UK EXECUTIVE PAY REFORM - GOVERNMENT MEASURES PUBLISHED

On 29 August 2017, the UK Government published a package of corporate governance reforms, intended to enhance the public's trust in business. Whilst the Government is not pressing ahead with all the initial proposals set out in its November 2016 green paper, changes are proposed in a number of key areas.

The report is wide ranging and covers directors' duties, annual reporting, corporate governance in private companies and board diversity. This update focuses on the proposals on executive pay.

KEY ISSUES

- FRC consultation on changes to Code => Autumn 2017
- Publication of draft legislation => Later in 2017
- Government approval of new legislation => March 2018
- Reforms in force => June 2018

What does the report mean for companies right now?

Although companies should start considering the impact of the reforms, we are a fair way off them being implemented and do not yet have details of many of the changes. The report is helpful in highlighting the changes that companies can expect but, for the time being, it is a case of waiting to see draft legislation and consultation documents later this year.

The reforms will be brought in through a combination of new legislation, changes to the Financial Reporting Council's Corporate Governance Code ("**Code**") and a change of practice by the Investment Association. This will take time and the current intention is that the reforms will only apply for reporting years starting **on or after June 2018**.

What are the key changes on pay?

CEO pay ratio

As has been widely anticipated, legislation will be brought in to require quoted companies to disclose the ratio of CEO v employee pay, being the ratio between CEO pay (currently proposed to be taken from the single figure in the annual directors' remuneration report) and the average pay of all UK employees. Companies will also need to publish a narrative explaining changes in the ratio from year to year plus how the ratio relates to pay and conditions across the wider workforce.

Not unsurprisingly, this proposal found favour with many institutional shareholder and advisory bodies but was strongly opposed by the majority of quoted companies that responded to the green paper. Those in favour of the proposal requested guidance on how the ratio should be calculated and the

Government is considering the methodology. Details will become clearer when the draft legislation is published later this year.

"Name and shame" register

The Investment Association will be invited to implement its proposal to maintain a public register of quoted companies that receive a shareholder vote of 20% or more against their annual directors' remuneration report, along with a record of what these companies have said about the steps they are taking to address shareholder concerns.

As this information is already public, it is difficult to see what the register really adds. It is possibly a case of making it easier for the Government to monitor whether the measures designed to address significant shareholder dissent on pay are really working – the Government has said that it will consider further action if companies do not take active and effective steps to respond to shareholder concerns on pay.

The Government is also inviting the FRC to revise its Code to include steps companies should take if they face significant shareholder opposition on pay.

So long to LTIPs….?

In contrast to the recommendation of the Business, Energy, Industrial and Strategy (**BEIS**) Select Committee, the Government is not proposing the abolition of LTIPs or any substantial changes to them.

The benefits of a properly designed and communicated LTIP are noted in the report and the Government is supportive of the Investment Association's Executive Working Group's proposals to encourage flexible and tailored LTIPs.

No specific proposals on the design of LTIPs are being implemented. Instead, legislation will be introduced to require more explanation of the potential outcomes from LTIPs so that investors have a better understanding of the likely value of possible LTIP payouts. In addition, the FRC is being invited to consider changes to its Code to include new guidance specifically related to LTIPs.

Longer vesting + holding periods

The FRC will be asked to extend the recommended minimum vesting and post-vesting holding period for share awards from 3 to 5 years to encourage a focus on longer-term outcomes when setting pay. Given that many quoted companies have already moved to a 5-year share awards (3 year vesting + 2 year holding), this should not make too much difference to quoted companies in practice.

Remuneration committee role

The FRC will also be asked to revise the Code to give remuneration committees greater responsibility for pay and incentive oversight, requiring them to engage with the workforce to explain how executive pay is aligned with the wider company pay policy.

In addition, following BEIS' proposal, the FRC will be asked to change the Code to provide that the chair of the remuneration committee should serve on the remuneration committee for at least one year before being appointed as chair, unless there are good reasons for this not being the case.

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What's out?

Some of the proposals from the green paper and the BEIS report are not being taken forward (at least not for the time being).

No change to frequency of votes

There will be no annual binding vote on executive pay (or parts of variable pay) and no requirement for approval of a directors' remuneration policy more frequently than every 3 years.

No cap on pay

There will be no cap placed on total executive pay. The Government will, however, announce details shortly of a review to examine the use of share buy backs to ensure they cannot be used to artificially meet performance targets and inflate executive pay.

No additional bonus disclosure

Despite the criticism of the disclosure around executive bonuses, particularly the level of disclosure on performance targets, no additional bonus disclosure is being recommended for the time being.

Employee representation

BEIS had recommended employee representation on remuneration committees as a way to build trust and gain support for pay proposals. This proposal is not being actioned but the Government is keen to ensure that employees' interests are better represented at board level.

The FRC is being invited to consider changing the Code to encourage companies to either assign a non-executive director to represent employees, create an employee advisory council or have a director nominated by the workforce.

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