

EXECUTIVE PAY

Shareholder voting rights
consultation

MARCH 2012

Contents

Executive pay: shareholder voting rights consultation.....	4
Foreword from the Secretary of State.....	5
Executive Summary.....	6
1. Background.....	10
Government proposals on executive pay.....	10
Policy objective.....	12
Focus of this consultation.....	12
Scope.....	13
2. Binding vote on remuneration policy.....	14
Background.....	14
Proposal.....	15
Content of the remuneration report.....	16
Frequency of the vote.....	18
Consequences of the vote.....	18
Impact on service contracts.....	19
Impact on recruitment.....	21
Interaction with other votes.....	21
3. Level of shareholder support.....	23
Background.....	23
Proposal.....	24
Consequences of increasing the level of shareholder support required.....	24
4. Advisory vote on the implementation of remuneration policy.....	25
Background and proposal.....	25

Content of the remuneration report.....	25
Consequences of the vote	26
Interaction with other votes	27
5. Binding vote on exit payments	28
Background.....	28
Proposal.....	30
Consequences of the vote	31
Impact on service contracts	32
Binding vote on notice periods.....	33
Interaction with other votes	34
6. Summary of consultation questions	35
7. How to respond.....	36
Annex A: The Consultation Code of Practice Criteria	38

Executive pay: shareholder voting rights consultation

On 23 January 2012, the Secretary of State for Business, Innovation and Skills announced a package of measures to address failings in the corporate governance framework for executive remuneration. This includes:

- Greater transparency in directors' remuneration reports
- Empowering shareholders and promoting shareholder engagement through enhanced voting rights
- Increasing the diversity of boards and remuneration committees
- Encouraging employees to be more engaged by exercising their right to Information and Consultation Arrangements
- Working with investors and business to promote best practice on pay-setting

This consultation document provides more detail on a proposed model which will give shareholders greater influence on the issue of executive remuneration through enhanced voting rights. The main components of this are:

- An annual binding vote on future remuneration policy
- Increasing the level of support required on votes on future remuneration policy
- An annual advisory vote on how remuneration policy has been implemented in the previous year
- A binding vote on exit payments of more than one year's base salary

The purpose of this consultation is to seek evidence on the impact, costs, benefits and likely behavioural effects of the proposals. The Government's objective is to enable shareholders to promote a stronger, clearer link between pay and performance in order to prevent rewards for mediocrity or failure, while still allowing for exceptional performance to be rewarded.

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Respond by: 27 April 2012

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This consultation is of particular relevance to: companies and business organisations, executive and non-executive directors, shareholders and institutional investors, employees and employee representative organisations, academics, governance experts, lawyers and other advisors.

Foreword from the Secretary of State



Since the Government published a discussion paper on executive remuneration last autumn, the debate surrounding this issue has grown in intensity. The call for action has been loud and clear. As the responses to our paper showed, business leaders and investors recognise the issues: that the link between pay and performance has grown weak; and the constant, ratcheting up of executive pay is unsustainable.

There is a legitimate role for high pay for exceptional talent and performance, for successful entrepreneurs and excellent managers. But there is frustration all-round when the people running companies are handsomely rewarded for mediocrity or failure.

In January I announced a package of measures to address this issue through greater transparency, shareholder empowerment and employee engagement, and more diversity in board rooms. Together, these reforms will create a more robust framework within which executive pay is set, agreed and reported on.

Shareholders are at the heart of these reforms, just as they are at the heart of the UK's corporate governance system. The UK is widely seen as a leader on corporate governance and I believe that this is important for creating the environment for long-term, sustainable growth. It is appropriate that we respond to this issue by putting more information and power in the hands of the owners of companies.

This consultation document outlines our proposals for giving shareholders binding votes on executive pay. This will encourage shareholders to be more engaged and companies to listen to what they say. Our objective is to promote an improved dialogue between companies and those that invest in them and a greater symmetry between pay and performance.

I am inviting feedback on these proposals and I look forward to discussing them with businesses and shareholders over the coming weeks.

A handwritten signature in black ink, which appears to be 'Vince Cable'. The signature is fluid and cursive, starting with a large 'V' and ending with a long, sweeping tail.

