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U.K. Announces Proposals Intended to Curb Executive Compensation

On June 20, 2012, the U.K. Secretary of State for Business, Innovation and Skills Vince Cable announced a package of proposals following the U.K. government's publication of a consultation paper in March and a consultation period that ended in April. The proposed measures, intended to curb executive pay, include:

- a *binding* shareholder vote on the company's policy regarding compensation (including "exit payments") of directors, including executive directors;
- continuing the annual advisory shareholder vote on how the company's pay policy was implemented in the previous year;
- enhanced compensation disclosure, including disclosure of a "single figure" for the total pay that directors received for the previous year; and
- consultation by the Financial Reporting Council regarding proposed changes to the U.K. Corporate Governance Code, which is applicable to all companies with a Premium Listing of equity shares in the U.K.

The impetus behind these measures is presumably the rising levels of executive compensation in the United Kingdom (according to recent press reports, the remuneration of FTSE 100 CEOs has quadrupled since 1998 from an average of £1 million to £4.2 million), and it appears that the Secretary was emboldened by the so-called "shareholder spring" targeting perceived excessive pay. Already, an unprecedented six companies – a number of them household names – have seen support levels of less than 50 percent in favor of their remuneration policies. Press reports indicate that failed votes have even led to executive departures.

While the U.K. government's measures would certainly represent a significant departure from current practice, they are not as draconian as the March consultation paper might have suggested. For example, the U.K. government determined that the binding vote could be held on a triennial, rather than an annual, basis, and it dropped its original proposal that exit payments be capped at one year's base salary, absent shareholder approval. In addition, it declined to mandate that shareholders approve pay policies by a 75 percent supermajority vote, and it also decided not to impose a maximum ratio between the lowest and highest paid employees at a company.

Applicable Companies

It is expected that these measures, if adopted, would apply to all U.K.-incorporated quoted companies (the March consultation paper notes that there were over 1,000 such companies listed on the London Stock Exchange's Main Market as of January 31, 2012, plus another 100 or so such companies listed elsewhere). Accordingly, a U.K.-incorporated company that is listed on the New York Stock Exchange, Nasdaq or in a European Economic Area state would not necessarily be insulated from these changes simply by virtue of not being listed in London. The current regime of non-binding shareholder votes on directors' remuneration reports already applies to U.K.-incorporated quoted companies, and the consultation paper made the point that the changes "represent an evolution of current practice and not a wholly new process." However, given the concern over the anti-competitive effect that this could have on U.K.-incorporated quoted companies (which might even seek to redomicile elsewhere), it remains to be seen to what extent any changes along these lines will be implemented more broadly through other means, such as through the requirements of the U.K. Corporate Governance Code, the UK Listing Authority or the index inclusion rules.

New Binding Vote on Pay Policy

As in the United States, the U.K.'s say on pay vote is currently limited to a shareholder advisory vote on the compensation of the executive directors (through the approval of the directors' remuneration report). The vote is retrospective in that it relates to the prior year's compensation. Under the proposed measure, companies would be subject to a *binding* vote on the compensation of directors, including executive directors, which would require the support of a simple majority of shareholders. Companies would be required to disclose their proposed pay policy, including potential payments and the use of performance metrics, as well as the calculation of exit payments. Once approved by shareholders, companies would be required to act within the policy and would not be able to make payments outside the scope of the policy.

Each company's policy report would contain the following elements:

- tabular disclosure of the key elements of pay and supporting information, including how each supports the achievement of the company's strategy, the maximum potential value and performance metrics;
- information on employment contracts;
- scenarios for what directors would get paid for performance that is above, on or below target;
- information on the percentage change in profits, dividends and overall spending on pay;
- the principles on which exit payments would be made, including how they would be calculated, whether the company would distinguish between different kinds of departures or the circumstances of any exits and how performance would be taken into account; and
- material factors that have been taken into account when setting the pay policy, specifically employee pay and shareholder views.

The vote would be required at least once every three years, unless a company chose to change its pay policy, in which case shareholder approval would be required.

If a company were to fail the binding vote, it would need to continue using the existing policy until a revised policy were approved by shareholders. Companies would have the choice of either convening an extraordinary general meeting to put forward a revised policy or waiting until the annual general meeting to do so.

Continued Advisory Say-on-Pay and Enhanced Disclosure

Shareholders will continue to have an annual advisory say on pay vote on the implementation of the company's pay policy, including actual amounts paid in the previous year. Under the proposal, each company's implementation report would contain the following items:

- single total figure of remuneration for each director;
- performance against metrics for long-term incentives;
- total pension entitlements (for defined benefit plans);
- exit payments made in the previous year;
- variable pay awarded in the previous year;
- total shareholdings of directors;
- a chart comparing company performance and CEO pay;
- information about who has advised the remuneration committee; and

- shareholder context.

The proposed “single figure” is intended to be comprehensive and would cover all types of compensation received by directors in the previous year, including fixed and variable elements, as well as pension benefits. For this purpose, variable pay would be calculated as annual pay earned, rather than potentially awarded, including full bonuses paid for the reporting period and long-term incentives for which the reporting year is the last financial year of the performance cycle.

If a director were to leave a company, the company would be required to publish a statement promptly, setting out exactly what the director had received. Exit payments would also need to be reported in the foregoing implementation report and subject to the advisory vote.

If a company were to fail the advisory vote, it would be required to re-seek shareholder approval of its overall pay policy in a binding vote the following year.

Proposed Consultation Regarding Changes to the U.K. Corporate Governance Code

The U.K. Corporate Governance Code sets forth standards of good practice with respect to board leadership and effectiveness, remuneration, accountability and shareholder relations. All companies with a Premium Listing of equity shares in the U.K. are required under the Listing Rules to report on how they have complied with the Code in their annual report and accounts. The Financial Reporting Council, the U.K.’s independent regulator responsible for promoting high-quality corporate governance and reporting to foster investment, is responsible for the Code and has announced that it will consult on potential changes to the Code. One such proposed change is that, when a substantial minority of shareholders vote against a company’s pay policy, the company should publish a statement saying how it plans to address shareholder concerns. Other items subject to consultation will be the possible extension of the Code’s existing provisions on clawback arrangements and limitations on the practice of executive directors serving on the remuneration committees of other companies.

Next Steps

To introduce the measures discussed above, the U.K. government intends to bring forward amendments to the Enterprise and Regulatory Reform Bill, which is currently before Parliament. At the same time, the U.K. government intends to publish revised, simplified regulations mandating the disclosure of director pay. These regulations would be subject to public comment prior to becoming law. The U.K. government intends to enact these measures by October 2013.

Whether or not these measures are enacted, the media and others have already raised public policy questions, such as whether these measures will have the unintended consequence of handicapping U.K. companies when better times return; whether these measures will strike the right balance between focusing on individual and aggregate executive pay; and how the success of these “reforms” will be measured.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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