Title: Shareholder votes on executive remuneration	Impact Assessment (IA)
IA No: BIS 0341	**Date:** 15/02/2012
Lead department or agency: BIS	**Stage:** Consultation
Other departments or agencies:	**Source of intervention:** Domestic
	Type of measure: Primary legislation
	Contact for enquiries: Gemma Peck 020 7215 1984

Summary: Intervention and Options

RPC Opinion: RPC Opinion Status

Cost of Preferred (or more likely) Option				
Total Net Present Value	**Business Net Present Value**	**Net cost to business per year** (EANCB on 2009 prices)	**In scope of One-In, One-Out?**	**Measure qualifies as**
£m	£m	£m	Yes	IN

What is the problem under consideration? Why is government intervention necessary?

Over the last decade, executive pay in the UK's largest listed companies has quadrupled, with little evidence that this is a result of improved performance or in any way connected to shareholder returns. Pay policies which do not appropriately link executive pay to company strategy and performance have an economic cost through diminished shareholder returns, weakened corporate governance and reduced confidence in the corporate sector.

This calls into question whether the 'principals' (i.e. shareholders, the owners of companies) have the right mechanisms and sufficient information to influence and control the 'agents' (directors) appointed to run the company on their behalf. Shareholders have told us that companies' remuneration reports are complex and opaque and the existing advisory vote on executive pay does not incentivise companies to act on shareholder views. Government has a role to address these regulatory failures in the corporate governance framework around executive pay. This IA is particularly focused on addressing the effectiveness of shareholder voting mechanisms.

What are the policy objectives and the intended effects?

The policy objective is to tackle the underlying market failure more effectively by equipping shareholders with the enhanced tools they need to challenge companies on executive pay. Shareholder empowerment lies at the heart of the UK's corporate governance framework and these reforms are consistent with that approach. They will enable shareholders to promote a stronger, clearer link between pay and performance and to clamp down on rewards for mediocrity or failure, while still allowing for exceptional performance to be rewarded.

What policy options have been considered, including any alternatives to regulation?

(1) Give shareholders a binding vote on future pay policy and an advisory vote on how policy has been implemented in the previous year, plus a vote on notice periods exceeding one year and on exit payments exceeding one year's salary
(2) Give shareholders a *single* binding vote on *all* pay and remuneration issues;
(3) Status quo.
(Sub-option A): Requiring a higher level of shareholder support on pay-related resolutions.
The preferred option (1) will give shareholders real tools to challenge on executive pay and prevent rewards for failure when executives leave a company before the end of their contract, while minimising administrative costs and legal risks. We will consult on sub-option A as an additional variant to options 1-3. Options 1 & 2 are regulatory but in all cases, Government would work with companies and investors on non-regulatory measures to improve the quality and usefulness of company remuneration reports and to promote good practice, including simplification of pay.

Will the policy be reviewed? It will be reviewed. **If applicable, set review date:** 10/2015

Does implementation go beyond minimum EU requirements?			Yes		
Are any of these organisations in scope? If Micros not exempted set out reason in Evidence Base.	**Micro** No	**< 20** No	**Small** No	**Medium** Yes/No	**Large** Yes/No
What is the CO_2 equivalent change in greenhouse gas emissions? (Million tonnes CO_2 equivalent)			**Traded:**	**Non-traded:**	

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.

Signed by the responsible SELECT SIGNATORY: .... Date: ....

Summary: Analysis & Evidence

Policy Option 1

Description: A binding shareholder vote on future pay policy, advisory vote on retrospective pay policy and binding vote on notice periods and exit payments.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised costs by 'main affected groups'

- None.
- We will discuss this further with stakeholders during the consultation but do not currently believe on the basis of discussions with stakeholders that the introduction of an additional binding vote will add directly to company costs.

Other key non-monetised costs by 'main affected groups'

- There may be some indirect costs in relation to increased shareholder engagement and adjustments to executive remuneration packages and we will explore these further with stakeholders during the consultation.
- Potential costs of additional General Meeting to vote on revised pay proposals, although we expect that most companies will take action to avoid such an outcome.
- Most significant impacts likely to be in FTSE 350 companies where shareholder concerns have been greatest.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

- Additional power for shareholders to hold companies to account over executive pay and limit payment of "rewards for failure".
- Ultimately we would expect a strengthened shareholder regime to lead to better corporate governance in UK companies which is associated with lower costs of capital. These measures are widely supported by a range of business and investor stakeholders (see paragraph 36 below)
- Most significant impacts likely to be in FTSE 350 companies where shareholder concerns have been greatest.

Key assumptions/sensitivities/risks **Discount rate (%)**

- Additional votes at AGM have a marginal cost close to zero (confirmed via discussions with registrars).
- The impacts of this policy intervention depend on the willingness of shareholders to use the strengthened voting mechanism as leverage with company management.

BUSINESS ASSESSMENT (Option 1)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs:	**Benefits:**	**Net:**	Yes	IN

Summary: Analysis & Evidence

Policy Option 2

Description: Single binding shareholder vote on the whole remuneration report

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised costs by 'main affected groups'

- None.
- We will discuss this further with stakeholders during the consultation but do not currently believe on the basis of discussions with stakeholders that the introduction of a binding vote will add directly to company costs.

Other key non-monetised costs by 'main affected groups'

- There may be some indirect costs in relation to increased shareholder engagement and adjustments to executive remuneration packages and we will explore these further with stakeholders during the consultation.
- Potential costs of additional General Meeting to vote on revised pay proposals, although we expect that most companies will take action to avoid such an outcome.
- Companies may face the cost of legal challenge if retrospective pay policies are voted down and have to be renegotiated.
- Executives may seek higher pay in future to compensate for this uncertainty.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

- Additional power for shareholders to hold companies to account over executive pay but binding vote on retrospective elements would lead to uncertainty on remuneration and might reduce shareholders' willingness to utilise it.
- Ultimately we would expect a strengthened shareholder regime to lead to better corporate governance in UK companies which is associated with lower costs of capital.

Key assumptions/sensitivities/risks **Discount rate (%)**

- Additional votes at AGM have a marginal cost close to zero (confirmed via discussions with registrars).
- Risk that shareholders will be unwilling to use the vote on the report even less than currently as a means of expressing their concern if this will lead to market uncertainty.
- Assumes willingness of shareholders to use the vote as leverage over company management.

BUSINESS ASSESSMENT (Option 2)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs:	**Benefits:**	**Net:**	Yes	IN

Summary: Analysis & Evidence

Policy Option 3

Description: No change in current voting arrangements.

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:**

COSTS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Cost** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised costs by 'main affected groups'

Other key non-monetised costs by 'main affected groups'

- Continued shareholder disquiet over executive remuneration packages, particularly exit payments.
- This will mean continued and possibly increasing agency costs of operating in a corporate governance structure that fails to provide satisfactory arrangements that safeguard shareholder interests.

BENEFITS (£m)	**Total Transition** (Constant Price)	Years	**Average Annual** (excl. Transition) (Constant Price)	**Total Benefit** (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

- (Compared to options 1 and 2) No change for shareholders and companies to adapt to

Key assumptions/sensitivities/risks | **Discount rate (%)**

BUSINESS ASSESSMENT (Option 3)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs:	**Benefits:**	**Net:**	Yes	IN

Summary: Analysis & Evidence

Policy Sub-Option A

Description: Requiring a higher level of shareholder support on pay-related resolutions

FULL ECONOMIC ASSESSMENT

Price Base Year	PV Base Year	Time Period Years	Net Benefit (Present Value (PV)) (£m)		
			Low: Optional	**High:** Optional	**Best Estimate:**

COSTS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Cost (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised costs by 'main affected groups'

Other key non-monetised costs by 'main affected groups'

- Potential cost for those companies that had to increase their shareholder engagement activity, and for shareholders that choose to increase their corporate governance.

BENEFITS (£m)	Total Transition (Constant Price)	Years	Average Annual (excl. Transition) (Constant Price)	Total Benefit (Present Value)
Low	Optional		Optional	**Optional**
High	Optional		Optional	**Optional**
Best Estimate				

Description and scale of key monetised benefits by 'main affected groups'

Other key non-monetised benefits by 'main affected groups'

- Encourage companies to improve their engagement with shareholders on the issue of pay, so as to secure sufficient support to pass the vote.
- May in turn encourage more shareholders to play an active role.
- Ultimately we would expect a strengthened shareholder regime to lead to better corporate governance in UK companies which is associated with lower costs of capital.