VINCE CABLE

SECRETARY OF STATE FOR BUSINESS, INNOVATION AND SKILLS

Executive Summary

1. Last autumn the Government published a discussion paper exploring the issues around executive pay and inviting views on ways in which the link between pay and performance could be strengthened. The responses showed that business leaders, investors, academics, governance experts and a range of others now agree that there is a problem with rising executive pay which is not linked to performance.
2. While this is primarily an issue for companies and their shareholders, the Government has a role to provide an effective corporate governance framework for executive remuneration; particularly where shareholders lack the information and powers they need to hold companies to account. In January, the Secretary of State for Business, Innovation and Skills announced a package of measures to address these failings, including greater transparency and shareholder power.
3. This consultation document provides more detail on a proposed model which will give shareholders greater influence on the issue of executive remuneration through enhanced voting rights. This will apply to the remuneration of directors in UK incorporated quoted companies and includes:
 - An annual binding vote on future remuneration policy
 - Increasing the level of support required on votes on future remuneration policy
 - An annual advisory vote on how remuneration policy has been implemented in the previous year
 - A binding vote on exit payments over one year's base salary

Binding vote on future remuneration policy

4. The advisory shareholder vote on the directors' remuneration report, which came into effect in 2003, was designed to give shareholders an effective and more focused way in which to influence directors' pay. Whilst it is clear that in some cases, having a large proportion of shareholders withhold support for remuneration proposals has triggered a substantial re-thinking of policy, historical voting records, feedback from shareholders and anecdotal evidence suggest that not all companies are responding adequately to shareholder concerns.
5. The Government proposes to address the shortcomings of the current advisory vote by giving shareholders a **binding vote on a company's remuneration policy**. Companies will have to set out, at the start of the year, a proposed pay policy for the year ahead, including potential payouts and the performance measures that will be used. This will be put to an annual shareholder vote. Any proposed changes to remuneration policy for the forthcoming year will be contingent on the resolution being carried and companies will be required to act within the scope of the remuneration policy agreed by shareholders at the start of the year.
6. The vote on remuneration policy will enable shareholders to approve a framework for remuneration but it is likely that the ultimate outcome will still rely to an extent on the discretion of the remuneration committee. Although individual shareholders will have

different preferences over the level of detail they expect and how formulaic they wish to be on remuneration policy, the Government anticipates that most will see an important continuing role for remuneration committee discretion and flexibility and will want to allow for this within the pay policy.

7. The effect of introducing a binding vote on remuneration policy should be to encourage better quality engagement between companies and shareholders at an early stage in the process of devising remuneration policy. In the event that the binding vote on remuneration policy is lost, the company would have to fall back on the last policy to be approved or hold a further general meeting where shareholders would be asked to vote on revised proposals.
8. Existing contracts will need to be amended to ensure they are consistent with the requirement to seek shareholder approval for remuneration policy and in future, companies will need to avoid entering into any agreement with respect to remuneration which could give an individual director an entitlement which may subsequently conflict with the remuneration policy agreed with shareholders.
9. Companies that recruit a director in-year will be able to offer that individual a remuneration package which is consistent with the policy that has had prior agreement from shareholders - although the company may have a large degree of freedom if it has secured shareholder agreement to a policy that allows for such flexibility.

Increasing the level of support required

10. In most cases, remuneration reports are supported 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, resolutions on pay attract higher average levels of dissent than any other vote and the average figures disguise a small but significant number of cases where a large proportion of shareholders withhold support for remuneration proposals.
11. Although shareholder activism on pay appears to be strong amongst institutional investors, the increasingly diverse and fragmented nature of shareholders in the UK means that the likelihood of seeing 50% or more votes cast against any resolution can be reasonably expected to remain extremely low.
12. This has led the Government to question the level of support that should be required for a vote on remuneration policy to be carried and the level of dissent required before the company has to act. Shareholders have expressed their frustration that companies are currently able to proceed with remuneration proposals even where a large minority of shareholders are opposed. The Government is therefore minded to consider the **requirement to secure a higher level of shareholder support, beyond the current majority threshold, on votes cast on future remuneration policy.**
13. The benefit of increasing the level of shareholder support required, beyond a simple majority, 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. This measure would also give more power to those shareholders that are engaged on the issue of pay and may in turn encourage more shareholders to play an active role.

