Department for Business Innovation & Skills

EXECUTIVE PAY: CONSULTATION ON ENHANCED SHAREHOLDER VOTING RIGHTS

Summary of Responses

JUNE 2012

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Introduction

In January 2012, the Secretary of State for Business, Innovation and Skills announced that the Government would bring forward a package of measures to address failings in the corporate governance framework for directors' remuneration. This would be done through:

- empowering shareholders and promoting shareholder engagement through enhanced voting rights;
- providing greater transparency in directors' remuneration reports; and
- working with investors and business to promote best practice on pay-setting.

Following this, the Government consulted on the details of how enhanced shareholder voting rights would work in practice. The main proposals on which the Government sought views were:

- introducing a binding vote on future remuneration policy;
- increasing the level of support required on votes on future remuneration policy;
- an annual advisory vote on how remuneration policy has been implemented in the previous year; and
- a new binding vote on exit payments over one year's salary.

The purpose of the consultation was to seek evidence on the impact, costs, benefits and likely behavioural effects of the proposals. It built on the evidence received in response to an earlier discussion paper on these issues published in 2011.[1]

The consultation sought views from anyone with an interest in the reforms, but in particular from companies and business organisations, shareholders and institutional investors, employees and employee representative organisations, academics, governance experts, lawyers and other advisors.

The Government received 180 responses to the consultation. This paper provides a summary of the main points raised in response to each of the consultation questions.

On 20 June 2012, the Secretary of State for Business, Innovation and Skills announced the results of the consultation process and outlined a new model of enhanced shareholder voting rights, which the Government will take forward in legislation.

The Secretary of State's statement, and a summary of the Government's reforms, can be found online at http://www.bis.gov.uk/policies/business-law/corporate-governance/executive-pay.

[1] BIS Executive Remuneration Discussion Paper, September 2011 www.bis.gov.uk/Consultations/executive-remuneration-discussion-paper

Overall themes arising from responses

Link between pay and performance

Both investors and companies supported the objective of promoting a stronger link between pay and performance and agreed that this was an important contributor to long term, sustainable growth.

Board responsibility

Many respondents felt strongly that reforms to shareholder voting rights must avoid blurring the responsibility of boards and shareholders; and that boards must retain overall responsibility for company management, including setting directors' remuneration. Shareholders said they were not interested in micro-managing companies.

Shareholder engagement

Respondents were clear that although voting reforms could help to empower shareholders, voting alone is not a substitute for good quality engagement between companies and shareholders; and so it is important for Government to continue to promote the stewardship agenda.

Companies said they were keen to engage in a constructive way with their shareholders and reforms should encourage and not jeopardise that. Companies wanted Government to avoid creating unnecessary process or turning voting into a tick-box exercise.

A wide range of respondents agreed that the reforms have the potential to improve the way companies and shareholders engage on pay issues and to promote a longer-term approach to pay policy. Many thought it would be a positive outcome if this freed up time to be spent on other, more material issues.

Summary of responses by question

Question 1: The Government proposes to require an annual binding vote on remuneration policy. What are the costs and benefits of this approach?

A substantial number of both business and investor respondents thought that a binding vote on future pay policy would promote better engagement between companies and shareholders. Respondents also noted that this would encourage companies to be clearer about the link between remuneration policy and corporate strategy.

Many respondents raised practical issues that would need resolving, such as which financial year the proposed pay policy should apply to and how this would fit with the existing vote on long-term incentive plans (LTIPs).

There was strong support for the Dutch model of binding votes, in which the framework for remuneration is put to shareholders only when there are material changes. Both investors and companies thought this would be preferable to an annual vote as it would encourage long-term thinking and reduce burdens.

Some suggested that defeat on the annual advisory vote could trigger a requirement to put a revised policy to a binding vote the following year.

Investors and companies also commented on the level of detail that should be included in the pay policy. Many thought the policy should explain the broad framework for remuneration and avoid going into a level of detail which would potentially place excessive constraints on remuneration committees.

Question 2: In the event that a company fails the binding vote on remuneration policy, the Government proposes that it maintains its existing policy or returns to shareholders with amended proposals within 90 days. What are the costs and benefits of this approach?

It was made clear that it is important for companies to have the option of falling back on their previous pay policy and so avoid the expense of calling an extraordinary general meeting (EGM). Some respondents noted that, if the circumstances of the company had changed, the previous year’s policy may be outdated; but agreed that that if the policy was drafted in an appropriate way and at the right level, this could be managed.

In general, people felt that the cost and time incurred from a lost vote would act as a deterrent and encourage companies and shareholders to engage early on, which was welcomed.

The vast majority of respondents were clear that 90 days would not be long enough to organise an EGM.

Question 3: The Government proposes that directors' service contracts and other arrangements should, if necessary, be amended to take account of the new requirement to seek shareholder approval of remuneration policy. What are the costs and benefits of this approach?

Although many companies and investors recognised this would be necessary and, in some cases, quite straightforward, a large number of respondents were also concerned about potential costs that could be incurred if contracts needed to be re-negotiated.

Some respondents suggested protecting existing contractual entitlements.

There was a clear message that transitional arrangements for existing directors need to be clarified soon so that companies can start to prepare.

Question 4: The Government proposes that remuneration packages offered to in-year recruits should be confined by the limits and structures set out in the agreed remuneration policy. What are the costs and benefits of this approach?

Investors and businesses were concerned to ensure that voting reforms do not impact on individual companies' ability to attract global talent. However, it was widely recognised that this could be mitigated if a company's pay policy contained the appropriate level of flexibility on terms for new recruits. This would need to be agreed with shareholders.