Key assumptions/sensitivities/risks **Discount rate (%)**

- Assumes shareholders will use their voting power wisely
- Risk of giving too much power to a minority of shareholders

BUSINESS ASSESSMENT (Option 4)

Direct impact on business (Equivalent Annual) £m:			In scope of OIOO?	Measure qualifies as
Costs:	**Benefits:**	**Net:**	Yes	IN

Evidence Base (for summary sheets)

This proposal will contribute to the Coalition commitment to, “investigate further ways of improving corporate accountability and transparency. “.

I. Problem under consideration

Background

1. The case for regulation of executive remuneration arises because of a well established market failure at the heart of the corporate governance regime. Classic agency theory suggests a relationship where the owners of companies (shareholders) delegate the management of the company to executives (directors). This separation of ownership from control leads to information asymmetries and leaves room for executives to act in their own self-interest to the detriment of the owner. Within the classic principal-agent theory literature, executive pay is a key mechanism for helping to minimise agency costs in order to align the incentives of managers with the interest of shareholders. It follows that where shareholders do not maintain control over executive pay there is a strong theoretical likelihood that executives will exhibit rent-seeking behaviour[1].

2. It is in response to this market failure that the UK has regulated the processes of setting and reporting on directors’ remuneration for over eighty years. During that time disquiet about executives’ ability to reward themselves with excessive pay packages has surfaced periodically, leading to a number of changes in the corporate governance framework (see Annex A for details). That disquiet has become more acute in recent years in the context of the economic downturn.

Current regulatory framework for executive pay

3. The last major change to the regulatory framework for executive pay came into effect in 2003. In line with the traditional model of UK corporate governance the regulatory framework is complemented by market rules[2], ‘comply or explain’ guidance in the UK Corporate Governance Code[3] and good practice principles issued by investors.[4]

4. Specifically, all UK quoted companies (i.e. those incorporated in the UK and listed on a main stock exchange – currently around 1,100 of our largest companies) are required by Company Law[5] to produce a Directors’ Remuneration Report (DRR) as part of the annual reporting cycle. The contents of the report are prescribed by regulations[6] and it must contain details of:

- The company’s policy on remuneration
- Salary, bonus and share-based compensation of each individual director
- Pension arrangements
- Performance conditions for any share-based schemes
- Policy on notice periods and termination payments

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[1] Rent-seeking behaviour is any action which leads to rewards or returns which are not justified or earned.
[2] UK Listing Rules www.fsa.gov.uk/pubs/other/listing_rules.pdf
[3] UK Corporate Governance Code www.frc.org.uk/documents/pagemanager/corporate_governance/uk%20corp%20gov%20code%20june%202010.pdf
[4] For example, Association of British Insurers’ Principles of Remuneration 2011 www.ivis.co.uk/ExecutiveRemuneration.aspx
[5] Sections 420-422, 439 Companies Act 2006
[6] Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, Schedule 8.

5. Companies must put this report to shareholders for a vote at the Annual General Meeting (AGM). The vote is advisory in nature and no part of a director's pay is contingent on the outcome of the vote.

6. In addition, market Listing Rules require all UK listed companies to comply with (or explain why they do not) the UK Corporate Governance Code. This includes provisions on the make-up and role of remuneration committees, the pay setting process and the structure of pay. The Listing Rules also require shareholders to approve any new share-based reward schemes, for all employees and not just directors. Companies typically seek approval every five to ten years for the broad structure of these schemes, but not the detail.

The growth in executive pay

7. Well-structured executive remuneration, which is clearly linked to the strategic objectives of a company, can promote business stability and growth. However, over the last decade, executive pay in quoted companies has increased substantially whilst overall company performance has been poor and thus the link between remuneration and company performance has been hard to discern. Academic research has pointed out that, despite executive compensation typically being viewed as an instrument of corporate governance used for addressing agency problems, the design of executive compensation can itself be subject to substantial managerial influence, thereby becoming inherently part of the agency problem itself.[7] Consequently, the intended relationship between pay and performance can break down if the design of pay packages is more reflective of managerial rent-seeking than the establishment of efficient incentives which lead management to maximise shareholder value.[8]

8. The median total remuneration of FTSE100 CEOs has risen from an average of £1m to £4.2m (13.6% a year) for the period 1998-2010. This represents over a four fold increase.[9] This is faster than the increase in the FTSE100 index, retail prices or average remuneration levels across all employees which have risen 4.7% for the same period. By comparison to the growth in pay for executive directors, employees have seen much slower growth in earnings.

9. Executive remuneration in FTSE250 companies has also risen fast, albeit at a slower rate, while growth in median CEO salaries in Small Cap and AIM companies has been more modest.[10] (See figure 1 below)

10. Research looking at the reasons for the growth in pay has reached different conclusions, with many studies pointing to the difficulty of identifying causal effects. As a result, no single, clear reason has emerged and the trend is most likely to be a combination of factors.[11] In a BIS discussion paper issued in July last year, we explored these issues further.

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[7] Bebchuk, Lucian Arye and Jesse M. Fried (2003), "Executive Compensation as an Agency Problem", Journal of Economic Perspectives, 17(3), pp. 71-92.

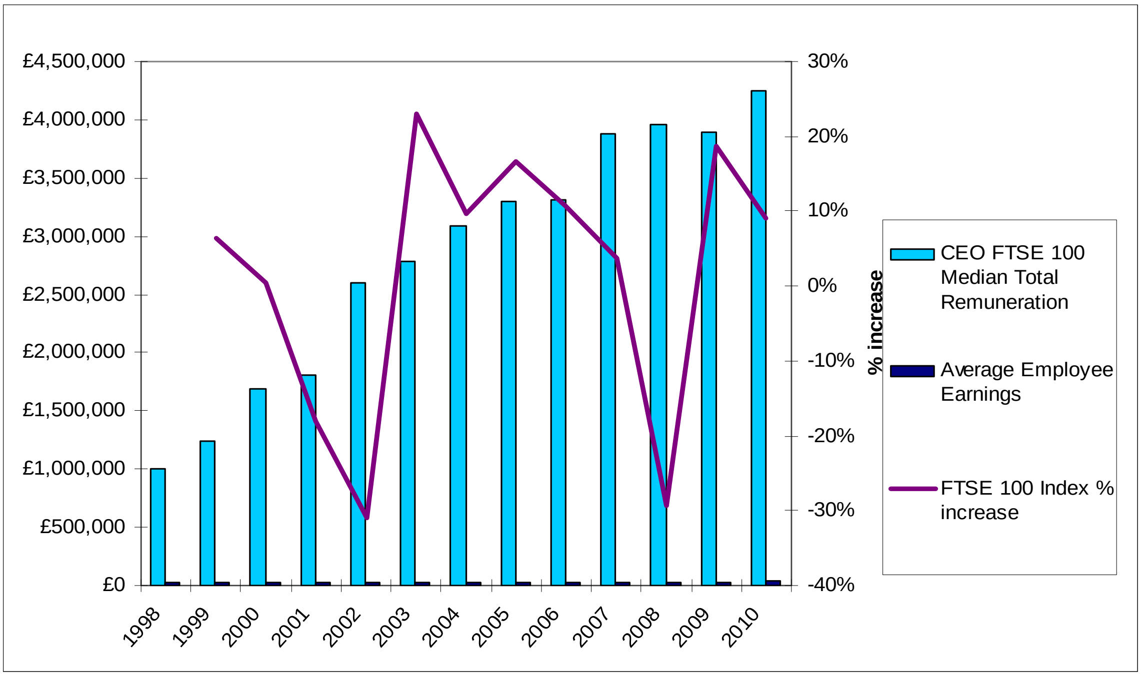
[8] A number of authors have noted that certain aspects of pay design are more reflective of managerial rent-seeking than efficient incentive design:
Blanchard, Olivier Jean, Florencio Lopez-de-Silanes and Andrei Shleifer (1994), "What do Firms do with Cash Windfalls?", Journal of Financial Economics, 36(3), pp. 337-60.
Yermack, David (1997), "Good Timing: CEO Stock Option Awards and Company News Announcements", Journal of Finance, June, 52, pp. 449-76.
Bertrand, Marianne and Sendhil Mullainathan (2001), "Are CEOs rewarded for luck? The Ones Without Principals Are", Quarterly Journal of Economics, August, 16(3), pp. 901-32.