Advisory vote on the implementation of policy

14. It is important that shareholders continue to have the opportunity to have a say on actual payments made to directors. The Government therefore proposes to maintain an **annual advisory vote on the backwards looking section of the remuneration report** (including actual sums paid in the previous year). This will allow shareholders to signal whether they are content with how the previously approved policy has been implemented, particularly where the remuneration committee has exercised its discretion.
15. Within the remuneration report, companies will have to clearly quantify and justify all awards made to directors so that shareholders have sufficient data and contextual information to judge whether remuneration policy has been implemented in an appropriate manner.
16. In the event that a company fails to secure support from 75% of votes cast on the advisory vote on implementation of pay policy, the Government proposes that the company should be required to issue a statement to the market detailing the main issues shareholders have raised and how the company proposes to work with shareholders to address these issues
17. The advisory vote will give shareholders the opportunity to express their satisfaction with how the company has operated within the parameters of the remuneration policy. Where a company and its shareholders have engaged effectively on agreeing a robust remuneration policy with clear links to performance, and the remuneration committee has built trust among shareholders, the Government would expect to see high levels of support in the advisory vote.
18. In the event that shareholders are routinely dissatisfied with how the remuneration policy is applied and how the remuneration committee has exercised the discretion afforded to it, shareholders will have the opportunity to vote against the re-election of directors.

Binding vote on exit payments

19. Individual cases of directors who have left companies with substantial exit packages have attracted widespread criticism from shareholders and the public who see this as 'payment for failure'. Given the significant rewards that directors typically accrue over the course of their career, including sizeable pensions, the Government sees no clear case for them to receive exit payments that represent an extremely generous package in comparison to other employees' termination packages.
20. Shareholders currently have limited leverage on this issue because they have no direct role in negotiating or agreeing directors' service contracts and other arrangements and it is these documents which make provision for such payments to be made.
21. Both shareholders and business leaders have called for the existing framework to be updated to provide for greater scrutiny of contractual terms and other arrangements, and for more transparency around exactly how much directors could receive in the event of early termination of their contract.
22. It is clear that shareholder voting powers in this area need updating. As such, the Government proposes to amend the existing law on payments for loss of office and

introduce a new provision which would **give shareholders a binding vote on any exit payment which exceeds the equivalent of one year's base salary.**

23. The Government proposes that this should apply where a director's contract has been terminated early and without due notice, either by the company or by the director themselves. Companies would be required to get approval from shareholders by way of an ordinary resolution at a general meeting. In advance of the meeting, the company would have to make available to its shareholders a memorandum detailing the amounts it proposes to pay, how they have been calculated and why they are deserved.
24. In the event that a proposal failed to gain support from a majority of votes cast, the company would be unable to pay the individual any award beyond the basic limit. The benefit of this measure would be to give shareholders a real say over payments for failure. It may also help to reduce drawn out negotiations between companies and departing directors.

Next steps

25. The purpose of this consultation is to seek evidence on the impact, costs, benefits and likely behavioural effects of the proposals. Following this consultation, the Government will consider the evidence received and confirm the exact measures it proposes to take forward in primary legislation later this year (subject to parliamentary time being available).
26. Subject to parliamentary process, the Government would expect legislation on new shareholder voting rights and revised reporting requirements on directors' pay to come into force in spring 2013. This being the case, the Government proposes that these provisions take effect for companies whose reporting years end after 1 October 2013 and for directors whose contracts are terminated after that date, and so this would impact on general meetings held after 1 October 2013.

1. Background

Government proposals on executive pay

27. Executive remuneration that is well structured, clearly linked to the strategic objectives of a company, and which rewards directors who contribute to the long-term success of that company, is important in promoting business stability and growth. But pay policies which do not appropriately link executive remuneration to company strategy and performance have a potential economic cost through diminished shareholder returns, weakened corporate governance and reduced public confidence in the corporate sector.
28. Over the last decade, executive pay in the UK's largest listed companies has quadrupled with no clear link to company performance.¹ Top pay appears to go up when performance is good, but there is comparatively less elasticity downwards when performance is moderate or poor.² As a result, average levels of executive pay have ratcheted upwards.
29. This raises the question whether, when it comes to remuneration, 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.³
30. Last autumn the Government published an Executive Remuneration Discussion Paper,⁴ exploring the issues around executive pay and inviting views on ways in which the link between pay and performance could be strengthened. Alongside this, the Government also consulted on ways of improving company narrative reporting, including reporting on directors' pay.⁵
31. Responses to the discussion paper showed that business leaders, investors, academics, governance experts and a range of others now agree that there is a problem with rising executive pay which is not linked to performance.⁶ Key stakeholders have spoken out in favour of action:

