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Briefing note

25 January 2012

Executive Remuneration: the Government's proposals

Following months of speculation, the Government has announced its response to last year's consultation and discussion paper on the regulation of executive pay. As expected, two principal areas of reform are targeted: how executive remuneration is determined and how it is reported.

Key issues

- Enhanced transparency in remuneration reporting
- Say on Pay: greater shareholder power
- Other measures
- Greater Board diversity
- Practical Implications

"No proposal on its own is a magic bullet..."

Vince Cable
Secretary of State for Business, 23 January 2012

Enhanced transparency in remuneration reporting

Clearer reporting requirements on executive remuneration will be introduced via secondary legislation later this year. This will (it is hoped by the Government) make it easier for shareholders to scrutinise executive pay and hold companies to account.

The Government had previously indicated that any new **disclosure obligations** will apply to all quoted companies and will come into effect for reporting periods falling on or after **1 October 2012**, but this has not yet been officially confirmed. Unofficially this is the timetable being worked to.

Under the proposals there will be two separate remuneration statements: a forward looking section on proposed future remuneration policy and a backward looking section reviewing the current year.

We expect that the 'Current Year' section of the report will have to include the following details:-

- The remuneration of each director will be shown as a single cumulative figure. It is anticipated that companies will have to account for share options, LTIP's and pensions in calculating this figure and explain how pay awards relate to the company's performance;
- A 'distribution statement' showing how executive pay compares with other dispersals such as dividends, business investment, tax, employee costs and so on;
- Details of the use of remuneration consultants, including the disclosure of fees spent on consultants, the consultants used and who they report to;
- A statement of how overall remuneration relates to the achievement of the company's strategic objectives over the course of the previous year.

The 'Future Pay policy' section of the report will include the following details:-

- How the remuneration proposals for the year ahead relate to the company's strategic objectives, how performance will be assessed and include estimates of future payouts based on different scenarios;
- An explanation of why the company has used specific benchmarks to determine pay;

- Details of how the Remuneration Committee has taken into account employees' earnings (including pay differentials) when setting future pay policy;
- How the Remuneration Committee has consulted and taken into account the views of employees;
- Details of how shareholders' views, and the result of previous votes, have been taken into account when setting the policy.

Say on Pay: greater shareholder power

Vince Cable has indicated that in the coming weeks he will release further details on proposed measures aimed at giving shareholders greater influence over executive pay, which will include giving shareholders a "binding" vote on: (a) future pay policy for the Board as a whole (including details of how performance will be judged and specific figures on the payouts executives could receive); (b) notice provisions exceeding 12 months in the contracts of new appointments; and (c) termination payments in excess of 1 year's basic salary or the minimum contractual amount (whichever is the lower).

In addition, shareholders will still have an advisory vote on how the company has implemented the approved pay policy in the preceding year including on amounts paid. Although at this stage the proposal is that the 'backward' vote will remain advisory only, Vince Cable has said that he will also consider whether further sanctions are required if a significant number of shareholders dissent in the advisory vote.

Consideration is also being given to increasing the threshold for shareholder approval to 75% of the vote cast for the motion.

Other measures

The Government has also indicated that the following measures will also be implemented in its bid to address excessive executive pay:

- Amending the UK Corporate Governance Code to require large plc's to include "claw-back" mechanisms for variable remuneration.
- The High Pay Centre will be established to monitor executive pay.

Greater Board diversity

The Government believes that greater diversity at Board level will help minimize conflicts of interest and give rise to 'fresh thinking'. Vince Cable has indicated that he would like to see at least two Board members without previous Board experience and has encouraged the appointment of lawyers, academics and public servants. Accordingly:

- Companies will continue to be encouraged to increase the diversity of Board composition on a voluntary basis.
- The UK Corporate Governance Code may be amended to prevent serving executives from sitting on other large companies' Remuneration Committees.

Practical Implications

Binding shareholder votes: this will of course make negotiations with departing executives extremely uncertain (and perhaps therefore more difficult to resolve). It will also be difficult to apply such a rule in a take-over situation (where the new shareholder will potentially have little interest in ratifying a deal for departing executives).

Clawbacks: at this stage the detail of how clawback will operate is unclear. Is the intention to impose a 'malus' regime permitting a company to adjust the level of, or extinguish, deferred variable compensation (which has been awarded but not yet received by the executive)? Alternatively if a 'true' clawback requirement is to be imposed where a cash bonus has been paid or shares under awards have been released to the executive this will give rise to practical issues. The executive may not be in a position to repay immediately. The position is also complicated by the fact that the executive will already have paid tax and national insurance on the remuneration.

Employee consultation: although employees will not be given an advisory vote on executive remuneration, companies will be required to explain how they have consulted employees when setting executive pay. In the absence of any existing employee representative forum, companies will have to consider how to achieve such consultation. Whether there is an existing employee forum or not companies will need to assess the nature and timing of employee consultation on this issue.

It is as yet unclear whether consultation is intended to achieve some form of agreement between employee representatives and the Remuneration Committee and/or company or whether it will be more akin to an information process on the part of the company who must give employee representatives the opportunity to express their views without any obligation to act on them. Vince Cable has encouraged employees to use their existing legislative right to set up an information and consultation arrangement in order to receive information and discuss issues about the company "including their bosses' pay".

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