[9] This figure includes salary, bonus, deferred bonus, other benefits, long-term incentives, share options and pensions. Taken from: Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011. Available at: http://blog.manifest.co.uk

[10] Hutton Review of Fair Pay in the public sector, Interim Report, December 2010. Available at: http://www.hm-treasury.gov.uk/d/hutton_interim_report.pdf

[11] Frydman, C & Jenter, D., CEO Compensation, Rock Center for Corporate Governance at Stanford, November 2010. University Working Paper No. 77

Figure 1: Comparison of FTSE100 CEO median total remuneration, average employee earnings and FTSE100 performance 1998-2010[12]



11. **Company size and complexity** can explain some of the increase in executive pay, with one study finding that the increase in CEO pay in the United States could be directly linked to the market captitalisation of large companies during the same period[13]. This may help to explain some of the faster growth in pay seen in the FTSE100 relative to smaller quoted companies but not the prolonged rise we have seen in the face of poor equity returns.

12. One of the most frequently cited reasons for high levels of pay is the impact of the **international market for CEOs** and the need to pay above average to attract the very best talent and mitigate against a flow of UK executives to other countries. However, the evidence to support this is limited and the proportion of non-UK directors in UK companies has remained relatively stable over time. Increasing globalisation should have increased the number of potential candidates for director level posts, which arguably should have helped depress pay - but we have seen limited evidence to support this. [International comparisons of pay are difficult to make given the complexity of the packages in place and limited disclosure in some countries but studies tend to find that executive pay is highest in the US (reflecting a more significant reliance on equity based rewards[14]) with the UK some way behind and other European countries at a slightly lower level

The structure of remuneration

13. The structure of remuneration has changed significantly over the past two decades as in an attempt to address the principal–agent problem, most companies now pay a much larger proportion of remuneration in the form of variable and deferred pay based on more complex models that attempt to link pay to performance. Most senior executive pay packages contain the following elements:

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12 Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, May 2011. Available at: http://blog.manifest.co.uk

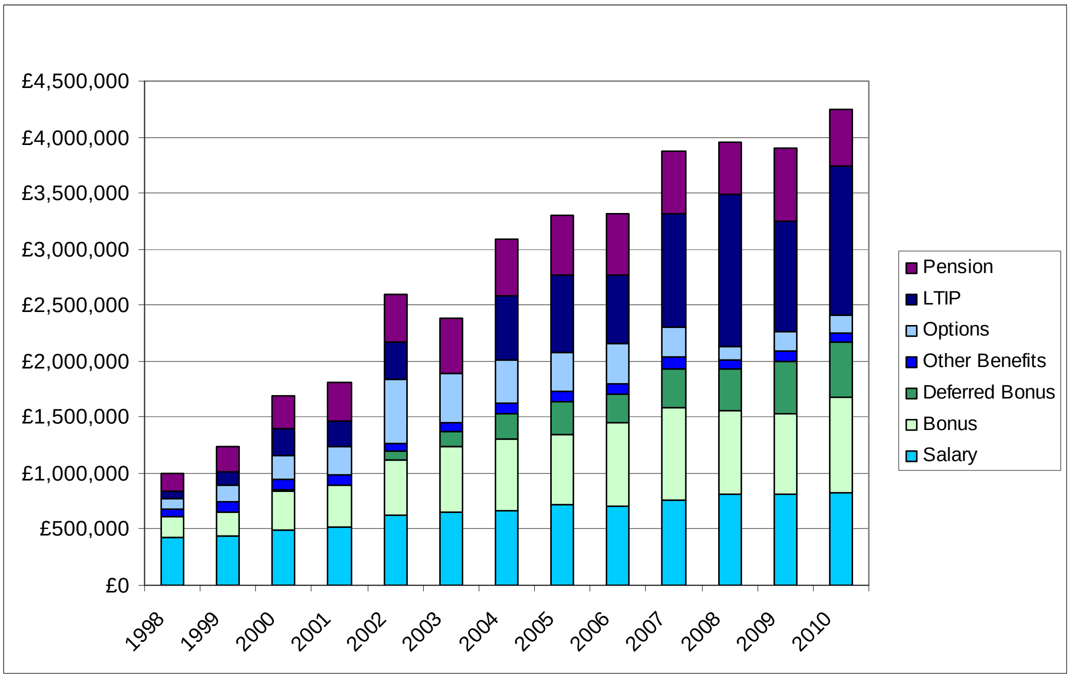
13 Gabaix, X. & Landier, A ., Why has CEO pay increased so much? April 2007. Quarterly Journal of Economics

14 For evidence that adjusting for the equity component of pay is important in explaining the US pay premium, see the study by Fernandes et al. (2011), "Are US CEOs Paid More? New International Evidence", SSRN Working Paper.

- Base Salary: usually determined through benchmarking, based on general industry salary surveys supplemented by detailed analyses of selected industry or market peers.
- Annual Bonus/Incentive Plans: Typically bonuses pay out an award based on the performance of the company over no more than one year, usually the previous financial year. The payments may be made in cash or shares or a combination.
- Long-Term Incentive Plans (LTIPs): LTIPS typically involve the granting of shares to directors after a three year period upon the achievement of performance criteria, and must include some qualifying conditions with respect to service or performance that cannot be fulfilled within a single financial year.
- Share Option Plans: Share option plans are contracts giving directors the right to buy shares at a pre-specified price for a pre-specified period of time, which usually starts three years after the agreement of the plan and ends no later than ten years after it. Share option plans are non-tradable and are often forfeited if the executive leaves the firm before they become exercisable.
- Deferred Bonus Plans: annual bonus plans which incorporate an element of deferral.
- Retirement Plans: Top executives routinely participate in supplementary retirement plans in addition to the company-wide pension plan.

14. Figure 2 shows how the composition of median CEO remuneration in FTSE100 companies has changed since 1998. In 1998, base salary made up over 40% of total remuneration for FTSE100 CEOs; by 2010 it accounted for less than 20%, with the remainder made up of a combination of bonus, long-term incentive plans (LTIPs), share options and pensions.[15]

Figure 2: FTSE 100 CEO median total remuneration composition 1998-2010[16]



15. Many researchers have argued that the move towards more complex remuneration structures has actually driven increases in overall remuneration because executives expect higher pay in reward for higher risk - in other words, the value of deferred pay may be discounted because of the possibility it will not be paid.[17] Our discussions with stakeholders

[15] The Manifest/MM&K Executive Director, Total Remuneration Survey, May 2011 Edition. Available at: http://blog.manifest.co.uk
[16] Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011, March 2011. Available at: http://blog.manifest.co.uk
[17] PwC, If executive pay is broken, making it more complex is not the answer: The psychology of incentives, March 2011, Available at: http://www.pwc.co.uk/eng/publications/if-executive-pay-is-broken-making-it-more-complex-is-not-the-answer.html

also suggest that the complex structure of pay makes it harder to disentangle what executives are actually earning and for shareholders to judge whether this is appropriate. Furthermore, inadequate or obtuse linkage between pay and performance has the potential to provide incentives for directors which are badly aligned with those of shareholders and consequently affect the quality of the directors' relationship with wider stakeholders, including employees.