¹ The average total remuneration of FTSE 100 CEOs has risen from an average of £1m to £4.2m for the period 1998-2010. Data from Manifest/ MM&K, The Executive Director Total Remuneration Survey 2011 (May 2011) available at <http://blog.manifest.co.uk>

² Brian Bell and John Van Reenen, Firm Performance and Wages: Evidence from Across the Corporate Hierarchy (2011)

³ A number of authors have noted that certain aspects of pay design are more reflective of managerial rent-seeking than efficient incentive design, for example: Blanchard, Olivier Jean, Florencio Lopez-de-Silanes and Andrei Shleifer, What do Firms do with Cash Windfalls?, Journal of Financial Economics, 36(3), pp. 337-60 (1994); Yermack, David, Good Timing: CEO Stock Option Awards and Company News Announcements, Journal of Finance, June, 52, pp. 449-76 (1997); Bertrand, Marianne and Sendhil Mullainathan, Are CEOs rewarded for luck? The Ones Without Principals Are, Quarterly Journal of Economics, August, 116(3), pp. 901-32 (2001).

⁴ BIS Executive Remuneration Discussion Paper, September 2011 www.bis.gov.uk/Consultations/executive-remuneration-discussion-paper

⁵ BIS The Future of Narrative Reporting, September 2011 www.bis.gov.uk/Consultations/future-of-narrative-reporting-further-consultation?cat=closedawaitingresponse

⁶ BIS Executive Remuneration Discussion Paper, Summary of Responses www.bis.gov.uk/assets/biscore/business-law/docs/e/12-564-executive-remuneration-discussion-paper-summary-responses.pdf

“Investors want simpler pay structures, better accountability to prevent reward for failure and greater transparency on how rewards are calculated, including by consultants.” **Otto Thoresen, Director General ABI, January 2012**

“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, January 2012**

“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, November 2011**

“The IoD has noted, with growing concern, the rapid rise in executive remuneration at the largest listed UK companies over the last 10-15 years... The legitimacy of UK business in the eyes of wider society is significantly damaged by pay packages that are not clearly linked to company performance.” **Simon Walker, Director General of the IoD, November 2011**

32. While this is primarily an issue for companies and their shareholders, the Government has a role to provide an effective corporate governance framework for executive remuneration; particularly where shareholders lack the information and powers they need to hold companies to account. On 23 January 2012, the Secretary of State for Business, Innovation and Skills announced a package of measures to address these failings:⁷

- Greater transparency in directors’ remuneration reports including splitting the report into two parts:
 - (i) proposed future policy and potential payouts
 - (ii) how policy has been implemented in the previous year and actual payouts
- Empowering shareholders and promoting shareholder engagement through enhanced voting rights
- Increasing the diversity of boards and remuneration committees
- Encouraging employees to be more engaged by exercising their right to Information and Consultation Arrangements⁸
- Working with investors and business to promote best practice on pay-setting

⁷ www.publications.parliament.uk/pa/cm201212/cmhansrd/cm120123/debtext/120123-0001.htm#12012313000002

⁸ Under the Information and Consultation of Employees Regulations 2004 (S.I. 2004/3426) which implemented the Information and Consultation Directive, all employees of organisations with 50 or more staff have the right to request an Information and Consultation Agreement.

Policy objective

33. The Government believes that together, these legislative and non-legislative measures will give shareholders more 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. They will enable shareholders to promote a stronger, clearer link between pay and performance in order to prevent 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 easy to understand and acceptable to shareholders, and to respond appropriately to shareholder challenge on executive pay issues.

