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Executive Remuneration: Government consults on enhanced disclosure and "say on pay" proposals

Vince Cable, the Secretary of State for Business, announced yesterday that the Government is contemplating further regulation of Executive Pay. The Department of Innovation Business and Skills (BIS) has published two documents: a discussion paper relating to executive remuneration; and a consultation paper on the simplification of company reporting requirements, including information regarding performance and pay. This is a consultation exercise at this stage, but the proposals raise some interesting practical and legal issues, and will no doubt cause some controversy.

The proposal draws in part on recent regulation of pay and bonuses in the financial sector (the FSA's Remuneration Code), and is perhaps a first sign that there may be a move towards wider adoption of the pay principles put in place for banks in the aftermath of the financial crisis.

The **disclosure proposals** described below will apply to all quoted companies and will come into effect for reporting periods falling on or after 1 **October 2012.**

No firm timetable has been announced for the **"say on pay"** proposals dealt with in the second part of this note, many of which will no doubt generate a wide range of responses from interested parties.

Enhanced Disclosure Regime

The Government wants companies to provide clearer reporting on remuneration to make it easier for shareholders to scrutinise executive pay and hold companies to account.

It therefore proposes to replace the current Business Review and Directors Report for listed companies with a "Strategic" Report which would contain enhanced disclosure on Executive Remuneration. The Strategic Report would contain key remuneration data, particularly the link between pay and performance, but the full remuneration report would still be required. Some of the key proposals are set out below:-

- A requirement for greater clarity on total pay: the remuneration of each director should be shown as a single cumulative figure (to avoid shareholders having to ascertain this from several different tables spread across the report). Comments are invited on how companies should account for share options, LTIP's and pensions in calculating this figure;

- The consultation invites views on whether remuneration disclosure should be extended to "senior managers" who are not directors, but who nevertheless have significant influence over the success of the company (comparable to the concept of material risk takers (or "Code Staff") in financial institutions covered by the FSA Remuneration Code);

- Companies are to provide a clearer statement of how remuneration relates to the achievement of the company's strategic objectives over the course of the previous year. It is also suggested that companies should provide remuneration data for the CEO over the previous 5 years to enable shareholders to assess the historic link between pay and performance;

- Disclosure of pay ratios (between the chief executive's earnings and the median earnings of the workforce as a whole);

Key Issues

- **Discussion and Consultation Papers published by BIS**
- **Enhanced Disclosure Regime**
- **Say on Pay Proposals**
- **Comments by 25 November 2011**

"*The general disconnect between pay and long term performance suggests that there is something dysfunctional about the market in executive pay or a failure in corporate governance arrangements...*"

Vince Cable, Secretary of State for Business, 19th September 2011.

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- Disclosure of how remuneration proposals for the year ahead relate to the company's strategic objectives, including estimates of future payouts based on different scenarios;
- Disclosure of total expenditure on executive remuneration as a proportion of profit;
- Improved transparency about the process of setting director's remuneration.

Say on Pay and other Proposals

The Government has invited views on the following proposals, which are aimed at ensuring accountability for and simplification of executive pay:-

- Making the shareholders' vote on executive pay "binding". Currently, shareholders have the right to vote on executive pay on an advisory basis (that is they may vote against the adoption of the directors remuneration report). It is not at all clear how this could work in practice, or whether whole-sale changes would be required to service agreements to allow for the terms to be overridden by shareholders. Query what terms would apply in the event that the agreed contract does not receive shareholder approval?
- Preventing "rewards for failure", possibly by way of an "ex post" vote on the contracts of new appointments or a vote on termination payments. This would 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);
- Including shareholders on nominations committees;
- Making changes to the composition of remuneration committees, including (i) requiring "independent" members who are not also directors in the company; (ii) employee representatives;
- Allowing an advisory "employee vote" on remuneration proposals for directors;
- Greater transparency over the use of remuneration consultants, including the disclosure of fees spent on consultants;
- Simplifying the structure of pay and strengthening the links between pay and performance (for example, using measures other than Total Shareholder Return or Earnings Per Share, such as cash flow and return on invested capital or company specific key performance indicators);
- Encouraging companies to defer a larger proportion of pay over more than three years to encourage management to take a "longer term" view;
- Encouraging companies to reduce the frequency with which long term incentive plans and other forms of remuneration are reviewed/changed;
- Introducing "claw-back" mechanisms where performance turns out to have been miscalculated or misstated.

BIS has invited responses to its consultation paper by **25 November 2011**. If you have any comments on the proposals that you would like to discuss with us, please let your usual client contact partner know, or speak to one of the partners listed on the front of this briefing note.

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