16. A PwC review of executive remuneration[18] summarises the problem:

The increase in pay has mainly been in the form of higher annual bonuses and long-term incentive (LTI) awards, which are nearly always performance-related. As our previous research has shown, the outcome has left almost everyone dissatisfied:

- *Generally management feel that incentives have become too complex and prescriptive, and are not aligned to the business strategy or within their control. As a result, they do not believe incentives drive performance or change behaviours and many perceive incentives simply to be a lottery.*
- *Many institutional shareholders believe there is a tenuous link between pay and performance.*
- *Few really believe that complex long-term incentives retain executives; they just make it more expensive for a new employer to buy-out the executive with golden hellos and guarantees.*
- *The public, particularly since the banking crisis, see executive pay as nothing other than a gravy train – pay regardless of performance rather than pay for performance.*

Complexity of reporting on pay

17. There have been various private sector[19] and regulator reviews[20] of the quality of UK companies' narrative reporting/business reviews (covering mainly quoted companies) over the last ten years. In general these reviews have found that the quality of narrative reporting is improving but that there is still considerable variation and room for improvement between the best and worst performers. There are also concerns with the increasing length and complexity of company reports. That is why BIS has recently consulted on changes to the regime for company narrative reporting.[21]

18. There is also a particular concern amongst stakeholders that substantial lack of transparency surrounding executive pay results in asymmetry of information and moral hazard. Despite companies already being required to give very full disclosure of remuneration under the Directors' Remuneration Regulations, companies do not give a clear figure for total remuneration for each individual director nor do they seem to provide a clear line of sight between levels and structure of remuneration and directors' performance in meeting the company's strategic objectives. This view is supported by recent research looking at the remuneration reports of FTSE150 companies, which found that only around a third clearly disclosed how remuneration is dependent on performance[22] and by feedback to our earlier consultation on company reporting:

> "*We need more transparency. We need more coherent and pared down remuneration reports, which do not blind shareholders with the science. Good regulation should require companies to make remuneration reports less dense and less confusing. […]*

[18] http://www.pwc.co.uk/en_UK/uk/assets/pdf/executive-compensation-review-of-the-year-2009-pwc.pdf

[19] For example, "Swimming in Words" Deloitte survey of narrative reporting in annual reports (October 2010) and "A Snapshot of FTSE 350 reporting" PWC (2009).

[20] Financial Reporting Council (FRC) reports "Louder then Words" (2009) "Cutting Clutter" (April 2011).

[21] http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation

[22] PwC, Insight or fatigue? FTSE350 reporting, 2010. Available at: http://www.pwcwebcast.co.uk/cr_ftse350.pdf

We agree that it would be helpful to have disclosure of a single figure of the total non-pensionable remuneration for each director." - **Railpen Investments**

"*When directors' rewards are significantly more generous than those given to other employees, there must [be] a clear and solid explanation about the link between pay and performance; and, furthermore, there should be no reward for failure. Complex bonus structures and the lack of transparency around boardroom pay are part of the problem. If we are to make progress on executive remuneration, it is critical that boardrooms explain clearly how rewards are linked to performance and how that impacts shareholder value*." - **NAPF**

"*Improved transparency would also help underpin our robust system. Changes should include disclosure of a single aggregate figure for directors' taxable remuneration, explanation of the nature of performance measures and additional disclosure relating to remuneration consultants*." - **CBI**

Limited impact of the advisory vote on the Directors' Remuneration Report

19. The advisory vote on the Directors Remuneration Report, which came into effect in 2003, was designed to empower shareholders and give them an effective and more focused way in which to influence directors' pay. It encouraged shareholders to become more engaged in corporate governance and to develop relationships with the companies they invest in.[23]

20. A number of high profile cases in the early years cemented the importance of the remuneration report and shareholder vote. For example there are cases of companies that have conducted full reviews of executive pay following major shareholder revolts, such as GlaxoSmithKline in response to an advisory vote against their policy in 2003[24]. The proportion of dissenting votes reduced to around 3% in 2008 but the financial crisis predictably led to an increase in shareholder activism and in 2009, around one fifth of FTSE100 companies had more than 20% of their shareholders withhold support for their remuneration reports.[25] The frequency of such significant votes against has since declined, but individual cases continue to attract a great deal of attention.

21. Whereas most company resolutions at AGMs receive near unanimous shareholder support, resolutions on remuneration see on average 10% of shareholder voting against. In the vast majority of cases, remuneration reports are passed by a substantial majority and this is often reflective of sustained and effective shareholder engagement over the course of the year and particularly in the run-up to the vote. However, the average figures disguise a small but significant number of cases where a large proportion of shareholders withhold support for remuneration proposals. In the 2007-2011 period there were 68 examples of remuneration reports which received in excess of 30% of shareholder votes against – three times the average level of dissent. More worryingly historical voting records, feedback from shareholders and anecdotal evidence suggests that in many of these cases, companies are not responding adequately to shareholder concerns. Examples of this include; Ladbrokes response to 40% of shareholders who voted against or withheld support for the remuneration report in 2011 (over concerns about a payment to a finance director who subsequently left the company) was to say "We have noted the disquiet expressed by some of our shareholders and have recorded it for future reference."[26] and WPP where around 40% of shareholders voted against the

[23] PIRC and Railpen Investments, Say on Pay: Six Years on: Lessons from the UK Experience, September 2009. Available at: http://www.pirc.co.uk/sites/default/files/documents/SayonPay.pdf
[24] PIRC and Railpen Investments, Say on Pay: Six Years on: Lessons from the UK Experience, September 2009. Available at: http://www.pirc.co.uk/sites/default/files/documents/SayonPay.pdf
[25] PwC, Executive Compensation: Review of the Year, 2009. Available at: http://www.pwc.co.uk/eng/publications/executive_compensation_review_of_the_year_2009.html
[26] http://www.guardian.co.uk/business/2011/may/13/ladbrokes-shareholder-pay-revolt

remuneration report in June 2011 leading the CEO to say “this strikes me as being a matter of excessive micro managing,”.

22. Under current rules, the shareholder vote is advisory and based on the entirety of the remuneration report, covering both retrospective and future pay policy. Companies are not obliged to take any action based on the outcome of the advisory vote, as a result of which shareholders have little leverage. We have heard from a range of major institutional shareholders who are frustrated that there are a number of companies seeing significant shareholder dissent year-on-year. For example:

> *“Under the current system where there is no formal sanction for a high level of shareholder opposition companies can be rather disingenuous in the manner they interpret such feedback. Also because points of contention are normally associated with awards already granted, companies often disregard such shareholder opposition as ex post. For this reason, it is all too common for there to be a lack of tangible reforms or even extended dialogue in response to such votes.”*[27]

23. At present, there exists no guidance on how companies should respond to shareholder dissent on remuneration votes and in the responses to our earlier discussion paper on executive pay, shareholders expressed their frustration that some companies fail to respond when a significant number of shareholders vote against remuneration proposals. Shareholders typically consider 'high' dissent to constitute 20% or more shareholders voting against (twice the average level of dissent for pay reports in the FTSE350). The evidence shows that within the FTSE100 there are four companies that have seen more than 20% of their shareholders voting against their remuneration report four times in the nine years that the vote has been in force, demonstrating that the advisory vote in its current form has limited effect.[28]

24. In many cases shareholders choose to 'abstain' on the remuneration to signal their discontent without going so far as to vote against management. This figure is not always apparent but is important as can represent a large number of shareholders refusing to back the remuneration report. Between 2007 and 2011, there were 11 companies in the FTSE All-Share Index that saw 50% of votes cast going against the remuneration report. But including abstentions shows that 19 companies actually failed to get a simple majority of all shareholders. In one FTSE250 example, the company ostensibly received 97% support for its remuneration report at the 2011 AGM. However, a closer look at the figures shows that a substantial number of shareholders abstained and taking this into account, almost a third of shareholders failed to back the report.[29]

25. A further point to note though is that dissenting votes might be expected to decline as the UK shareholder base has become more fragmented and internationalised over the past 10 years. In the UK the proportion of shares owned by domestic institutional investors (insurance companies and pension funds) who have traditionally devoted significant resources to these issues, have declined significantly (from over 50% in 1990 to around 25% today). However, within the overall figures, there is strong evidence of shareholder activism on pay, including among the largest institutional shareholders. This is confirmed by data from a leading proxy adviser which shows that major investors are more likely to vote against remuneration reports than other company resolutions and that some of the largest UK investors voted against over 50% of remuneration reports on which they had a vote in 2010 - suggesting a significant level of concern.

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[27] Co-operative Asset Management, response to Executive Remuneration Discussion Paper
[28] http://blog.manifest.co.uk/2011/07/5131.html
[29] http://www.investegate.co.uk/article.aspx?id=201101271446042105A

26. Academic studies[30] have also found that this level of dissent is higher than against other company resolution and that companies with the highest paid CEOs have seen higher levels of dissent; but again there is limited evidence of higher votes against the remuneration report affecting future pay awards.

