

Practical Implications for Companies

Background

Many of the new proposals on executive remuneration were originally set out in Vince Cable's statement to Parliament and speech at the Social Market Foundation towards the end of January and have been widely publicised. The proposals fell under three main headings of greater transparency when reporting executive pay, greater effective control by shareholders and greater diversity of remuneration committees.

Further details of the proposals with respect to control by shareholders were published on 14 March 2012, and the legal and practical implications are summarised below.

Other aspects of the new proposals, such as claw-back arrangements, will be introduced through changes to the UK Corporate Governance Code – details of these changes are yet to be announced.

What are the Proposals on Shareholder Voting?

There is already an existing requirement for the directors' remuneration report of quoted companies to be put to a shareholder vote at the AGM. However, the outcome of this vote is currently advisory rather than binding. The consultation relates to the following proposals:

- an annual binding vote on future remuneration policy;
- an annual advisory vote on the implementation of remuneration policy in the previous year; and
- a binding vote on any exit payment in excess of one year's salary.

Further details of each of these are set out below.

Which Companies Will the Proposals Apply to?

The changes will apply to all UK-incorporated companies that are quoted on the London Stock Exchange and certain other overseas markets. AIM companies are excluded.

When Will the Changes Take Effect?

Submissions to the consultation must be made by 27 April 2012. The Government will then confirm the measures that will be taken forward, with a view to the relevant legislation on shareholder votes being enacted in spring 2013, at the same time as the revised requirements relating to the reporting of directors' remuneration.

The changes are intended to take effect for financial years ending after 1 October 2013 and for directors' contracts that terminate after that date. Changes to the directors' remuneration report will, therefore, start to be seen from the end of 2013 and the changes to shareholder voting will apply to AGMs from early 2014.

Binding Vote on Future Remuneration Policy

The proposal is that a company will have to set out its proposed pay policy for the year ahead, including the potential level of payouts and performance criteria that will be used. This dovetails with the new proposals that the directors' remuneration report will in future have to be divided into two sections; one setting out future remuneration policy and the value of potential payouts and the other detailing the way remuneration policy has been implemented in the previous financial year, including the actual value of awards made.

An alternative of a binding vote only being required where there are "substantial changes" to remuneration policy has been considered, but is likely to be rejected on the basis of the difficulty of defining what constitutes substantial changes in this context.

This forward-looking policy for each year will be put to a binding shareholder vote. This vote is intended to cover all types of remuneration, including salary increases and the level of and criteria for bonus and long-term incentive arrangements. If the company's future policy is not approved by shareholders, it is proposed that the company either has to maintain its existing remuneration policy or puts amended proposals to shareholders within 90 days. The stated purpose of this proposal is to encourage more prior engagement between companies and shareholders about executive remuneration, to ensure that policies are approved on the first vote.

The proposals acknowledge the role of flexibility in allowing some discretion to be exercised by the remuneration committee and it is anticipated that future remuneration policy statements will allow for such flexibility and discretion. This is a key point – companies that engage successfully with shareholders may be able to maximise this flexibility in order to ensure that the new regime does not have a negative impact on the company's business.

If a new director is appointed within the year in question, the company will be expected to offer the appointee a package within the policy framework that has been agreed by shareholders.

Practical issues will arise for a company if its directors' existing service contracts contain specific provisions as to entitlement to variable remuneration and how it is calculated. The changes mean that, in future, no such provisions will be allowed. Such service contracts will need to be amended.

In the case of new service contracts and any other remuneration arrangements, such as new awards under existing share plans, companies must be careful not to include any provisions that may conflict with the future remuneration policy as approved by shareholders. It is proposed that the sanction for this should be the same as currently applies under the Companies Act to unauthorised payments for loss of office, that is, the recipient must hold the payment on trust for the company and any director who entered into or authorised such an offending contract or arrangement is liable to account to the company for any loss.

Level of Shareholder Support

It is proposed that the threshold for the binding vote on future remuneration policy should be somewhere between 50 percent, the percentage currently applying to the advisory shareholder vote on the directors' remuneration report, and 75 percent, the percentage required to pass a special resolution. The percentage will be set following the consultation exercise.