Focus of this consultation

34. This consultation document provides more detail on a proposed model which will give shareholders greater influence on the issue of executive remuneration through enhanced voting rights. The main components of this are:

- An annual binding vote on future remuneration policy
- Increasing the level of support required on votes on future remuneration policy
- An annual advisory vote on how remuneration policy has been implemented in the previous year
- A binding vote on exit payments over one year's base salary

35. The purpose of this consultation is to seek evidence on the impact, costs, benefits and likely behavioural effects of the proposals. The Government recognises that there is a need to ensure that these measures do not impede the effective management of business or the dialogue between companies and shareholders, or lead to unintended consequences which could ultimately be counter-productive.

36. Following this consultation the Government will confirm the exact measures it proposes to take forward in primary legislation later this year (subject to parliamentary time being available).

37. At the same time as confirming its intentions for enhanced shareholder voting rights, the Government will also issue draft regulations which will determine the content of directors' remuneration reports.⁹

38. Subject to parliamentary process, the Government expects legislation on new shareholder voting rights and revised reporting requirements on directors' pay to come into force in spring 2013. This being the case, the Government proposes that these provisions take effect for companies whose reporting years end after 1 October 2013 and for directors whose contracts are terminated after that date, and so this would impact on general meetings held after 1 October 2013.

⁹ These regulations will replace Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (S.I. 2008/410)

Scope

39. Evidence shows that executive remuneration has risen fastest in the very largest companies – namely the FTSE 100 - although practice in the FTSE 250 has followed closely behind.¹⁰ The Government proposes that these measures should apply to all UK incorporated quoted companies¹¹ (of which there are around 1,200¹²) as is the case for the current regime for shareholder votes on directors' remuneration reports. Compared to private companies, the shareholders of public quoted companies are a more diverse and geographically dispersed group and therefore have less leverage over the actions of the agents they employ to run the company on their behalf. This means that there is an increased risk of governance failure and poor allocation of resource if shareholders do not have sufficient information or legal powers to challenge management decisions.
40. The term 'quoted company' is a recognised term in company law and so offers a definitive category of companies to which the proposed rules can apply. Distinguishing further between quoted companies according to their market listing or any other arbitrary size threshold is inappropriate for legislation and impractical for companies as the list of companies which fall within the scope of the legislation would fluctuate over time.
41. As all UK incorporated quoted companies are already required to produce a directors' remuneration report and put this to a shareholder vote, they are well accustomed to this regime. The changes proposed in this consultation document will therefore represent an evolution of current practice and not a wholly new process. Consistent with the existing legislation, these measures will apply to the remuneration of all *directors* of UK incorporated quoted companies and will be most relevant for executive directors.¹³
42. In respect of shareholder votes on exit payments for directors, it is intended that the new provisions will apply to all UK incorporated quoted companies. Other kinds of companies (including private companies and other public companies) will continue to be subject to the existing regime for compensation payments for loss of office.¹⁴
43. Following the introduction of these measures for UK incorporated quoted companies, the Government will work with the UK Listing Authority to consider how the requirements of the Listing Rules may need to be reviewed to ensure that UK companies are not subject to conflicting legal requirements.

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

¹¹ 'Quoted company' as defined in section 385 of the Companies Act 2006

¹² 1,058 UK incorporated companies listed on the Main Market, as of 31 January 2012 www.londonstockexchange.com/statistics/companies-and-issuers/companies-and-issuers.htm plus around 100 UK incorporated companies listed on the NYSE, NASDAQ, or in an EEA state.

¹³ The Government has consulted separately on proposals to improve transparency of remuneration below director level in financial services businesses specifically www.hm-treasury.gov.uk/consult_merlin_remuneration_disclosure.htm