Limited levers to prevent rewards for failure

27. Individual cases of executives leaving failing companies with substantial exit packages have attracted high profile resistance on the part of shareholders, and outrage among the public[31] Given the significant rewards that executives accrue over the course of their career there is no clear case for them to receive pay-offs that represent a uniquely generous package in comparison to any other employee (who would typically receive salary in lieu of notice - usually around three months). However, the practice of paying large exit payments to departing executives, as compensation for foregone earnings, has become embedded in corporate practice. Shareholders currently have limited leverage on this issue because they have no role in negotiating or agreeing executive contracts and it is these contracts which make provision for such payments.

28. Over the last five years, corporate governance regulation has been amended to try and address this. A 2008 amendment to the Companies Act 2006 introduced the requirement that compensation payments to outgoing directors be put to a shareholder vote, as should contracts of more than two years in length. In 2008, regulations were amended to require that notice periods of directors be included in the annual remuneration report (DRR), and in the most recent revision of the UK Corporate Governance Code (2010), companies are advised to adopt one year contracts for directors. Institutional shareholders have also issued good practice guidance on this issue, stating that: *"It is unacceptable that poor performance by senior executives, which detracts from the value of an enterprise and threatens the livelihood of employees, can result in excessive payments to departing directors. Boards have a responsibility to ensure that this does not occur."*[32]

29. Although most companies have now moved to one year rolling contracts and all are required to disclose the severance terms of these contracts within their remuneration report, there continue to be examples of extended notice periods and substantial exit payments for outgoing directors. The mandatory shareholder vote on compensation payments, (section 215-222 Companies Act 2006), applies only to those made over and above that which the executive director is contractually entitled to. It therefore excludes payments made as part of the company's contractual agreement giving remuneration committees a great deal of latitude over what is paid out.

30. Although payment in lieu of notice need not consist of anything beyond base salary, it is frequently the case that this includes other elements of pay. Around three quarters of executive contracts allow for the discretion of the remuneration committee on the matter of termination payments above base salary (with the remainder containing 'liquidated damages' clauses spelling out exactly how much the departing executive would be entitled to). Owing to the complexity of remuneration, these pay-offs can be correspondingly complex. They can include bonus that would have been earned that year and long-term incentives that would have accrued. In some cases these additional benefits are pro-rated for performance and service, in others they are paid in full regardless. In some (less common) circumstances this can also

[30] Conyon, Martin and Graham Sandler (2010), "Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK", Corporate Governance: An International Review, 18(4), pp. 296-312.

[31] BT's CEO of Global Services left with a £1.6m 'golden parachute' in 2008 despite very poor performance. The company was contractually bound to pay out. http://www.information-age.com/channels/it-services/news/1048482/disgraced-bt-global-services-boss-payment-for-failure-criticised.thtml; Fred Goodwin's pension top-up, compensating him for the pension he would have earned had he stayed at RBS until the age of 60, was part of a contractual entitlement.

[32] http://www.ivis.co.uk/ExecutiveContractsAndSeverance.aspx

include very expensive pension top-ups. Where the remuneration committee has discretion it is able to consider the terms under which the individual is departing (as a 'good' or 'poor' performer) and reward accordingly. The level of discretion available to the remuneration committee places departing executives in a strong negotiating position to secure a favourable deal.

31. The legislation introduced to address this issue has not served to prevent excessive termination payments. Many shareholders and business leaders have called for this legislation to be amended to provide for greater scrutiny of contractual terms and for more transparency around exactly how much executives could receive in the event of early termination of their contract. In response to our discussion paper on executive pay, one major investor noted that: *“The levels of discretion non-executive directors have in determining whether an executive is a good-leaver or otherwise can be problematic...There is arguably an insurance policy (in some cases) for directors to take on disproportionate levels of risks to meet highly charged bonus targets, all the while knowing that if things go wrong their personal wealth is insured if their contract is terminated."*

II. Rationale for intervention

32. Pay policies which do not appropriately link executive pay to company strategy and performance have an economic cost through diminished shareholder returns, weakened corporate governance and reduced confidence in the corporate sector.

33. In response to a series of consultations on this and related issues, and in our discussions with them, business leaders, business representatives, investors and leading academics now agree that there is a problem of rising executive pay which is not linked to performance. For example, a survey[33] of 20 UK-based investors in late 2011 found strong support amongst interviewees for the notion that executive remuneration is disproportionately high relative to performance. When asked whether executive pay has "become disproportionate to company profits and should [...] be reduced when the performance of the business does not meet expectations", out of the 17 respondents, 16 said "yes" while 1 said that the issue required a case-by-case approach. Key stakeholders have also made their views known:

> "*What is unacceptable is soft targets delivering high returns.*" **Roger Carr, President of the CBI, June 2011**
>
> *"One, we need business to show greater transparency – the public need to see [pay] figures that they understand. Two, companies need to demonstrate that rewards are for stellar performance, not for just doing the day job."* **John Cridland, Director General of the CBI, Nov 2011**
>
> "The simple truth is that remuneration schemes have become too complex and, in some cases, too generous and out-of-line with the interests of investors." **Dominic Rossi, chief investment officer of equities at Fidelity, Jan 2012**

34. While this is primarily an issue for companies and their shareholders, there is a consensus that - given the existence of a well-established market failure in this area[34] - Government has a role to play in increasing transparency and improving leverage for shareholders on pay matters. As such, the Prime Minister and Business Secretary have committed to doing more to empower shareholders.

35. The Government is therefore proposing a package of measures to address these failings which include:

(i) Greater transparency on pay reports including splitting the report in two parts:
- proposed future policy and potential payouts
- how policy has been implemented in the previous year and actual payouts

(ii) Empowering shareholders with stronger voting rights including the following possible options:
- a binding vote on future pay policy
- advisory vote on implementation of pay policy
- a binding vote on termination payments
- requiring a higher level of shareholder support on pay-related resolutions

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[33] Corporate Governance Survey, The Share Centre, Nov 2011, prepared by Richard Davies Investor Relations Limited.

[34] See Jensen, Michael and Meckling, William, (1976) "Theory of the Firm: Managerial Behaviour, agency costs, and ownership structures", ,*Journal of Financial Economics* vol 3, 305-360 and **La Porta, R., Lopez-de-Silanes, F., Shleifer, A and Vishny, R**., (2000) "Investor Protection and Corporate Governance" *Journal of Financial Economics* vol 58 pp 3-27.

(iii) Changes to the Corporate Governance Code to increase the diversity and independence of Boards and Remuneration Committees
(iv) Investor and business best practice on the setting and oversight of pay

36. This package has been widely supported including by business organisations such as the CBI and IoD, investor organisations such as the ABI, NAPF as well as individual investors like Fidelity and L&G. The proposed measures will give shareholders more leverage to challenge executive remuneration packages. Ultimately it is hoped that these measures, along with others to be introduced later this year will improve the link between corporate pay and performance to the benefit of the UK economy.

37. The evidence provided above shows that many of these problems are most acute in the very largest companies -particularly FTSE 100 - although practice in the FTSE250 tends to follow suit. However, we propose that these measures should apply to all quoted companies, as is the case for the current regime. The term ‘quoted company' is a recognised term in company law. Distinguishing between sub-sets of quoted companies according to their market listing or any arbitrary size threshold would be legally challenging as the FTSE classifications are updated several times a year. We intend to raise these issues in our forthcoming consultation and seek views on how widely these measures should apply.

Policy objectives

38. Together, we believe that these legislative and non-legislative proposals will give shareholders real leverage on executive pay. Shareholder empowerment lies at the heart of the UK's corporate governance framework and these reforms are consistent with that approach. Empowering shareholders with stronger voting rights will enable them to promote a stronger, clearer link between pay and performance and to clamp down on rewards for mediocrity or failure, while still allowing for exceptional performance to be rewarded. Companies will be encouraged to be proactive in designing pay policy which is acceptable to shareholders and to respond appropriately to shareholder challenges to executive pay.

39. A successful outcome for the reform to shareholder voting rights would be a greater level of shareholder engagement and satisfaction with pay packages and an improved link between pay and performance. We will measure this though levels of shareholder voting against remuneration reports and by testing stakeholder views as well as monitoring the quality of remuneration reports and the relationship between pay and performance. There is no prior assumption that these measures will directly reduce the overall quantum of executive pay, although a result of a stronger link between pay and performance could be that average pay levels fall or cease to rise as quickly as they have in the last decade.

