interpret these factors and make the judgement itself. Therefore, where we set out each factor to take into account, we also describe how each one might indicate a lower or greater level of risk that a “windfall gain” has occurred. In the absence of a “formulaic” approach, we believe an assessment which considers all of these factors “in the round” is likely to be most appropriate.

As would be expected, many of the factors in the framework involve consideration of share price movements, which is consistent with the Investment Association guidance to “look at the general market and share price response over the performance period”. We believe any assessment should at the very least include remuneration committee consideration of the share price chart, shown “through the trough” of early 2020, against relevant benchmarks. As described above, it is also important to consider the broader remuneration context and therefore some of the factors relate to this area.

For that small minority of companies that made an adjustment to their 2020 award at the point of grant, this is likely to have mitigated the risk of a windfall gain. However, we would still recommend making an assessment at vesting using the framework below, to flag whether there may be any risk that shareholders or proxy agencies take a different view.

Finally, it should be noted that the framework below is intended to be applied in the very specific context of the “windfall gains” issue as it pertains to the number of LTIP shares originally granted. As described earlier, the remuneration committee would also be expected to undertake the normal broader assessment of the performance and vesting outcome.

Of particular relevance for the vesting of 2020 LTIP awards will be to ensure that any performance target set during the significant uncertainty in the initial phase of the pandemic can be seen to be, in retrospect, to have been sufficiently stretching and robust. Remuneration committees may wish to ask the following questions on the performance outcome:

- Does the vesting percentage genuinely reflect overall performance or, in retrospect, do the targets appear overly cautious?
- Where maximum vesting has occurred, to what extent has the achieved performance exceeded the stretch level for maximum pay-out? Does it reflect exceptional performance or indicate the target range was insufficiently stretching?
- What impact did any unexpected changes in the external environment, after targets were set, have on performance? (for example – how did the development and roll-out of the COVID-19 vaccine impact performance?)
- How will shareholders perceive the performance outcome?

A&M Framework for assessment of "windfall gains" at vesting

		LOWER RISK	HIGHER RISK
Share price fall prior to grant	Measure the fall in share price (by reference to the prior year grant) to determine whether a windfall gains assessment is even relevant. In other words, how many more shares were granted than the prior year(s)?	Where the share price had not fallen, or had declined only marginally, a windfall gains assessment should not be necessary.	Based on investor guidance and market insights, a share price decline above c.20-30% would normally be the trigger for a windfall gains assessment.
Share price recovery – magnitude	Measure share price performance from grant to vest. Again, this acts as an initial "gateway" for whether a windfall gains assessment is relevant.	If the share price has been broadly flat or has declined, it is hard to argue a windfall gain has occurred (i.e. the post-COVID share price is essentially "the new normal" for the company).	Where share price performance has been strong over the period since grant, there is greater risk of a windfall gain and further information should be considered.
Share price recovery – timing	Consider the length of time that the shares took to "rebound" to their pre-COVID levels after the 2020 "trough", as an indication of the extent to which the grant size benefitted from a share price which was "artificially depressed" at grant simply as a result of market volatility.	No obvious short-term "rebound" in the share price following the 2020 trough (again indicates a post-COVID "new normal" rather than a temporary blip).	A relatively quick recovery to pre-grant levels may indicate the price was artificially low at grant. For reference, of those FTSE All Share companies that had experienced an annual decline of at least 20% to March 2020, 15% had recovered to the pre-COVID level within just 6 months. The FTSE All Share index did not return to its February 2020 average until August 2021.
Share price recovery – drivers	Consider the extent to which periods of strong post-grant share price growth can be attributed to company performance / management actions – in response to COVID or otherwise.	Lower risk of a perceived "windfall" where price recovery can be clearly attributed to management action on strategic and operational delivery.	Where the share price recovery is less clearly attributable to management action and business performance, and more to sector / market recovery, arguably more risk of a perceived "windfall".