Advisory Vote on Implementation of Remuneration Policy

It is proposed that there should be a separate advisory vote each year on how remuneration policy has been implemented over the previous year. However, the significance of this vote will be reduced by the increased rights of shareholders to vote on the forward-looking policy aspects. It will cover, for example, the determination of the annual bonus for the previous year (within the policy previously agreed by shareholders).

Although this vote will not be binding, if the company fails to gain 75 percent support in the vote then the company will be obliged to announce, within 30 days, the main reasons for the dissent and how it proposes to engage with shareholders to address the issue.

In addition, it is proposed to increase the disclosure in the directors' remuneration report to include how the results of previous votes and shareholder views have been taken into account in remuneration policy.

There is to be no consultation on the requirements with respect to increased transparency in the directors' remuneration report that have already been announced, and these will be implemented by revised regulations to be published later this year. These will require the inclusion of items such as a single figure for the total pay of each director.

Binding Vote on Exit Payments

It is proposed that there should be a binding shareholder vote on any termination package for a director if the value of the package exceeds one year's salary. The package includes all amounts under bonus arrangements, unvested long-term incentive plan (LTIP) awards and share options for the current year. This is specifically targeting the favourable use of discretion under share plans such as LTIPs, under which directors may be allowed to keep awards if they leave before the specified vesting date.

The required level of shareholder vote to approve such arrangements is proposed to be 50 percent.

Companies will have up to 1 October 2013 to bring their arrangements into line with this proposal. However, there is no confirmation that existing service contracts will automatically be amended by law to comply. Therefore, in cases where directors have existing contractual rights that cut across the proposed new law, companies should develop a strategy for agreeing the necessary changes with those directors - the consultation paper specifically envisages that this may involve buying out existing rights. Companies will need to review service contracts and bonus and share plan rules to determine how the changes should be implemented.

It is not proposed to change the existing law requiring shareholder consent for director service contracts with notice periods of more than two years (i.e. this will not be reduced to a one year). However, the new rules on exit payments would override the contractual entitlements to termination payments under such contracts.

In the small number of cases where directors may have rights to pension enhancement on termination, it is not proposed that the new rules should change those arrangements.

Directors' Remuneration Report Changes

As mentioned above, the changes to shareholder voting powers will go hand-in-hand with the changes to the new requirements for the directors' remuneration report. These are to be implemented by changes to the relevant Companies Act legislation and can be summarised as follows:

- splitting the report into two sections, one dealing with proposed future remuneration policy and proposed payouts and the other with how policy has been implemented in the previous year and actual payouts;
- explaining why specific benchmarks have been used and how they have taken employee earnings, including pay differentials, into account when setting pay;
- explaining how they have consulted and taken into account the views of employees;
- explaining clearly how the proposed pay packages reflect and support company strategy, how performance will be assessed and how it will translate into benefits in various scenarios;
- specifying the performance criteria for bonuses, including justifying exceptional payouts;
- providing greater openness on exit payments, including the contractual terms offered to executives;
- providing a single figure for total pay for each director and showing how this is related to company performance and how executive pay compares to other liabilities, such as dividends, business investment, taxation and general staffing costs; and
- explaining how remuneration consultants are appointed, to whom they report and whom they advise, and their fees.

What Action Should Companies Take Now?

At this stage, companies should:

- take the potential impact of the proposals into account in all remuneration decisions relating to directors (including the granting of awards under discretionary share plans) from today. For example, this may mean inserting a rule into any relevant share plans to ensure that no share rights will vest on termination that would place the company in breach of the new legislation;
- review any directors' service agreements to consider the impact of the proposals and whether they may need to be amended. In particular, this review should focus on any contractual entitlements to participate in variable remuneration in a particular way; and
- consider whether to participate in the consultation. Please let us know if we can assist in formulating your submission.

For additional information about these changes, please contact one of the Squire Sanders lawyers listed below or one of the Squire Sanders lawyers with whom you routinely work.

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