New powers for shareholders

Matthew Howse and Celia Kendrick examine the impact of the government's proposals to reform the law on the remuneration of directors in publicly listed companies

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'Under the new rules, the remuneration of directors of quoted companies will be subject to increased public scrutiny and it will be important for boards to seek advice on new or renewable directors' service agreements in the light of the proposed changes.'

In a speech to the House of Commons in January 2012, the business secretary, Vince Cable, outlined a number of proposals to reform executive pay within listed companies. The government's aim was to address the discrepancies between top executives' pay and their companies' performance, the problem being, according to the government, that the most senior executives' pay has continued to rise each year even when their companies' financial performance has stagnated or deteriorated. The announcement came at a time when criticism of executive pay was a constant feature of media reporting. Mr Cable outlined four aims to address this 'clear market failure':

- greater transparency about what executives are being paid;
- more shareholder power, including the introduction of a binding shareholder vote;
- increased diversity on boards and remuneration committees; and
- the business and investor community taking a lead on best practice.

In another speech to the House of Commons on 20 June 2012, Mr Cable announced specific proposals to reform the law on the remuneration of directors of listed companies. This article examines those proposals.

The proposals

Mr Cable announced a 'far-reaching package of reforms', which aims to build on the so-called Shareholder Spring by increasing shareholders' power to challenge remuneration policies. However, the government has stressed that it remains keen not to impose unnecessary regulatory burdens.

The first proposal is to give the shareholders of each public listed company a binding vote on that company's pay policy, including its approach to exit payments. The company will have to produce a pay policy report on which the shareholders will vote (see box 1 on p23). This vote will be by ordinary resolution, so only a majority of 50% will need to approve the policy. The binding vote will happen at least every three years, but only if a company leaves its pay policy unchanged during that time. If the company changes its policy or if it fails the advisory vote (see below), the vote on pay policy will happen annually. The pay policy will be forward-looking and, once it has been approved, the proposal is that quoted companies can only make payments to directors in line with the policy.

The second proposal is that shareholders will have an annual advisory vote on how the approved pay policy is being implemented. The company will have to produce an implementation report on which the shareholders will vote (see box 2 on p23). Under the Companies Act 2006, shareholders of quoted companies already have an annual vote (by ordinary resolution) to approve directors' remuneration. However, the vote is consultative and no element of a director's remuneration entitlement is conditional on the vote being passed – in other words, the current vote has no teeth. This proposal intends to change that, and if a company fails the advisory vote, it will need to put the pay policy back to shareholders the following year for them to vote to re-approve it. It is

Box 1: Implementation report

The government proposes that the annual implementation report will include the following information:

- A single total figure showing actual remuneration for each director. It is proposed that there will be a set methodology for calculating this figure.
- Details of performance against metrics for long-term incentives and bonuses, including an explanation of how any discretion was applied.
- Total pension entitlements (for defined benefit schemes).
- Exit payments made in the reporting period.
- Details on variable pay, such as share schemes, awarded in the reporting period.
- Total shareholdings of directors, including share options.
- A chart comparing the company's performance (measured as total shareholder return) and the chief executive's pay. The Department for Business, Innovation and Skills (BIS) has asked for views in its consultation on whether total directors' pay would be a more appropriate measurement.
- Information about who has advised the remuneration committee, with a particular focus on consultants, including the other services they provided to the company, who appointed them and the total cost of the advice.
- So-called 'shareholder context': how the shareholders voted on the policy in the previous year as percentages, reasons for dissent and any action taken by the company in response.

proposed that the changes will be in force from October 2013.

In addition, the government has stated that it supports calls from stakeholders that where a substantial minority of shareholders votes against the pay policy or the advisory vote, companies should have to respond and say what they will do to address shareholder concerns. The proposals will be implemented through:

- the Enterprise and Regulatory Reform Bill, which, once enacted, will add sections to, *inter alia*, Part 10 (A Company's Directors) and Part 15 (Accounts and Reports) of the Companies Act 2006; and
- the Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2012, which are currently in draft form, but which will revoke and replace Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008.

