



BRIEFING

# Directors' remuneration – the government's proposals for reform

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## Summary

The government has announced proposals that will make significant changes to the governance and disclosure of directors' pay. Taken together, we think the proposals are pretty sensible, though their success depends on shareholders becoming more activist on director pay issues. But there is room for improvement – for example, having to boil down the value of each director's package to one figure will grab a headline, but isn't necessarily useful information for shareholders.

Although the full details will not be available until the spring, this briefing summarises the proposals and our views on a number of the key issues.

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The package of measures that the government proposes has four main ingredients:

- greater transparency so that directors' pay is clear and easily understood;
- greater shareholder powers, including various categories of binding vote, so that shareholders are better able to hold companies to account;
- more diverse board and remuneration committees 'to tackle the status quo'; and
- encouragement of best practice led by the business and investor community.

The government fully acknowledges that it is not its role to micro-manage company pay, but it believes that this package will establish a better framework for pay decisions.

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### Transparency on directors' pay

The proposals on improving transparency on directors' pay largely involve additional disclosures that are designed to make directors' remuneration reports (DRRs) more informative and useful. All UK incorporated listed companies are required to prepare a DRR.

We set out below the proposals on transparency, which can be implemented without primary legislation by amending Schedule 8 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (the DRR Regulations). It is not clear when the new regime will begin.

### Structuring DRRs

To make DRRs 'less impenetrable', it is proposed that they should be split into two sections: (i) proposed future policy for directors' pay, and (ii) how pay policy was implemented in the preceding year. This split will affect the layout of DRRs, but not their content. Companies are already required to provide information on both areas. It remains to be seen whether strict segregation will improve DRRs.

### Employee engagement and line-of-sight with employee pay

The government is pressing for employee engagement on directors' pay, and companies will have to explain in the DRR how they have consulted and taken into account the views of employees when determining directors' pay. The mechanism for UK employees to be consulted already exists under the 2004 Information and Consultation Regulations. How this would work is looked at in more detail below.

Companies will have to explain how they have taken employee earnings – including pay differentials – into account in setting directors' pay. This is not a wholly new requirement. The DRR Regulations were amended so that, since 2010, companies have needed to state how pay and conditions elsewhere in the group were taken into account when determining directors' pay. Revised regulations may well beef up this disclosure.

The government does not now propose to require disclosure of the ratio between directors' pay and median or average employee pay. This recognises that different companies will have different ratios because of the nature of their business.

### Pay policy and company strategy

The government has responded to shareholder concerns that pay policy often appears to be totally disconnected from the company's overall strategy. It is proposed that DRRs will need to show how pay policy reflects and supports company strategy, particularly by explaining how the performance of directors is assessed and how this translates into rewards under different scenarios. This should not be particularly onerous as it merely requires remuneration committees to articulate in the DRR various matters they have considered when putting together pay packages.

### Single figure for each director's pay

DRRs will need to state a single figure for total pay for each director, and explain how the pay awards relate to the company's performance.

There are real difficulties in producing a single pay figure that is meaningful. There will need to be clarity on:

- (i) what the single figure is seeking to show – whether it is the actual value realised by the director in a year, eg the cash value received as salary and bonus and the market price of shares actually realised from vested long-term incentive plans (LTIPs), or alternatively the value of awards granted to a director in a year (even if those awards will not vest for some years); and
- (ii) if the latter case in (i) is to be used, a prescriptive method for valuing tricky items – in particular, unvested share awards and final salary pension arrangements.

Where directors are still entitled to final salary pension provision, the valuation of such benefits for producing the single-figure disclosure could use the pension calculation method set out in recent pension tax legislation. In summary, this involves taking the increase in value of pension for the year (after deducting an allowance for indexation), and multiplying that value by 16. Although this is rough-and-ready, it would be a reasonable ‘standardised’ platform for revised pension disclosures to adopt – as it applies to all UK employees for tax purposes.