¹⁴ As per sections 215-222 of the Companies Act 2006

2. Binding vote on remuneration policy

Background

44. The shareholder vote on the directors' remuneration report, which came into effect in 2003, was designed to give shareholders an effective and more focused way in which to influence directors' pay.¹⁵ It encouraged shareholders to become more engaged in corporate governance and to develop relationships with the companies they invest in.¹⁶
45. The vote is advisory and in respect of the entirety of the remuneration report, covering both retrospective payments and future remuneration policy. The company is not obliged to take any particular course of action based on the outcome of the vote, and no part of a director's remuneration is contingent on the vote. This is still the position under the provisions of the Companies Act 2006.¹⁷
46. A number of high profile shareholder revolts in the years immediately after the introduction of the remuneration report and shareholder vote cemented their importance. The proportion of dissenting votes reduced to around 3% in 2008 but the financial crisis led to an increase in shareholder activism and in 2009, around one fifth of FTSE 100 companies had more than 20% of their shareholders withhold support for their remuneration reports.¹⁸
47. Despite the fact that on average most remuneration reports in the FTSE 350 receive backing from around 90% of shareholders¹⁹ this figure disguises a significant amount of variation between companies and over time. For example in 2011, in the FTSE 100 alone, fifteen companies saw more than one fifth of their shareholders withhold support for remuneration proposals – compared to just seven the year before.²⁰
48. 'High' dissent is typically considered by companies and shareholders to constitute 20% or more shareholders failing to back the remuneration report. Compared to the average level of dissent on all other shareholder resolutions, which is only 3%,²¹ stakeholders have made it clear that having one fifth of shareholders withholding support is generally viewed by companies as a major cause for concern and most do their best to avoid this.

¹⁵ The Directors' Remuneration Report Regulations 2002 (SI 2002/1986) inserted a new section into the Companies Act 1985 which gave effect to a new schedule which required quoted companies to produce a directors' remuneration report for each financial year. 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.

¹⁶ PIRC and Railpen Investments, Say on Pay: Six Years on: Lessons from the UK Experience, September 2009. Available at www.pirc.co.uk/sites/default/files/documents/SayonPay.pdf

¹⁷ Section 420 of the Companies Act 2006 requires quoted companies to publish a report on directors' remuneration as part of the annual reporting cycle; section 421 makes provision for the Secretary of State to regulate what should be in the remuneration report; section 439 requires companies to put the report to a shareholder vote. Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (S.I. 2008/410) sets out what must be included in the remuneration report.

¹⁸ PwC, Executive Compensation: Review of the Year, 2009

www.pwc.co.uk/eng/publications/executive_compensation_review_of_the_year_2009.html

¹⁹ Average levels of dissent (i.e. votes against and withheld) in the FTSE350, taken from ISS Voting Results Report Europe 2011 www.issgovernance.com/docs/2011EuropeanVotingResultsReport

²⁰ www.independent.co.uk/news/business/news/investors-staging-record-numbers-of-pay-revolts-2375159.html

²¹ ISS Voting Results Report 2011, Europe www.issgovernance.com/docs/2011EuropeanVotingResultsReport

49. In the small but significant number of cases where a large proportion of shareholders withhold support for remuneration proposals, this is often indicative of poor engagement during the process of preparing the remuneration report or of a failure to address concerns raised the previous year. In the responses to the Government's discussion paper on executive remuneration, published last autumn, shareholders expressed their frustration that some companies fail to respond even when a significant number of shareholders refuse to endorse the remuneration report. One institutional investor noted that:

"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." **Co-operative Asset Management**²²

50. The public statements made by companies following relatively high votes against remuneration reports demonstrate the different attitudes towards responding to the advisory vote:

- *"We have noted the disquiet expressed by some of our shareholders and have recorded it for future reference"* – FTSE250 firm's response to 40% of shareholders withholding support for the remuneration report
- *"The vote on the report was carried by a very substantial majority of shareholders, who recognise that the group needs to retain its world class talent by running an effective remuneration policy. We will continue a dialogue with our shareholders on this important issue."* – FTSE250 company's response to 29% votes cast against the remuneration report
- *"This strikes me as being a matter of excessive micro managing."* - FTSE100 CEO response to 42% votes cast against the remuneration report

51. Whilst it is clear that in some cases, having a large proportion of shareholders withhold support for remuneration proposals has triggered a substantial re-thinking of policy, historical voting records, feedback from shareholders and anecdotal evidence suggest that not all companies are responding adequately to shareholder concerns. Within the FTSE 100 there are four companies that have seen their remuneration reports receive at least 20% votes against, four times in the nine years that the vote has been in force.²³ Clearly, there are cases where the advisory vote has had limited impact.

Proposal

52. In response to the discussion paper, stakeholders were concerned that a binding version of the existing vote on the remuneration report as a whole would be difficult to

²² Co-operative Asset Management, response to BIS Executive Remuneration Discussion Paper

²³ <http://blog.manifest.co.uk/2011/07/5131.html>

implement and could have undesirable consequences.²⁴ Recovering remuneration which had already been paid or reversing equity rights which had already vested would present a range of practical and legal challenges.

