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Executive remuneration: Government proposals for reform

Introduction

The Secretary of State for Business, Innovation and Skills, Dr Vince Cable, has recently announced the Government's proposals for ensuring greater correlation between executive pay and performance in quoted companies.[1] The Government's stated aim is to reconcile two objectives: to support 'responsible capitalism' (which precludes rewarding failure) and to boost Britain's economic recovery (which includes the provision of competitive rewards).

Background to the proposals

The proposals follow the consultation launched by the Government in its 2010 Consultation Paper, 'A Long-term focus for corporate Britain', the publication in November 2011 of a report by the High Pay Commission[2] and the recently published responses to the Government's 2011 discussion paper on executive remuneration.[3]

The proposals

In general terms, the proposals provide for:

- greater transparency in the reporting of executive pay packages;
- greater shareholder involvement in approving executive awards;
- the reform of remuneration committees; and
- the encouragement of best practice by industry and shareholder groups.

More specifically, the proposals include the following:

Greater transparency

It is proposed that the remuneration report be split into two sections:

- one setting out the proposed future policy for executive rewards; and
- the second detailing how executive pay policy has been implemented in the previous year.

This aspect of the proposals would appear to be limited to the question of the format of the report given that the current regime already requires the report to contain a forward-looking policy statement regarding directors' pay and conditions, as well as historical information for the financial year in question.

It is, however, further proposed that, in the section on future policy, the remuneration committee will be expected to explain:

- what benchmarks they have used, and why;
- how they have taken employee earnings (including pay differentials) into account[4];
- how they have consulted with employees and taken account of their views;
- how the proposed pay structures relate to company strategy; and
- how performance will be assessed and reflected in awards in different scenarios.

At present, quoted companies have to state how the pay and employment conditions of other group employees have been taken into account in determining directors' remuneration for the financial year in question. The current requirements are, however, widely drafted and give companies some measure of flexibility in their reporting.

Although it is difficult to comment definitively until the publication (expected in March this year) of more detailed proposals, it would appear that the new requirements relating to future pay policy will be much more prescriptive as to the factors to be taken into account.

1 The proposals are contained in the following (links available at the end of the article): a statement made by Dr Cable to the House of Commons on 23/01/2012, a Written Ministerial Statement dated 24/01/2012 and Dr Cable's speech of the same date to the Social Market Foundation.

2 Report entitled 'Cheques with Balances: Why tackling high pay is in the national interest'.

3 BIS: Executive Remuneration: Discussion Paper: Summary of Responses: January 2012 available at: http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-564-executive-remuneration-discussion-paper-summary-responses.pdf

4 There will, however, be no obligation to publish details of the ratio of pay differentials between the highest and lowest paid employees.

In respect of executive pay awards made in the previous year, companies will, under the proposals, have to publish a single figure showing the total pay of each director and explain how the pay awards relate to the company's performance. There will also be a new requirement to provide a statement comparing the levels of expenditure on executive pay with other out-goings (including dividends, investment, tax and general staffing costs).

Although quoted companies already have to disclose details of the various categories of award making up each director's pay package, it may be difficult to convert this information into a single figure showing the director's total pay as the figures within some categories may well be contingent.

In general terms, the proposals also emphasise the increased importance the Government places on disclosure of the relationship between executive pay and company strategy, and between executive pay and the performance of the company.

In order to address questions about conflicts of interest in the pay-setting process, the Government will also, for the first time, require greater transparency regarding the appointment, role and pay levels of remuneration consultants.

Greater shareholder involvement

The Government plans to give shareholders new powers to hold the board to account and, in a forthcoming consultation process, will consider whether shareholders should have a binding vote on:

- future executive pay policy;
- directors' notice periods where these are in excess of one year; and
- exit payments for directors where these exceed one year's salary.

Shareholders will continue to have an advisory vote on how the agreed policy has been implemented although the Government will consider applying additional sanctions in cases of significant shareholder dissent.

The consultation will also consider whether to increase from 50% to 75% the threshold of shareholder support required to approve pay proposals.

Reform of remuneration committees

In a further move designed to avert conflicts of interest, the Government will ask the Financial Reporting Council ('FRC') to revise the UK Corporate Governance Code ('the Code') to prevent serving executives sitting on the remuneration committees of other large companies.

The Government has rejected calls to require companies to appoint employee representatives to remuneration committees but is keen that the membership of remuneration committees is broadened to include, for example, academics and public servants.

Best practice: the role of business and investor groups

The Government will encourage business and investor groups to agree, and promote, principles of best practice for setting and agreeing executive pay.

Other FRC corporate governance initiatives

As part of the package of reform, the FRC will also:

- consult on proposed amendments to the Code to require 'large public companies' to adopt claw-back mechanisms in executive remuneration arrangements; and
- revise the Stewardship Code to incentivise shareholders to use the new powers that will be available to them.

New High Pay Centre

To help with the Government initiative, a new independent think-tank, the High Pay Centre, has been launched. Its remit is to monitor pay at the top end of the scale and set out a road-map for better business and economic success in the future.

Responses to the proposals

The proposals have been broadly welcomed by investor groups and those representing business. The Government has, however, been criticised in other quarters for entrusting shareholders with the responsibility for controlling executive pay.

The next steps

Given the political and public pressures, it is likely that the new proposals will be implemented sooner rather than later. We will monitor developments and keep you up-dated.

House of Commons: Hansard Debate for 23 January 2012 available at: http://www.publications.parliament.uk/pa/cm201212/cmhansrd/cm120123/debtext/120123-0001.htm

Written Ministerial Statement, 24 January 2012 available at:

http://www.parliament.uk/documents/commons-vote-office/1.BIS-Executive-Pay.pdf

Dr. Cable's Speech on Executive Remuneration, Social Market Foundation, 24 January 2012 available at: http://nds.coi.gov.uk/Content/detail.aspx?NewsAreaId=2&ReleaseID=422961&SubjectId=2

How Squire Sanders can help

We would be pleased to discuss with you in more detail any of the matters raised in this article.

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