Coverage of this Impact Assessment

40. This impact assessment covers the second part of the package outlined above, **empowering shareholders with stronger voting rights**.

41. Changes to transparency of pay reports were subject to a consultation stage IA: BIS 0284 (Narrative Reporting). We intend to submit a final stage IA in relation to these elements in the summer. Changes to the Corporate Governance Code are the responsibility of the Financial Reporting Council who will be consulting formally later this Spring. The other, crucial elements of the package are non-regulatory.

III. Description of options considered (including do nothing);

Option 1 (Preferred option): Significant strengthening of shareholder rights including:

- **binding vote on future pay policy (potential payouts)**
- **advisory vote on implementation of policy in previous year (actual payouts)**
- **binding vote on notice periods exceeding one year and exit payments exceeding a year's salary**

Binding vote on future pay policy

42. The proposed changes to reporting on executive pay (i.e. splitting the remuneration report into: (a) future policy (potential payouts); and (b) how policy has been implemented in the previous year and actual payouts) make way for a new voting model. This will involve giving shareholders a binding vote on future policy, enabling them to approve the proposed structure of executive pay, how it will be determined in line with performance and what the overall quantum could be under different scenarios.

Advisory vote on implementation of policy in previous year

43. Shareholders would retain an advisory vote on the backwards looking section of the report – allowing them to signal whether they are content with how the previously approved policy has been implemented, particularly where the remuneration committee has used its discretion.

Binding vote on notice periods exceeding one year and exit payments exceeding a year's salary

44. Shareholders' power to influence executive pay would be extended in two further areas: directors' notice periods and exit payments for new contracts.

45. Companies in the UK are not currently obliged to consult shareholders on directors' notice periods unless a director is entitled to a notice period of two years' pay or more, although the UK Corporate Governance Code indicates that best practice should be notice periods of no more than one year. It is proposed that the existing best practice be set out as a legal requirement in order to establish a level playing field and give shareholders more say in limiting potential payouts.

46. We also propose to consult on giving shareholders a binding vote on any exit payments which exceed the equivalent of one year's base salary. This measure was introduced in Australia in 2009, where companies are also permitted to seek advance approval to pay benefits over the limit. A recent report shows that median termination payments for Australian CEOs have since fallen but it is too early to link this clearly to the change in legislation rather than more cyclical impacts.

Option 2: Give shareholders a single binding vote on the remuneration report as a whole (future policy and actual payouts)

47. This is ostensibly a simpler structure, requiring fewer changes to the existing legal framework as it would simply replace the current advisory vote on the remuneration report with a binding one. Companies would have to act if a majority (over 50%) of shareholders voted against the report.

Option 3: Status Quo

48. This would represent the current position where shareholders have an advisory vote on the remuneration report.

Sub-option A: Requiring a higher level of shareholder support on pay-related resolutions (could be applied to any of the above)

49. The evidence and feedback from shareholders has led us to question the level of support that should be required for a remuneration vote to be carried.

50. For matters that are less routine or of particular importance, such as changes to the articles of a company, disapplying pre-emption rights on the issue of shares or a switch from being a private to a public company, companies are required to put a 'special resolution' to shareholders. To be passed, this type of resolution must be supported by 75% of those votes cast. We propose to consult on whether the vote on the remuneration report and any vote on notice periods and exit payments should require a special resolution of this kind.

IV. Analysis of options: costs and benefits

Option 1 (Preferred option): Significant strengthening of shareholder rights including:

- **binding vote on future pay policy (potential payouts)**
- **advisory vote on implementation of policy in previous year (actual payouts)**
- **binding vote on notice periods exceeding one year and exit payments exceeding a year's salary**

Binding vote on future pay policy

51. **Benefits -** A binding vote on pay policy would give shareholders more power to influence the design of remuneration within companies from an early stage and enable them to agree the framework for actual payouts.

52. This will allow shareholders to better hold companies to account and ensure a stronger link between pay and performance. It is possible that better aligned remuneration packages could lead to lower levels of executive pay on average relative to the counterfactual (a company benefit) but this cannot be assumed and will very much depend on the outcome of individual company negotiations with shareholders and is therefore unlikely to be quantifiable at an aggregate level.

53. Where shareholders' influence leads to remuneration packages that are more closely aligned to rewarding long-term sustainable performance, this could have a positive impact on the behaviour of executives by reducing the risk of perverse incentives.

54. In the Netherlands, where shareholders have been entitled to a binding vote on major changes to remuneration policy since 2004 there is some evidence of greater levels of engagement between companies and shareholders. Evidence provided to us in response to the earlier discussion paper suggested anecdotal evidence that there appears to be a stronger tendency for Dutch listed companies to engage with shareholders prior to shareholders' meetings, although the extent to which individual companies consult with shareholders varies. Furthermore, a 2007 study by Groningen University, conducted on behalf of the Dutch Corporate Governance Code Monitoring Committee, finds a positive correlation between shareholder value and remuneration, particularly with respect to the award of shares and stock options. It should be emphasised, however, that this may not necessarily reflect a causal relationship.

55. In practice we do not anticipate a large number of remuneration reports would be voted down (as now) but would expect that the threat of a binding vote would put pressure on companies to act early to ensure shareholder support and to be more open and transparent with respect to setting executive remuneration packages. This should lead to reduced agency costs for shareholders as companies are more likely to propose acceptable remuneration packages that require less engagement. As part of the consultation we will discuss further with shareholders how it might be possible to quantify such savings.

56. The effectiveness of the policy will depend on the willingness of shareholders to engage with companies and use the leverage provided by the binding vote

57. **Costs** – Our conversations with stakeholders suggest that there are no direct costs to companies of having a binding vote rather than an advisory vote and no more than a negligible increase to the cost of the AGM of having additional votes on the order paper.

58. Indirect costs to companies are likely to include greater consultation with shareholders and their advisers to ensure pay policies are acceptable. Again the impact of this will vary greatly from company to company and year to year. Many companies will already be undertaking significant engagement with shareholders so will have to devote very little additional effort. Where this engagement identifies significant shareholder concerns, companies will have the choice of either amending their remuneration policy (which might result in lower remuneration levels, more stringent performance targets or closer alignment with company performance) or greater levels of engagement with shareholders to try and persuade them to support the proposed policy. This is no different from the current system.

59. In the event that this engagement proves unsuccessful (or the company chooses not to engage at all) and the binding vote on remuneration policy is lost the company will have two options. It may choose to fall-back on the existing policy or face the additional cost of revising the proposals and holding an EGM and another shareholder vote.

60. In practice we expect that very few companies will be forced into an EGM given that such a long and drawn-out public disagreement between company management and their shareholders is likely to lead to uncertainty and a falling share price which both sides would wish to avoid. Any indication that a significant negative vote may occur is likely to trigger conversations between shareholders and management to try and resolve the situation as quickly as possible.

61. Some commentators have suggested that a tightening in regulation with respect to executive pay might put the UK at a competitive disadvantage in the international market for CEOs with consequential impacts on company performance. However, the measures to be implemented will not limit pay for performance and shareholders will continue to have the discretion to agree executive remuneration packages that meet the needs of the company's situation.

62. It should also be noted that the UK has led the way over the last ten years in promoting shareholder empowerment in the area of executive pay without any obvious detrimental impacts on our ability to attract talented CEOs. Many countries, including the US and Australia, are now implementing similar measures to give shareholders greater power to tackle the problem of excessive pay for poor or moderate performance.

63. The precise impact of the move to a binding vote is unknown because it depends to a large extent on behavioural reactions and the quality of the relationship between a company and its investors. The uncertainty over the likely outcome of this process makes it extremely difficult to monetise any possible costs to companies but we will discuss this further during the consultation period.

64. Risks from this extension of the current regulatory framework include the possibility that shareholders choose not to vote down a remuneration report because of the reputational risk and associated costs of the company losing a vote and the possibility that company boards feel too constrained to offer attractive pay packages. Stakeholder discussions to date do not suggest that either of these risks is likely to materialise but we will be working with them during the consultation period to better understand these and other possible costs and unintended consequences.