53. However, a number of investors called for shareholders to have more influence over the *design* of remuneration and suggested that companies should be required to seek up front approval for remuneration policy. This would, according to one investor “*lead to companies being more responsive to shareholder concerns during consultation [and]... motivate a greater number of institutions to engage with companies on remuneration matters.*”²⁵ Another investor noted that this would “*offer an opportunity for the remuneration committee to set forth its vision to shareholders and demonstrate alignment with strategy and long-term value creation.*”²⁶
54. The Government proposes to address the shortcomings of the current advisory vote by giving shareholders a **binding vote on a company’s remuneration policy**.²⁷ Under this proposal, companies would be required to act within the scope of the remuneration policy agreed by shareholders at the start of the year.
55. 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 in response to the Government’s earlier discussion paper suggests 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.
56. The binding vote on policy would give shareholders an opportunity to approve variable remuneration, including: salary increases; the level and criteria for performance related pay for the year ahead; material changes in a directors’ benefits and pension arrangements; material changes to service contracts and any other discretionary payments. Shareholders would not be able to use the vote on policy to ‘undo’ basic salary or pension agreements already entered into, or the award of deferred variable pay granted in previous years.²⁸

Content of the remuneration report

57. To facilitate a binding vote on remuneration policy, the Government intends to amend the existing reporting regulations and provide in future for two distinct sections in the directors’ remuneration report: one which outlines the proposed future remuneration policy and *potential* payouts; and a second which explains how remuneration policy has been implemented in the previous financial year, including *actual* awards made. Shareholders would have the opportunity to vote separately on each section of the

²⁴ Summary of Responses www.bis.gov.uk/assets/biscore/business-law/docs/e/12-564-executive-remuneration-discussion-paper-summary-responses.pdf

²⁵ Jupiter Asset Management response to BIS Executive Remuneration Discussion Paper

²⁶ USS response to BIS Executive Remuneration Discussion Paper

²⁷ In order to do this it will be necessary to make amendments to section 439 of the Companies Act 2006, and to bring forward regulations under section 421 of that Act.

²⁸ Notwithstanding the fact that companies will be able to recoup or withhold variable pay awarded in previous years where remuneration has been designed in a way that allows for this, e.g. through clawback or malus mechanisms.

report although only the section relating to future policy would be subject to a binding vote.

58. Although companies are already required to provide a statement of remuneration policy and any major changes made to performance measures, the complexity of current pay structures means that remuneration reports are often lengthy and frequently lack a coherent explanation of what these pay structures could mean in practice for individual directors.

59. To address this, the Government will publish a draft set of revised regulations later this year which will prescribe the content of remuneration reports. The regulations are likely to state that the section of the report which sets out the company's future policy on directors' remuneration should include the following as a minimum:

- The composition and potential level of pay for each individual director
- How proposed pay structures reflect and support company strategy and KPIs²⁹
- What the performance criteria are, how performance will be assessed and how this will translate into total level of reward for each individual under different scenarios (e.g. on-target and stretch performance)
- How and why the company has used benchmarks and other comparison data to inform pay levels and structures
- How employee pay and views have been taken into account
- How shareholder's views have been sought and taken into account, including the results of the previous year's votes on remuneration

60. The Government will work with shareholders to ensure that the regulations create a framework which facilitates proportionate and informative reporting. The vote on remuneration policy will enable shareholders to approve a framework for remuneration (such as the maximum potential award and the performance measures that will be applied) but the ultimate outcome will still rely to an extent on the discretion of the remuneration committee.³⁰ Although individual shareholders will have different preferences over the level of detail they expect and how formulaic they wish to be on remuneration policy, the Government anticipates that most will still see an important continuing role for remuneration committee discretion and flexibility and will want to allow for this within the policy.

²⁹ The Government is conscious that the publication of certain performance targets could compromise commercial interests and will work with companies and shareholders to balance this against the need for greater transparency.

³⁰ Although it is recommended by the UK Corporate Governance Code that all listed companies establish a remuneration committee of at least two independent non-executive directors, there are a small number of companies that do not have a remuneration committee. Nevertheless, the directors responsible for executive pay-setting are expected to report and account to shareholders on the issue of pay and would continue to do so under the proposals set out in this consultation document.