A&M Framework for assessment of "windfall gains" at vesting

		LOWER RISK	HIGHER RISK
Share price recovery – relativity	As one means of considering whether the recovery is related to management action, consider the relative share price (or TSR) performance vs. equity benchmarks (market and sector), although it is important not to be too "formulaic" as the purpose is not to retrospectively introduce a relative TSR condition. It is critical that this is measured "through the trough" (e.g. from a start point of, say, 1 Jan 2020) and not from the grant date, to ensure that any outperformance is not simply the result of a lower start point in the trough.	All else being equal, clear outperformance of the relevant benchmarks would suggest a lower risk that a "windfall" has occurred.	Underperformance is more likely to indicate a windfall gains risk as the increase in share price might be seen as simply "riding" a rising equity market recovery from a low base. Of particular risk would be a company which has performed relatively poorly against peers but in a sector which has seen significant out-performance of the general equity market.
Broader remuneration context	To what extent have executives experienced, over the period, what might be called "windfall losses" as a direct result of the impact of COVID-19. These might include: ■ Temporary voluntary reductions to salary ■ Reduced bonus outcomes ■ Reduced LTIP outcomes – both in 2020 and beyond (if in-flight targets were not re-set)	Where there has been a significant negative impact in other areas of the package, this may counterbalance any "windfall" on one LTIP award.	In circumstances where other remuneration elements have not been impacted, arguably there is a greater risk that an outsized LTIP outcome is a windfall gain.
Award – value (£ / % salary)	Consider the value which will be receivable (both £ and % of salary) against value granted, previous vestings etc.	A relatively low value compared to the grant and / or amounts received previously.	A relatively high value (both in £ and % of salary) which is clearly outsized against the original grant or previous award vestings.
Award – proportion vesting (% max)	Consider the percentage vesting of the award, alongside the value receivable. For RSU awards, also consider the award value vs. the prior LTIP value to assess the extent to which the "haircut" on transition has been eroded.	Generally, a low level of vesting is unlikely to represent a "windfall" (and would normally be aligned to a low value).	A higher vesting outcome creates higher risk (and greater scrutiny on the targets – see above). However, note that a low vesting outcome when combined with a high value could indicate a "windfall".

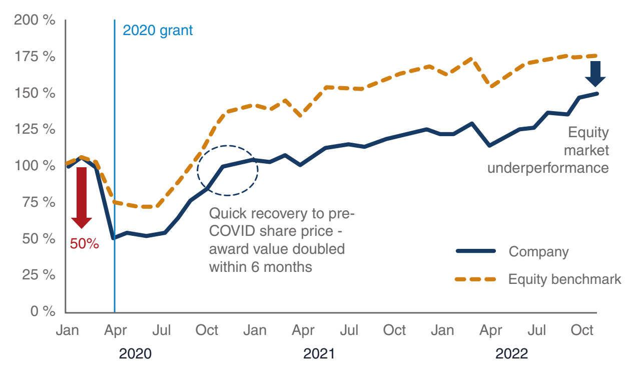
Illustrative scenarios

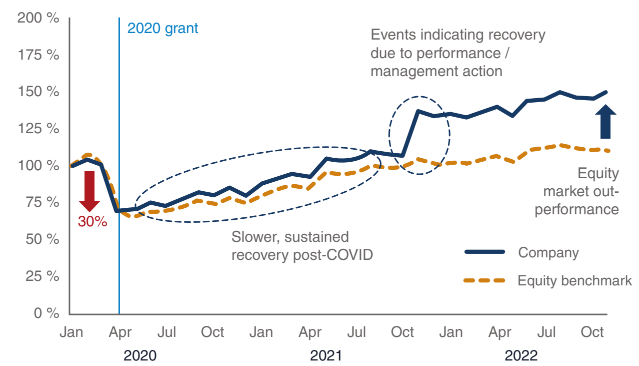
Identifying whether a windfall gain may have occurred will require judgment based on consideration of all the factors in the framework above. While it is therefore not possible to provide a definitive list of circumstances which will, and will not, be a windfall gain, the <u>illustrative</u> scenarios below are intended to demonstrate how the supporting analysis may inform an overall judgement.

The illustrative scenarios below both assume exactly the same increase in share price (+50%) measured from a pre-pandemic start point (1 January 2020) to now. The two differences between the scenarios relate to:

- The trajectory and timing of the share price into and out of the COVID "trough" around grant; and
- The relativity to equity benchmarks

Note this is a highly simplified example, which is not exhaustive of all of the factors in the framework above nor reflective of any broader performance assessment (on whether the amount receivable "feels right" in this context)