Advisory vote on implementation of policy in previous year

65. **Benefits** – An advisory vote on the backwards looking section of the report (including actual payouts for the previous year) would allow shareholders to signal whether they are content with how the previously approved policy has been implemented, particularly where the

remuneration committee has used its discretion. No payout would be contingent on the outcome of the vote, although it would send a message to management on whether shareholders are happy.

66. In effect, this would be a continuation of the power that shareholders already have (although our parallel reforms to the content of remuneration reports will mean that shareholders have the aid of more transparent information about what has been paid out and why). The fact that shareholders will have been engaged on agreeing the policy in advance should ultimately mean that the outcome (in the form of payouts) is less of a surprise and therefore requires less time spent on engagement with the company.

67. **Costs** – No additional direct cost.

<u>Binding vote on notice periods exceeding one year and exit payments exceeding a year's salary</u>

(i) <u>Notice periods</u>

68. **Benefits** – Service contracts determine the notice period for executives and therefore the obligation of the company to pay salary in lieu of notice when an individual's contract has been terminated prematurely. The benefit of this would be to mitigate against excessive termination payments**.**

69. **Costs -** The costs of this measure would be minimal. Companies would either reduce the length of service contracts (at no cost) or seek shareholder approval. As is the case with the current legislation in this area, approval may be sought via a written resolution to shareholders along with details of the proposed contract, so there would be no need for a shareholder meeting. We will use the consultation to seek more data on the costs and benefits.

<u>(ii) Exit payments</u>

70. **Benefits -** The benefit of this measure would be to give shareholders a real say over payments for failure. It would also help to reduce drawn out negotiations between companies and departing executives. In the event that a company sought approval at the AGM for a payment above one year's salary, there may be a delay before the non-salary payment could be made but this would have the additional benefit of allowing for the company's performance over the year to be confirmed.

71. Again the aggregate impact on total remuneration payments is uncertain and therefore unmonetised at this stage. In the consultation we will seek further views on this.

72. **Costs -** There would be a minimal cost to the company in the event of seeking shareholder approval at the AGM for an exit payment above one year's base salary. As part of the consultation we will seek feedback on and evidence to support what the threshold for seeking shareholder approval should be and whether companies should be able to seek advance approval, as is the case in Australia.

73. An impact of this proposal could be to lead to an increase in base salary, to compensate for lack of bonus and incentives in a departing executive's package. However, this would require an increase to *all* executives' salaries and companies will have to justify this. Our proposals on improving transparency, including on the quantum of pay, and to give shareholders a binding vote on future policy (including salary increases) lead us to conclude that this risk is not significant.

Option 2: Give shareholders a single binding vote on the remuneration report as a whole (future policy and actual payouts)

74. **Benefits** – On the face of it this seems an attractive option as it appears to strengthen shareholders' power to hold companies to account. It would give them a veto over actual payouts as well as future policy. It is also simpler as there would be one vote on the report instead of two.

75. **Costs** - Changing the nature of the existing vote to give it a binding effect on the entirety of the pay report is by no means straightforward and there are various practical issues that arise.

76. A binding vote on all pay and remuneration policy would mean that, in the event of a vote against, the board would be required to put revised proposals back to shareholders at an EGM. This would create uncertainty around the status of payments already made and vested and could require renegotiation of contracts and potentially, some executives to make repayment.

77. This could be made possible by writing into all future contracts that all pay is subject to shareholder approval but the fact that tax and national insurance may already have been paid on the sum adds further complexity and the whole area would become a legal minefield. When recruiting executives, the remuneration package offered would have an extra element of uncertainty to it, which could actually have the perverse effect of pushing up pay. Some companies have highlighted that the uncertainty could make it harder to recruit from overseas, impact on director mobility and put the UK at a competitive disadvantage. It is likely that, rather than empowering shareholders to challenge remuneration policy, they would in fact be hesitant to do anything that could have a damaging effect the company and its share price.

78. Uncertainty over how exactly companies and shareholders might respond to the availability of a binding vote on the overall pay report makes it difficult to monetise any possible costs and benefits most of which will be indirect. Direct costs of the proposal will be the same as for Option 1 but without the need for an additional shareholder vote at the AGM.

Option 3: Status Quo

79. **Benefits** – No change for companies and shareholders.

80. **Costs** - It is possible that the other measures the Government is pursuing to improve transparency and promote good practice could encourage greater shareholder activism and improve pay-setting practice, but the continuation of an advisory vote would allow companies the ability to ignore shareholder concerns where they exist. This will mean continued and possibly increasing agency costs of operating in a corporate governance structure that fails to provide satisfactory arms-length bargaining arrangements that safeguard shareholder interests..

Sub-option A: Requiring a higher level of shareholder support on pay-related resolutions (could be applied to any of the above)

81. **Benefits** -One benefit of this would be to encourage companies to improve their engagement with shareholders on the issue of pay, so as to secure sufficient support to pass the vote. Given that over 40% of UK shares are now held by overseas investors, and that the UK shareholder base is increasingly fragmented (many investors have holdings spread across hundreds of companies), this measure would also give more power to those shareholders that are actively engaged in challenging on pay. This may in turn encourage more shareholders to

play an active role.

82. **Costs** - There would be a potential cost for those companies that had to increase their shareholder engagement activity, and for shareholders that choose to increase their corporate governance. However, this would be consistent with the direction of existing Government policy designed to improve engagement between companies and their long-term owners.[35]

83. Ultimately we would expect a strengthened shareholder regime to lead to better corporate governance in UK companies which is associated with lower costs of capital.

Summary of Costs and Benefits of Policy Options

84. As set out above Option 1 would provide the greatest strengthening in shareholder rights and appears, from its implementation in other countries and preliminary discussions with stakeholders, to have limited costs. Any potential cost can be mitigated by companies engaging more effectively with shareholders. The behavioural impact of option 1 is to some extent unknown and there is the possibility of unintended consequences which we will explore further with stakeholders during the consultation period.

85. Option 2 would provide similar benefits to option 1 but the binding vote on the retrospective element of the remuneration report would run the risk of additional costs for companies who might face legal challenge and possible unintended consequence of higher executive remuneration if executives demand compensation for increased uncertainty.

86. Option 3 represents the least change for companies and shareholders to adjust to but would not alter the balance of power between shareholders and companies (even in conjunction with sub-option A) and so is unlikely to bring about change.

87. Sub-option A would (when combined with options 1 or 2) give greater power to actions of long-term shareholders and create more impetus for companies to secure their support on remuneration issues. Detailed discussions with key stakeholders, including the corporate sector, will be needed during the consultation period to better understand the likely consequences.

88. All options will depend for their effectiveness on shareholder engagement and the use of these regulatory powers in a meaningful manner.

Rationale and evidence that justify the level of analysis used in the IA (proportionality approach)

89. The IA draws on a significant amount of evidence that has been provided to the department by a wide range of stakeholders including companies, shareholders, remuneration consultants and academics, either as part of formal or informal written consultations (e.g. Long Term Focus for Corporate Britain[36] (September 2010), Narrative Reporting consultation[37] (September 2011), Executive Pay Discussion Paper[38] (July 2011) and the Kay Review[39] (September 2011) or through more informal stakeholder engagement that has taken place over the last six months. Much of this evidence has been focused on identifying the problems in the setting of executive remuneration and identifying possible measures to improve the current situation. However, this IA and consultation represents the first opportunity to explore with stakeholders in detail the likely impact of the specific proposals on new voting powers for shareholders, as set out here. We would therefore expect in the final stage IA to be more

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[35] See: A Long Term Focus for Corporate Britain; FRC Stewardship Code, Kay Review of Equity Markets

explicit about the likely costs and benefits of the proposals and in particular any unintended consequences of a move to a binding vote or change in the voting threshold.

Risks and assumptions

90. As set out in the discussion on page 14, the regulatory measures included within this IA represent only one small element of the overall package of measures we believe is necessary to enable change in this area. As the Secretary of State for Business made clear to parliament on announcing this package, lasting reform also depends on active shareholders and responsible businesses accepting the need for change and pushing the agenda forward.

91. There is clearly therefore a risk that the measures included in this IA will not be as effective as anticipated if other elements of the package are not fully implemented or adopted by companies and shareholders in the way we expect; or if a behavioural shift does not take place of the type and scale which is necessary.