Some respondents noted that this would be positive if it forced companies to set out their strategy on pay and stick to it; it would increase transparency, help to prevent pay ratcheting upwards and may encourage better succession planning.

Question 5: The Government proposes that the report on future remuneration policy should provide more details on how approved long-term incentive plans will operate for directors in that particular year. Do you agree with this approach?

There were mixed views on whether it would be helpful for future pay policy to say more about how LTIP schemes will operate for directors. Some investors welcomed this and companies agreed it was sensible; others cautioned about adding to the length of annual reports.

Companies were concerned about revealing commercially sensitive targets and some suggested that details of how LTIPs have operated should appear in the backwards looking report.

It was also noted that the intended interaction between company law and the listing rules needed to be clarified.

Question 6: The Government proposes to increase the level of shareholder support that should be required to pass the vote on future remuneration policy. Do you agree with this approach and if so, what would be an appropriate threshold?

Almost without exception, respondents were against increasing the threshold for votes on remuneration, largely because it would place a disproportionate focus on remuneration compared to other issues.

Respondents also felt it would empower minority shareholders and potentially allow for the wishes of the majority to be ignored, something that both companies and investors saw as inequitable.

Question 7: The Government proposes to require companies to explain how the results of the advisory vote have been taken into account the following year and to issue a statement to the market sooner than this where there is a significant level of shareholder dissent. What are the costs and benefits of this approach?

There was support for retaining an advisory vote on actual payments made to directors. A large number of investors and companies thought that it was a good idea to require companies to explain, in the following year's report, how the results of the advisory vote had been taken into account.

Many respondents also favoured the idea of companies issuing a statement to the market immediately after a poor result in the advisory vote. This would improve transparency and accountability.

Some respondents were concerned that 30 days would not be sufficient time to produce this and suggested 90 days would allow companies to issue a more meaningful and worthwhile statement. There were mixed views on whether this would be a burden on companies, or easy to deliver at marginal cost. Many agreed this would depend on what companies were expected to say in the statement.

A few companies cautioned that the reasons why shareholders vote against is not always clear and suggested that either shareholders should be compelled to explain this, or the company's statement should explain shareholder views 'so far as they are known'.

Question 8: The Government proposes to give shareholders a binding vote on exit payments of more than one year's base salary. Do you agree with this approach or would an alternative threshold for requiring a shareholder vote be more appropriate?

The majority of respondents raised concerns with this proposal. Of those that were in favour, the main reasons given were that it would prevent rewards for failure and improve shareholder engagement.

A principle concern of both investors and businesses was that this would lead to increased levels of base pay and discourage the use of longer term incentives, resulting in a shorter-term approach to pay-setting.

A number of respondents also raised concerns that this could give rise to potential additional costs for companies in terms of buying directors out of contracts and associated legal fees as well as increasing the risk of litigation. Issues were also raised about the practicalities of the proposals, namely that it could lead to a delay in moving directors on, could require a costly and time consuming EGM, or that it could take up a lot of additional management time.

Business respondents also raised concerns that this proposal would put UK business at a competitive disadvantage compared to overseas businesses and UK quoted companies at a competitive disadvantage compared to private companies.

Question 9: The Government recognises that the circumstances under which a director leaves their post are complex and diverse and so invites feedback on the appropriate scope and breadth of the proposed legislative measures.

Almost all respondents felt that one year's base salary was too low, particularly as it could deprive people of long-term incentives that they had partly earned and which had already been approved by shareholders. Both investors and companies re-iterated that there were a range of circumstances under which a director may leave and that companies need to be able to respond quickly and appropriately. A threshold of one year's salary would require a shareholder vote in nearly all cases.

A large number of shareholders and companies suggested the Australian model as a more workable alternative. Companies should be able to agree their approach to exit payments as part of the binding vote on policy, and seek shareholder approval only where they intend to pay more than their policy allows.

Many respondents were in favour of improved disclosure on exit payments awarded as part of the backwards looking report and noted that this would enable shareholders to vote down the report, or the re-election of the remuneration committee chairman, if they were unhappy.

Question 10: The Government proposes that directors' service contracts and other arrangements should be amended to take account of the new requirement to seek shareholder approval for exit payments over one year's base salary. What are the costs and benefits of this approach?

Respondents raised a number of potential costs associated with this proposal, including compensating directors for lost benefits and the risk of litigation. Some also raised the possibility that directors would take the opportunity to seek a wider renegotiation of their contract on more favourable terms.

Some respondents highlighted that although costly, this was possible and preferable to overriding contracts through legislation. Others noted that the costs would only occur on a one-off basis, after which contracts would be aligned with the law.

A number of respondents suggested 'grandfathering' rights in existing contracts and allowing them to stand until they expire.

Question 11: The Government notes that a small number of directors could be entitled to generous pension enhancements if their contract is terminated early. It proposes not to legislate to override these rights, owing to the rarity of such arrangements and the complexity of legislation that would be required. Do you agree with this approach?

A significant majority of respondents agreed with this approach without offering further comment.

Question 12: The Government proposes to leave unchanged the existing requirement in company law (section 188 of the Companies Act 2006) to get members' approval for notice periods of more than two years. Do you agree with this approach?

The vast majority of respondents agreed that there should be no change to the existing legislation on notice periods.

Of the few that disagreed, the most common view was that this should change to notice periods of more than one year, to bring this into line with existing practice and the Government's wider proposals non exit payments.

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