The valuation of unvested LTIP awards for disclosure purposes is less straightforward. However, there is a process that is already in place in the US where companies account for the expected value of share incentives based on certain assumptions, including the likely vesting level and the risk of forfeiture. For consistency, the legislation would need to specify whether LTIP awards should be valued as the maximum number of shares receivable ignoring performance conditions and leaver provisions, or whether companies would need to determine the expected value of awards based on the likely satisfaction of performance conditions.

Valuation issues aside, any single figure for pay would need to be hedged about with cross-references to detailed information set out elsewhere in the report.

Although it is not the government’s favoured approach, we believe that it would be better to have four separate disclosures, covering cash remuneration for the year (including salary and bonus), the expected value of share awards granted in the year (vesting in eg three years’ time), the value of additional pension accrued in the year (or any cash pension allowance), and the value of shares that vested in the year (arising from share awards granted in previous years).

### **Distribution statements**

The DRR will need to contain a ‘distribution statement’ comparing directors’ pay with other company dispersals such as dividends, business investment and general staff costs. This enables shareholders to assess directors’ pay in the context of the business’s overall financial performance. Although shareholders could readily put this information together for themselves, it is potentially quite a useful disclosure for shareholders.

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### **Greater powers for shareholders**

The government is keen to beef up the current regime under which shareholders have an annual ‘advisory vote’ on the DRR. This vote relates to the whole report, so does not differentiate between the forward-looking section dealing with pay policy and the backward-looking section setting out actual pay for the previous year. The significance of the vote being ‘advisory’ is that no remuneration is repaid if the DRR is voted down – although this would normally amount to a no-confidence vote leading to changes in the remuneration committee.

Even though the advisory vote regime is acknowledged to be working well, the government wants shareholders to have other categories of binding vote – on pay policy, on service contracts exceeding a year and on exit costs exceeding a year’s salary.

The government is consulting on these binding votes, which will require primary legislation. The government is also consulting on the possibility of a 75 per cent threshold for a successful vote – a proposal that we believe companies should resist as it potentially gives excessive power to a minority group of shareholders.

We look below at each of these proposed binding votes in turn.

### **Forward-looking pay policy**

Although the details are unclear, this would probably involve hiving-off that part of the DRR that relates to forward-looking policy into a separate document, which would then be subject to a separate shareholder vote. The government's introduction says that the pay policy would include 'details of how performance will be judged and real numbers on the potential pay outs directors could receive. The company will have to include a statement of how they have taken account of shareholder views and the result of previous votes.' This wording is a bit of a mish-mash, and could just have easily have been slotted into the new DRR content requirements under the Transparency heading above.

Some practical points here are set out below.

- In principle, this binding vote will make remuneration committees more cautious about the outcome of the vote, and lead to greater consultation with shareholders to ensure they are happy with proposals (though this may not be welcome to shareholders, who often feel over-consulted anyway).
- It is unclear what the consequences would be if the binding vote was not passed. (For example, would the company need to convene another meeting within a couple of months, to present a new policy?) This is something that the detailed legislation would need to address.
- This binding vote on pay policy is much less draconian than some other categories of binding vote that have been mooted in recent weeks, including director-by-director votes on each year's LTIP awards (as is the case in Australia), and/or shareholder approval of the entire variable pay package for the year, and/or approval of LTIP payments in the year of vesting.

### **Avoiding excessive pay-offs to leavers**

The other two binding vote proposals impact on pay-offs to leavers – which the government sees as part of the continuing battle against 'payments for failure'.

The government's proposals would give shareholders a greater say over the key ingredients that determine the level of pay-offs to leavers.

