

The long awaited Financial Reporting Council (FRC) consultation in respect of various aspects of directors' remuneration has finally been released. Given the 16 months that have passed since the FRC agreed to consult on changes to the UK Corporate Governance Code (the Code), you may think there would be some relatively ground-breaking proposals in the paper. You would be mistaken.

Consultation Areas

The Government asked the FRC to consult on three specific proposals, namely whether:

- clawback provisions should be codified;
- the Code should be used to deter companies from appointing executives of other companies as members of their remuneration committees; and
- in the event that a company fails to obtain a substantial majority in support of a resolution on remuneration, the Code should require that company to report to the market.

Clawback – A Chance Missed?

The consultation in respect of clawback has probably been the most eagerly awaited aspect of the FRC paper. The Code currently requires companies to simply consider using provisions that permit the clawback of remuneration "in exceptional circumstances of misstatement or misconduct". In addition, the new directors' remuneration reporting regulations (effective 1 October 2013) require companies to tell shareholders in the annual report of the existence of any such provisions, as well as whether any such provisions were actually used during the year.

Other than in the financial sector, clawback therefore remains an optional extra in bonus and share incentive arrangements, albeit approximately four-fifths of the FTSE 100 have already introduced such measures. It was hoped that the FRC would consider providing guidance as to how best to implement clawback provisions, perhaps distinguishing between clawback and malus provisions (with the latter reducing unpaid awards as opposed to requiring a payment from employees of previously vested amounts), as well as taking steps towards ensuring there is a joined up approach in respect of the tax issues.

The December 2012 tax tribunal decision (see our alert *Clawback: A Tax Loss or Lost Tax?*) continues to be the sole UK decision in respect of clawback and, without guidance from HMRC, companies are themselves required to consider whether the clawed back amounts should be on a gross or net basis. In addition, any employer's national insurance paid on the remuneration subsequently clawed back seems to be lost, with no legal ability to recover that cost from the employee. Perhaps it's no wonder this potential windfall for the Treasury hasn't been addressed (yet).

However, the FRC's consultation paper simply asks respondents to opine on whether the requirement for "consideration" of clawback is sufficient or whether the Code should be used to specify circumstances under which clawback could be operated. The paper also asks for details of practical and/or legal considerations that may restrict the application of clawback arrangements. Hardly the pioneering reform that many were hoping for.

Remuneration Committee Membership

When the proposed changes to executive remuneration issues were announced in January 2012, the Secretary of State made reference to a perceived conflict when remuneration committee members are executives in another FTSE 350 company, not least because these individuals "have a personal interest in maintaining the status quo in pay setting culture and pay levels".

The Code currently suggests that boards should establish a remuneration committee of at least three (or, in the case of smaller companies, two) independent non-executive directors. Executive directors of other companies would normally be classified as independent unless they hold cross-directorships or have significant links with other directors through involvement in other companies or bodies.

The FRC's consultation paper sets out the percentage of FTSE 350 companies whose remuneration committees include individuals who are also executive directors on other FTSE All Share Index boards. The numbers show that this problem (if indeed there is one) has lessened, with 45% of the FTSE 100 having such remuneration committee members in 2004, yet that number dropped to just 31% in 2012.

The FRC has also analysed and set out the levels of shareholder dissent in terms of votes against the remuneration report of FTSE 350 companies over the same period, with the data showing little difference between companies that have executive directors of other companies on their remuneration committees, and those that don't.

Again, another area in which the FRC doesn't seem inclined to amend the Code.

Votes Against – How to React

The final topic on which the FRC is consulting is how companies should react in the event they fail to obtain at least a substantial majority in support of a resolution on remuneration. The Code currently requires that a board, and in particular the chairman, “should understand and respond” to shareholder concerns. It also requires the annual report to set out the steps the board has taken to ensure that all board members, in particular non-executives, develop an understanding of the views of the major shareholders about the company. However, the Code does not explicitly state how the board should respond in the event they fail to obtain support on remuneration resolutions.

The new directors’ remuneration report regulations require disclosure as to the votes on remuneration resolutions at previous AGMs and, where there has been a significant percentage of votes against a resolution, companies are required to give “a summary of the reasons for those votes, as far as known to the directors, and any actions taken by the directors in response of those concerns”. Given the annual report is a yearly occurrence, it has therefore been suggested that an additional, earlier disclosure may be useful to investors.

The GC100 and Investor Working Group’s Guidance expands on the directors’ remuneration report regulations’ use of the term “significant percentage” by suggesting that companies may wish to consider votes against in excess of 20% as being significant (although there may be reasons why, for some companies, a higher or lower level might be more appropriate). The Guidance also suggests that the company may wish to consider including a statement as to how it will react to any such significant votes against in the RIS announcement which sets out the results of the AGM.

The FRC is therefore keen to understand whether an explicit requirement in the Code is needed in addition to the regulations, the Guidance and the Code and, if so, whether the Code should set the criteria for determining a “significant percentage”, what time period should apply to these discussions and how companies should report to the market.

Closing Thoughts

The consultation closes on 6 December 2013, with the FRC committing to putting any changes to the Code that are ultimately proposed to consultation in the first quarter of 2014. A new Code will then apply to accounting periods beginning on or after 1 October 2014.

Given the length of time the FRC has had to seek opinions as to the relevance of the Code in these areas, as well as whether additional guidance should be provided, it is easy to understand why some parties will be disappointed with the lack of progress this consultation document represents. In particular, the area of clawback remains murky and unclear, without any real direction from the Government as to what companies should be doing and how they should be doing it. Companies are therefore likely to continue to rely on the feedback given to them by their investors for at least the next few months.

In short, given the language used in the consultation paper, it seems the FRC is hesitant to conclude that any changes to the Code are required. It may be that only a huge response to the consultation that urges reform and guidance will actually result in a change to the status quo.

If you would like to contribute to the Squire Sanders response to this consultation paper, please do not hesitate to contact one of our team.



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