92. There is a risk that shareholders will shy away from using these new powers if they fear the possible consequences of a remuneration vote being lost. However, under the preferred option (1) the practical consequences are minimal and shareholders have already shown (through the advisory vote) that they are willing to send a strong signal by voting against management. As set out above we believe that companies and shareholders will mostly try to prevent this situation from arising through extensive engagement prior to the vote but we do expect shareholders to exercise these powers where they are needed to leverage intransigent management.

93. A further risk from the proposal to change the voting threshold is that it will place excessive power in the hands of a minority (see sub-option A) of shareholders who will use it to pursue their own ends rather than the wider shareholder base. That is why this package of measures will be complemented by a programme of engagement with companies and major UK investors to identify and promote good practice. There are already signs that institutional investors are becoming more interventionist on the issue of remuneration and that large companies recognise the current trend is not sustainable.

94. As discussed on page 20, a small number of stakeholders have highlighted the risk of creating an environment where UK firms are at a disadvantage when recruiting internationally. We believe this risk is minimal given that companies will retain the ability to reward for excellent performance and the UK is by no means alone in recognising and addressing issues with executive remuneration.[40]

Direct costs and benefits to business calculations including OIOO considerations

95. At this stage of policy development process we have been unable to identify any costs and benefits that might be monetised as a result of the potential regulatory tightening in options 1 and 2 and sub-option A but have assumed that it qualifies as an “in” under the OIOO methodology.

96. There may be some indirect costs if companies lose a vote on their remuneration policy and have to hold an EGM for an additional vote. However, as set out above it is expected that companies will do everything they can to avoid the reputational impact of losing a vote and incurring this additional cost and inconvenience. We will be consulting further on this matter.

97. Most of the cost impacts are therefore likely to be indirect (e.g. greater levels of engagement by companies with their shareholders) and will depend to a great extent on how

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[36] http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain

[37] http://www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation

[38] http://www.bis.gov.uk/Consultations/executive-remuneration-discussion-paper

[39] http://www.bis.gov.uk/Consultations/kay-review-call-for-evidence-uk-equity-markets

[40] ‘Executives asked to take stock on salaries’ (Australia) http://www.abc.net.au/news/2011-10-11/executives-take-stock-of-pay-packets/3499354/?site=sydney ; ‘CEO pay soars while workers’ pay stalls (US) http://www.usatoday.com/money/companies/management/story/CEO-pay-2010/45634384/1

quoted companies are dealing with executive remuneration issues now, including the resources they devote to corporate governance engagement. These regulations will only apply to those companies that choose to list on a public market and qualify as “quoted” under the company law regime (currently around 1,100 medium and large companies). As such they choose to subject themselves to higher levels of scrutiny and regulation and consequently benefit from lower costs of capital.

98. In particular, these measures are likely to impact most on the very largest UK quoted companies (particularly those in the FTSE 350) where these issues are currently causing most concern. These companies generally already devote significant resources to corporate governance activities and we do not expect these measures to significantly add to that cost. We expect from initial stakeholder discussions that the impacts on smaller quoted companies will be minimal. However, we will be consulting further on the likely costs and benefits of the measures, particularly in relation to the proposals around changing the voting threshold, and any possible unintended consequences.

Wider impacts

99. We will be consulting with stakeholders on likely wider impacts and any possible unintended consequences of the policy proposals.

100. As the policy proposals apply to the largest public companies we do not believe that there will be any diversity, gender or human rights impacts of these proposals. The proposals apply only to quoted companies so no microbusinesses are within scope.

Summary and preferred option with description of implementation plan

101. For the reasons set out above option 1 represents our preferred option to tackle the identified failure in corporate governance of executive pay. This significant strengthening of voting rights will enable shareholders to have a real impact on executive remuneration policy and to bring it more in line with performance.

102. We believe this is a proportionate response to a well-recognised problem that shareholders and other stakeholders require Government to act upon. The proposed changes to shareholder powers should be in the context of a wide package of largely non-regulatory measures.

103. It is not Government’s role to micro-manage company pay and hence we have ruled out direct regulatory intervention in the structure or quantum of remuneration. We believe that the proposals are likely to command widespread stakeholder support and do not appear to impose any significant costs on companies. Indeed, reactions to the package thus far have demonstrated that both the investors and business welcome the package:

> *“We have been clear that executive pay must always be fair and transparent, and that high pay must be for outstanding, not mediocre, performance. Millions for mediocrity does a disservice to the reputations of hard working businesses. ...The CBI strongly supports measures to reduce, withhold, or in exceptional circumstances claw back executive pay as it sends a powerful message to future executives. And it is right that remuneration committees should take into account the organisation’s broader pay strategy when setting executive pay....It is encouraging that some of the heat has been taken out of this issue by government coming up with some practical proposals.”* **John Cridland, CBI Director-General**, **23 Jan 2012**

> *"Greater simplicity and transparency in the reporting of executive pay is urgently needed. A binding shareholder vote on executive remuneration policy will remind institutional investors of their key governance responsibilities. The Government is also right to consider ways in which boards of directors can become more diverse - companies must incorporate views beyond those of current and former executives in*

the setting of chief executives' pay." **Dr Roger Barker, Corporate Governance, Institute of Directors, 23 Jan 2012**

"Greater transparency and simpler pay structures are a must. Boiling all the pay awards and bonus options down to a single figure will help shareholders hold executive pay up to the light." **Joanne Segars, Chief Exec, National Association of Pension Funds, 23 Jan 2012**

"This is a welcome package of measures which, taken overall, will help shareholders establish stronger links between pay and performance and tackle excessive pay for failure. Investors want simpler pay structures, better accountability to prevent reward for failure and greater transparency on how rewards are calculated, including by consultants. This is a step forward on all three fronts." **Otto Thoresen, Director General ABI, 23 Jan 2012**

104. Following this consultation we intend to bring forward primary legislation to make the necessary changes to the Companies Act 2006. Subject to parliamentary time, this will be included in the next parliamentary session. The legislation will come into force in 2013 and have an impact on shareholder voting from 2014.

105. Prior to introducing legislation we will update this impact assessment to reflect the evidence and data received through the consultation period. During the consultation we plan to host a series of consultation events alongside seeking written responses.

Enforcement

106. Enforcement will continue as now through a combination of shareholder oversight and more formal monitoring by the FRC with respect to the UK Corporate Governance Code.

Post Implementation Review

107. The measures put forward in this IA represent only one of part of a much larger package of proposals to tackle issues around executive remuneration, many of which are non-regulatory in nature and require shareholders and companies to change their behaviour. We will be working with stakeholders over the next few years to ensure a smooth implementation of the policy proposals and ensuring in particular that the regulatory elements, including the binding vote are working as intended.

108. As set out above in paragraph 39 we would expect the success of this policy to be reflected in higher levels of shareholder engagement, greater satisfaction with executive remuneration packages and a more discernible link between executive pay and company performance.

ANNEX A

Summary of the evolution of company law reporting requirements on directors' remuneration

Section 148 of the **1929** Companies (Consolidation Act) required companies to furnish information on remuneration of directors to shareholders 'on demand'.

Section 196 of the Companies Act **1948** required a company's accounts to show:-
(a) the aggregate amount of the directors' emoluments;
(b) the aggregate amount of directors' or past directors' pensions; and
(c) the aggregate amount of any compensation to directors or past directors in respect of loss of office.

The Companies Act **1967** section 6 required the accounts to show the emoluments of the chairman, and in respect of the directors, in bands of £2.500, the numbers whose emoluments fell within those bands.

The Companies Act **1985** consolidated and reformed company legislation. The bands for directors' pay were uprated to commence at £5,000, and bands of £5,000.

In **2002** a new section was inserted into the 1985 Act which gave effect to a new Schedule 7A. That schedule required quoted companies to produce a **directors' remuneration report** for each financial year. The schedule set out the details of the report. The regulations also provided for a new section 241A of the Companies Act 1985 which gave the members the **right to an advisory vote** on the remuneration report.

The latest consolidation and reform of company legislation was the Companies Act **2006**. The provisions for all companies other than quoted companies now appear in section 412. The provisions on quoted companies are in section 420 – 422 and section 439 (members' vote). The details of the remuneration report are now set out in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations **2008**, Schedule 8.