Provisions in the Companies Act 2006

Once the pay policy has been approved, directors' remuneration payments and payments to directors for loss of office must be made in accordance with the policy or, if not, such payments must be approved by a shareholders' resolution in a general meeting. There are also detailed requirements for informing shareholders of the proposed payments.

If a payment is agreed with a director in breach of the approved policy without valid shareholder approval, the obligation to make the payment will have no effect. In addition, if the payment is actually made, it will be held on trust in favour of the company, whoever made the payment or the former shareholders, depending on the circumstances. Directors who approve the payments will also be jointly and severally liable to indemnify the company for any loss resulting from the payment.

These new provisions will not apply to payments that arise under agreements

Box 2: Pay policy report

The government proposes that the pay policy report, which must be produced at least triennially, will include the following information:

- A table setting out how the company structures pay and all elements of pay to which any current or potential director is entitled. The supporting information will include:
  - how each element of pay supports the achievement of the company's strategy;
  - the maximum potential value; and
  - a summary of the performance metrics.

It is proposed that this table will be accompanied by a narrative explanation of whether the directors' remuneration policy differs from the other employees' and, if so, why.

- Information on directors' service contracts and the contractual remuneration provisions.
- Information in graphical form on directors' remuneration for on-target, below-target and above- target performance, including the different elements of that remuneration (for example long-term incentive plans and options). There will be no methodology for calculating this information and it will be indicative only.
- Information on the percentage change in profit, dividends and the overall spend on pay in the reporting period.
- The principles on which exit payments will be made, such as types of leaver and how performance will be taken into account as well as details of pre-existing contractual obligations that could affect termination payments.
- Material factors that have been taken into account when setting the pay policy, specifically employee pay and shareholder views.

made before 27 June 2012 (the date on which BIS published the proposed new clauses), unless that agreement is subsequently modified or renewed.

Ordinary resolution

The shareholder votes only need to be approved by a simple majority.
Mr Cable had suggested in his speech to the Commons in January 2012 that the government was considering setting an approval threshold of 75%, but this has now been abandoned. This will undoubtedly be welcomed by the organisations affected by these changes.

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Cost

Preparing for and complying with the new requirements is likely to cost affected companies heavily in terms of advisers' fees and management time.
To mitigate this, the government is proposing that the company's auditors only need to sign off the following sections of the reports:

- single total figure for remuneration;
- detail of performance against metrics for variable awards included in the single figure;
- total pension entitlements (for defined benefit schemes);
- exit payments made; and
- detail on variable pay awarded in year.

High-earning employees who are not directors

These proposals only affect directors and not other high-earning executives of listed companies. The government is addressing its concerns about executive pay in the financial sector separately under the Financial Services Bill, because it is Mr Cable's view that the problem of some employees earning more than a company's directors is only a real issue in the banking sector.

Consultation

The BIS consultation, which closed on 26 September 2012, sought views on the government's proposals to increase transparency in pay reporting and, in particular, on the draft regulations.
The aim of the consultation was to seek evidence on the impact, costs and benefits of the proposals. BIS sought the views of companies and business organisations, executive and non-executive directors, shareholders and institutional investors, employees and employee representative organisations, academics, governance experts, lawyers and other advisors.

Increased public scrutiny

Under the new rules, the remuneration of directors of quoted companies will be subject to increased public scrutiny and it will be important for boards to seek advice on new or renewable directors' service agreements in the light of the proposed changes.
One concern is that being a director of a quoted company could become a less attractive prospect given the increased attention on remuneration and exit payments, and public companies will want to balance shareholder concerns with attracting top talent. By consulting with key institutional shareholders before proposing the pay policy and any one-off payments, quoted companies will be less likely to face shareholder revolt.

These proposals will only affect quoted companies, although the government has confirmed that they will apply to all quoted companies rather than just the FTSE 100, for example. However, the changes may well have a knock-on effect on private companies also. Executive pay is likely to stay at the top of the political agenda as the Bill passes through Parliament and following its implementation. This could affect best practice in corporate governance, which might mean that companies that are not subject to the changes nevertheless amend their remuneration policies to satisfy their investors. Such sweeping changes in corporate mindsets may take some time, however, particularly if the focus on executive pay in the political and media arenas falls away, which it could do if the economy improves. ■