IT'S EXECUTIVE PAY, BUT NOT AS WE KNOW IT...

The UK government's Business, Energy, Industrial and Strategy (BEIS) Select Committee report on corporate governance was published yesterday (5 April 2017). While the report is wide ranging and covers directors' duties, annual reporting, corporate governance in private companies and women on boards, this update focuses on the recommendations on executive pay.

What does the report mean for companies right now?

Before looking at the proposals, it's worth being aware that the report sets out BEIS' findings and their proposals but these are simply recommendations. They are not legislation, regulation or guidance and, in that sense, there is nothing coming out of the report that companies are legally obliged to comply with now.

The next step is for the Financial Reporting Council (FRC) to consult on amending the Corporate Governance Code to take account of BEIS' recommendations. For the time being, companies are simply encouraged to take the views of BEIS into account when they consider executive pay and given the changes to pay structure and disclosure that may come in if the recommendations are adopted, it makes sense for companies to bear the recommendations in mind when making decisions over the next year.

What are the key pay recommendations?

So long to LTIPs….?

The most striking recommendation is that LTIPs should be "phased out as soon as possible".

The report recommends that no new LTIPs should be set up from 2018 and that "existing agreements should not be renewed". It's not entirely clear whether this means that no new LTIP awards should be granted or simply that existing LTIPs should not be renewed but, given BEIS' comments about replacing LTIPs "over time", an immediate end to LTIP grants sounds unlikely. What we suspect is more likely is that we would see a reduction in LTIP use and a move to new types of award in the short to medium term.

It is very apparent from the report that BEIS does not have an issue with share-based remuneration itself. BEIS' concern is the complexity of LTIPs, particularly around performance conditions which they feel can lead to pay outs where the conditions are met but overall company performance is lacking. There is also a concern that LTIPs encourage short term thinking by executives who are motivated to ensure awards vest.

BEIS' proposal is that companies should move to a much simpler structure and grant executives "deferred stock options" – these are share options without performance conditions, and which vest in phases over at least five years.

If this approach becomes best practice, it would be a significant change to existing UK market practice given that the vast majority of FTSE 350 companies operate an LTIP. Interestingly, despite support for this more simple structure from other quarters – notably the Executive Remuneration Working Group – the structure is yet to find much favour with shareholders. In 2016, shareholders in Weir Group plc voted against adoption of this type of plan. Whether shareholders of other companies proposing restricted share plans or deferred stock options in 2017 will fare better, remains to be seen.

Use of bonuses

The recommendation here is to move away from targets based on share price and rather to use targets linked to company objectives and broader corporate responsibility, such as health and safety or customer service.

BEIS also reiterated that bonuses should only be paid as an incentive and not as a routine part of a remuneration package.

Shareholder votes on executive pay

It had been suggested that companies should put pay to an annual binding vote, but BEIS is <u>not</u> in favour of this proposal.

Instead, BEIS favours a requirement for a company that receives less than 75% approval for its annual report on remuneration (i.e. the advisory vote) to put their remuneration policy back to shareholders the following year. This is one area that would need a change in legislation to implement and BEIS recommend that it is implemented as soon as possible by amending the relevant UK legislation.

In addition, BEIS recommends that remuneration committee chairs should resign where their pay proposals receive shareholder approval of less than 75%. The immediate impact of this recommendation may be limited, however, as shareholder support for both remuneration policy and remuneration reports has typically been over 90% since the two vote system was introduced for the 2013/4 AGM season.

Remuneration Committee structure

BEIS propose that prospective chairs should serve on the remuneration committee for at least one year before being appointed as chair.

BEIS is also in favour of including employee representatives on remuneration committees, as a vital way to improve trust and gain support for pay proposals. While this recommendation will not be mandatory, BEIS is clear it expects "leading companies" to appoint employee representatives.

CEO pay ratio and disclosure of "people policy"

As has been widely anticipated, BEIS recommend that companies are required to disclose CEO v employee pay ratios, being the ratio between CEO pay and that of the wider executive team and that of all UK employees. While BEIS recognised the limits of the use of these ratios (e.g. the pay ratio in a retail company may be much wider than in a financial services company), it felt disclosure would be useful to highlight increasing pay gaps or significant differences between companies in the same sector.

Companies will also be required to publish their broader "people strategy" if the proposals are adopted, which should explain the type of employment model used (e.g. fixed term contracts, zero hours contracts) and how employees at all levels are rewarded. BEIS has recommended that the FRC prepare guidance on this requirement.

Finally, BEIS makes clear that it, and the majority of respondents, believe executive pay is too high and cannot be justified in relation to performance and general employee pay. BEIS believe this is damaging business and public confidence in business. Changes in the structure of executive remuneration are certain, but given existing industry norms and shareholder expectations it remains to be seen whether these will be a far reaching as BEIS suggest.

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