The binding vote would apply to:

- (a) any director's notice period that is longer than one year. This upfront approval recognises that the seeds are sown for potential high pay-offs from the moment a director's service contract is signed. In practice, companies will be reluctant to go for this shareholder vote, which will make it much less likely that companies will go beyond the one-year notice period that is already recommended in the UK Corporate Governance Code. This proposal will probably be implemented by lowering from two years to one year the threshold at which shareholder approval is currently required for long-term service contracts (section 188 of the Companies Act 2006); and
- (b) at the other end of the director's life-cycle, a binding vote will be required on exit payments where they exceed a year's salary. This is potentially very significant if – as is likely – it captures all termination benefits, including the high-value items such as LTIP awards that may be preserved on leaving (usually at remuneration committee discretion) and enhanced early retirement pension rights that may be triggered when a director leaves. Assuming the government goes ahead with this approach, many termination packages would end up needing shareholder approval because, in most cases, the real value in the package lies in the elements going beyond base salary.

On (b), there are a range of practical issues that will need to be addressed as part of the consultation, principally the points below.

- How would the legislation deal with elements of the termination package, in excess of base salary, that are already contractual? Into this category would fall many payment in lieu of notice provisions in service contracts, automatic 'good leaver' provisions in LTIPs (for example, on redundancy or retirement), and final salary pension enhancements.

As grandfathering such rights would emasculate the government's proposal, it is quite likely that new legislation would enable such pre-existing contractual rights to be 'voided' by a negative shareholder vote. Failing this, directors could sue for damages, or even claim constructive dismissal, if companies did not fulfil their obligations by reason of a negative shareholder vote.

- The legislation could permit shareholder approval for the relevant termination benefits to be obtained in advance. This is the position in Australia, where shareholder guidelines contemplate the advance approval being renewed on a triennial basis.
- Without approval in advance, a departing director is in a very weak position – often unfairly so. The risk the director faces is that the relevant termination package is put up for shareholder approval after the departure date – and voted down. What incentive is there for shareholders to vote in favour?
- The legislation would need to address how the value threshold would be calculated – as indicated above, the valuation of LTIP awards and pension rights is far from straightforward.
- In terms of legislation, this binding vote would involve fundamental changes to the shareholder approval provisions under sections 215–220 of the Companies Act relating to compensation payments to leaving directors. Currently, such shareholder resolutions are very rare because payments that reflect the director's contractual entitlement, or that are within the terms of existing discretions under bonus plans and LTIPs, are not caught by these provisions.

### **Beefing-up clawback provisions**

As a further protection to shareholders, the government plans to reinforce Financial Reporting Council (FRC) and Association of British Insurers (ABI) recommendations on the inclusion of clawback provisions in directors' service contracts, bonus plans and LTIPs. These provisions allow vested shares (or the proceeds of sale) to be clawed

back in circumstances where the director has benefited from financial misstatement. Currently, the FRC says that companies should 'consider the use of arrangements for reclaiming variable components in certain circumstances'. The ABI, more strongly, states that remuneration structures should 'include provisions allowing companies to implement malus or clawback arrangements'. Any reinforcement of clawback will likely be effected through an amendment of the Corporate Governance Code.

In the context of contractual employment rights, clawback is not straightforward to implement. The use of clawback provisions in new or revised service contracts and plan rules, if tightly drafted, is unlikely to be problematic from a legal perspective although, if the clause is invoked, there is scope for disputes over the quantum of the clawback and the fairness of the process to decide on quantum. However, the insertion of clawback in existing service contracts and plan rules, without consent, is problematic without a legislative voiding provision that effectively 'trumps' contractual promises.

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### **Employee engagement**

Shareholders, as owners, have primary oversight over the remuneration committee's work, but their willingness to carry out this role will continue to be widely questioned. Even though employees are not owners, the government has been keen to find a way of involving them in the directors' pay process.

Several ideas were mooted in consultation, including having an employee on the remuneration committee and having an employee vote on directors' pay. We favoured the idea of an employee forum in which employee representatives would be involved in a facilitated discussion of the DRR, and their report could be taken into account by shareholders in reaching the voting decision. This was not very popular either.

Fortuitously, the government has identified that a mechanism for UK employees to be consulted already exists under the Information and Consultation of Employees Regulations 2004 (ICE Regulations). So the government's approach to achieving

engagement might well simply be to encourage employees to use their existing rights to be consulted. This links in with the proposed changes to the DRR Regulations requiring companies to explain how they have consulted and taken into account the views of employees when determining directors' pay.