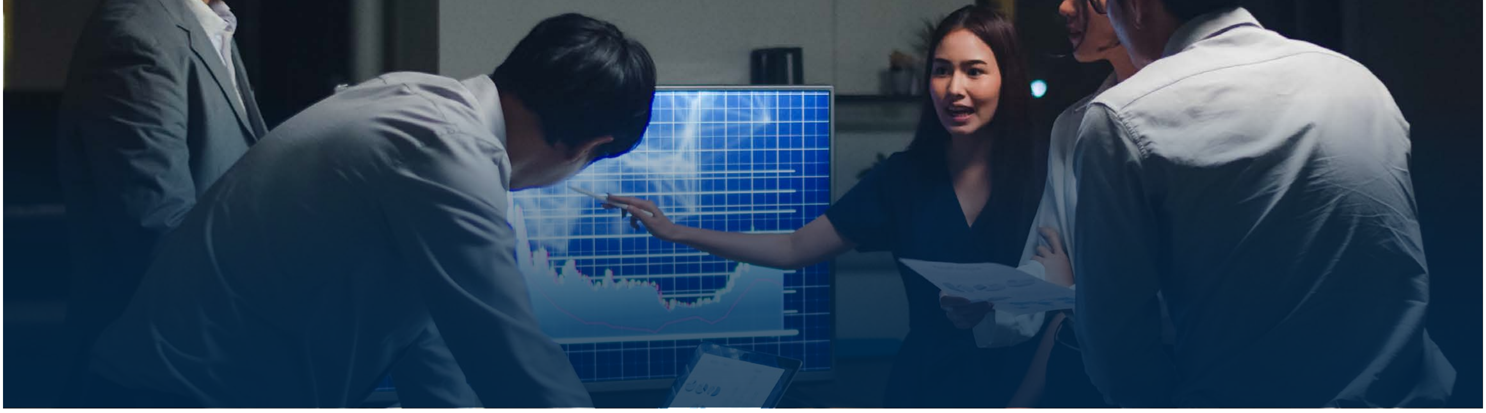


- Larger initial share price fall (50%) and therefore greater increase in the number of shares originally granted (+100%). At vesting, maximum value is 3x initial award.
- Faster recovery in share price after initial shock, suggesting potential role of volatility at grant – award value approximately doubled after just 6 months.
- Share price broadly tracks the trajectory of the equity benchmark, but underperforms over the period, as measured through the COVID "trough" (note the importance of this approach as the shares would outperform if measured from the grant date as a result of a lower start point following the COVID decline).

All else being equal, **<u>higher risk</u>** of "windfall gain"

- Lower initial share price fall (30%) – smaller increase in number of shares granted (+43%). At vesting, maximum value is c.2x initial award.
- Slower post-COVID recovery, less indicative of grant-date volatility and an "artificially low" share price at that time.
- Share price broadly tracks the trajectory of the equity benchmark, but outperforms over the period, including examples of share price increases which can be considered reflective of performance and management actions.

All else being equal, **<u>lower risk</u>** of "windfall gain"



If the assessment indicates a high risk that a windfall gain has occurred, the remuneration committee will then want to consider whether any adjustment to vesting should be made and, if so, what level is fair and appropriate to all stakeholders.

Again, we believe that a "formulaic" approach is unlikely to be applicable, and would instead favour making a judgment which takes into account a range of relevant reference points and perspectives, such as those discussed below.

Clearly, any adjustment would also need to be considered in the context of the committee's assessment of the extent of any windfall gain (which itself will be a matter of judgement as the "in the round" assessment above is unlikely to quantify this).

Hypothetical reduction at grant	Typical discretionary adjustments in the market	Analyse alternative averaging periods around grant
The remuneration committee could consider the following hypothetical question – "assuming we had made an adjustment at grant instead of waiting until vesting, what might that adjustment have been?". As described above, a potential "rule of thumb" for adjusting at grant would be to reduce the award level by half the share price decline. While purely hypothetical, it provides a reference point for what the outcome would have been if the committee had been able to operate in line with the subsequently established best practice (which had not been as firmly entrenched in 2020 as it is now).	While there is not yet an established market precedent for discretionary adjustments for windfall gains at vesting, recent years have seen an increase in the use of discretionary adjustments to override formulaic incentive outcomes for other reasons (such as overriding the formulaic outcome to reflect broader performance or a specific issue). In our experience, where an adjustment to the incentive outcome is being made, it is most likely to be around 10-25% of the amount being received, although adjustments can obviously be above that range for more extreme cases. It is relatively unusual to see adjustments below 10%, which we ascribe to a view that if it is considered that adjustment should be made at all, it should meet a threshold which is sufficient to be meaningful to the participant and which avoids being seen as a "token gesture" by other stakeholders. However, adjustments below 10% could be appropriate depending on the circumstances. To date, we are aware of only one specific example of an adjustment at vesting in respect of windfall gains (Weir, 15%) which is not unexpected as the normal vesting date for 2020 LTIP awards will be in early 2023. Weir's approach is discussed in more detail below.	Share awards are typically "priced" (i.e. converted from a monetary value to a number of shares) using the prevailing spot share price (or a 3 or 5 day average) at the point of grant. This common feature of share plan administration is highly relevant to the current windfall gains issue as it was the mechanism by which a greater number of shares were awarded as grants were priced close to the trough of the market post-COVID. Remuneration committees could consider conducting analysis on what the impact on the number of shares awarded would have been if alternative averaging had been used to price the award (for example a one, three or six month averaging period prior to, or around, the grant date). While again purely hypothetical, it can provide useful reference points for the award size if the award had not been priced so close to the trough of the market.