This structure is not ideal – not least because the rights seem to be restricted to UK employees only.

Further, how the structure would work would differ depending on whether a company already operates a national employee forum as part of its obligations under the ICE Regulations:

- **forum already established and individual agreement negotiated:** many companies already operate a national employee forum, but there are fewer bodies that have been set up under the ICE Regulations. Therefore, there would need to be clarity as to whether these non-statutory forums would have the same rights to be consulted as those set up under the ICE Regulations. These forums discuss key issues facing the company, and are provided with significant information by management, often confidentially. Management members get involved in explaining proposals and facilitating discussions. If a forum is already in place, it would be relatively straightforward to re-open negotiations on the information and consultation agreement to add directors' pay as an item for annual discussion;
- **forum already established and standard information and consultation provisions apply:** where no agreement was reached as to an individual information and consultation agreement following negotiations or where the parties simply agreed that the standard provisions (SICPs) in the ICE Regulations should apply, then the SICPs could in principle be amended by the government to include directors' pay. Currently, the SICPs do not cover general employees' changes in pay or monetary benefits; and

- **no forum established:** where companies do not have a forum or agreement established for matters to be discussed between the company and the employee representatives, they will have to consider whether such a forum should be established to comply with any government procedure to account for employee say on directors' remuneration. Under the ICE Regulations, at least 10 per cent of the workforce needs to make a request to the employer for there to be an obligation to initiate negotiations to reach an information and consultation agreement. However, a company may be better establishing an informal forum rather than one under the ICE Regulations because:

- it may retain more control over what the agreement will govern, and the level of information and/or consultation required, ie is the company required just to inform, consult or reach an agreement with the representatives?
- it may reduce the threat of any trade union requesting recognition for its members and then voicing its opinion on directors' remuneration on behalf of the workforce.

There are of course cost and time implications involved with establishing a forum, whether under the ICE Regulations or otherwise, and engaging with employee representatives on executive remuneration may open up the door for engagement on other matters that were not previously envisaged by the company.

Employee consultation under the ICE Regulations would not of itself loop back to shareholders. There could be a mechanism by which the output from employee engagement would be made available to shareholders, and be taken into account on the DRR vote.

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## More diverse boards and remuneration committees

The government sees greater boardroom diversity as critical in changing the status quo of directors' pay. This is consistent with wider government policy, including the Women on Boards initiative. This is not the place to debate the wider diversity issue, but the key point is that the government is no longer proposing that non-directors – or employees – should be remuneration committee members.

More generally, the government has focused on two potential areas involving conflicts of interest in the pay-setting process:

- greater transparency around the role of remuneration consultants, including how they are appointed and paid, who they advise and to whom they report. The DRR Regulations already require advisers to be named, and other work they do for the company (where a potential conflict may arise) to be identified. It seems that the government intends to go further – though it is not clear whether consultant's fees will need to be disclosed; and
- a bar on having remuneration committee members who are executives in another FTSE 350 company. Although the scope for potential back-scratching has almost certainly been exaggerated (the government says that 6 per cent of committee members are executives elsewhere), the government still emphasises the potential for conflict insofar as these individuals 'have a personal interest in maintaining the status quo'. It would not be onerous for companies to accept legislation – or some other form of intervention such as an amendment to the Governance Code – to address the issue.

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## Best practice

Dr Cable's announcement finishes by emphasising that lasting reform depends on active shareholders and responsible businesses accepting the need for change, and pushing the agenda forward. This will be reinforced by the launch by Deborah Hargreaves of the High Pay Centre – which will provide 'high quality research that this area of debate badly needs'. It will also be reinforced by updating the Stewardship Code. And finally, the government has emphasised that companies have got to show leadership, to build on the current momentum for reform, agree on what best practice looks like and promote this more widely.

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