The impact of any adjustment is only required to be fully disclosed for the executive directors. There is therefore typically greater flexibility on the approach which can be taken to below board participants, and aligning that population with the treatment for executive directors may not be considered necessary or appropriate. We see a range of market practice on this question of alignment, based on the nature of the issue at hand and the desired "cultural" impact from LTIP participation. We would expect some companies to apply any adjustment consistently throughout the entire LTIP population on the basis that alignment of treatment for all those in the LTIP "club" is an important factor in driving a collegiate management culture through incentives. Other companies are likely to seek to limit any adjustment to the executive directors only on the basis that discretionary downward adjustments to LTIP vesting in the current market may unnecessarily damage the retentive and motivational impact of these awards in that wider participant group. If a different treatment is to be applied to different groups within the same LTIP population, careful management of implementation from a communications and legal perspective is recommended.

Case study – The Weir Group plc

For most companies, the vesting of their 2020 awards will occur in early 2023. As a result of the structure of the 2020 RSU award at The Weir Group plc ("Weir"), the vesting of the first tranche of the award took place after two years, in April 2022.

Based on the disclosure in Weir's 2021 DRR, it can be seen that a "discretionary adjustment for windfall gain" of 15% was made. Weir received support from the main investor bodies and proxy agencies, and over 95% support for the DRR.

Clearly, the approach will have been developed by the Weir Remuneration Committee, and assessed by shareholders and proxy agencies, based on the specific facts and circumstances for Weir. As a result, the 15% adjustment does not represent a "benchmark" or "precedent" level of reduction which will necessarily be right for all companies or supportable by all shareholders.

However, it does provide one market reference point and there are some important observations which can be made on Weir's disclosed approach:

- **Balanced and non-formulaic** overall approach, with the implication these were assessed "in the round": "This is a complex issue which requires judgement rather than a 'formulaic answer,' and in developing our approach the Committee considered a range of reference points and perspectives".
- Significant disclosure around the **"reference points"** used: For example, those relating to "business performance" (discussing financial performance and strategic delivery such as "execution of the Oil & Gas disposal") and also "share price reference points", as well as "alternative pricing" ("we analysed the impact a longer averaging period around the time of grant would have had to the number of shares awarded").
- Consideration of the **wider remuneration context**: The DRR states that the "Committee also reflected on the broader context of executive remuneration at Weir" including "withdrawal of base salary increases in 2020… waiver of any bonus in respect of 2020… and the reduction to the RSU awards vesting in early 2021".
- In terms of **communication and engagement**, there is reference to an "extensive" shareholder consultation, and the DRR narrative is clear and comprehensive. Finally, the DRR also commits to making **adjustments at grant** going forward: "the Committee intends to address concerns about potential windfall gains, if relevant, by making any adjustment at the time of grant, in line with the latest shareholder guidance".

Looking forward – remuneration committee checklist

- **Don’t ignore it!** This is a live issue for UK shareholders and proxy agencies. It is important to consider the issue, develop an approach, and communicate well.

- **Develop your approach.** Consider the factors in the risk framework and determine whether a windfall gain has occurred. If so, consider the adjustment and how far it will apply through the LTIP population. Bring management with you on this journey.

- **Shareholder engagement and DRR communication.** Consider whether engaging with shareholders is required, and develop the strategy and materials. Ensure the DRR provides a clear and compelling rationale in support of the proposal.

- **Consider your grant policy and process for 2023 and beyond.** If the share price has declined materially from your 2022 awards, ensure you monitor the situation and are ready with an approach to the grant level in 2023.

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