61. Where shareholders and the board have a good dialogue on pay issues and the board is broadly trusted to execute its responsibilities effectively, shareholders may be less inclined to scrutinise the detail of pay policy and more confident with allowing the remuneration committee a greater degree of discretion. Shareholders want to see that their views have been taken on board and so in future companies will be required to report on how shareholders voted on all pay resolutions in the previous year, how shareholder views have subsequently been sought and how the company has responded and adapted its remuneration policy accordingly.
62. Ultimately, it will be for companies and their shareholders to determine how much detail is desirable and appropriate but the regulations should provide a suitable framework within which to work. The Government will look to shareholders to give a steer to companies on what policy reports should contain and to promote and support good practice.

Frequency of the vote

63. Given that remuneration policies can vary year-on-year in response to changing circumstances, the Government proposes that the default position should be that remuneration policy is reported on annually and put to an annual shareholder vote. Any proposed changes to remuneration policy for the forthcoming year would be contingent on the resolution being carried.
64. An alternative option is to require a binding vote on remuneration policy only where there are substantial changes proposed, as is the case in the Netherlands. However, the difficulties of such an approach include the need to define what constitutes a 'substantial' change, and the risk that more 'minor' yet potentially significant changes to policy could be implemented without shareholder approval.

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

Consequences of the vote

65. The effect of introducing a binding vote on remuneration policy should be to encourage better quality engagement between companies and shareholders at an early stage in the process of devising remuneration policy. Many companies already undertake to do this and for those companies there will be very little change.
66. In the event that this engagement is ineffective in persuading shareholders of the appropriateness of the proposed policy and the binding vote on remuneration policy is lost, the company would have to fall back on the last policy to be approved by shareholders. Alternatively, if the company wished to proceed with a new policy for the forthcoming year, it would be necessary to hold a further general meeting where shareholders would be asked to vote on new proposals, as set out in a revised policy section of the remuneration report which would be circulated in advance to shareholders. In order to ensure that this is done without delay, the Government proposes to require that any such meeting should be held within 90 days of the AGM at which the original resolution failed to secure shareholder support.

67. It is not the Government's intention that failure to pass the vote on remuneration policy and the decision to hold a further meeting to consider revised proposals, should delay the filing of any statutory reports and accounts.

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

68. In practice, the Government expects that very few companies will be placed in this position as they will mitigate against this by engaging with shareholders in advance. Ultimately, better engagement which leads to companies securing shareholder support for their remuneration policies is a preferable outcome to having more companies experience substantial levels of shareholder dissent.

69. The Government acknowledges that there is a risk of perverse consequences if shareholders vote down a policy and the company chooses to continue with the previous year's policy (rather than hold an EGM) which shareholders find equally unsatisfactory. This could occur where a company makes no changes to its policy but as a result of performance, external events or other circumstances (such as a significant change in the shareholder base), the shareholders deem that policy to be no longer fit for purpose.

70. In these circumstances, the Government would expect shareholders to make it very clear that should the company fail to amend the policy and so effectively attempt to force shareholders to accept the status quo, then they would use the other votes at their disposal, such as on the re-election of directors, to express their dissatisfaction.

71. The Government notes that on certain other areas of company expenditure, the Companies Act 2006 provides for a civil liability where the directors authorise a payment which is not compliant with the law or with the policy sanctioned by shareholders. For example, on the matter of political donations and expenditure, shareholders may bring proceedings against company directors where the shareholder-approved policy on donations has not been complied with; and where a company is found to have made unlawful loans to a director, the responsible directors and person benefiting from such a loan are liable for the repayment and any costs.³¹

72. This type of enforcement model could potentially be applied in the case of remuneration policy and would ensure shareholders had sufficient leverage to challenge companies on unauthorised pay awards. However, given the other mechanisms which shareholders have at their disposal, including the vote on the annual re-election of directors, it is not clear that such a measure is necessary.

Impact on service contracts

73. Most directors' service contracts provide details of the broad types of variable remuneration that the individual has a right to, or can be invited to participate in, from

³¹ See sections 369 (unauthorised donations or expenditure) and 213 (loans to directors) of the Companies Act 2006

time to time. In the vast majority of cases, service contracts offer no certainty as to the size and type of variable pay that will be made and make it clear that this will be at the discretion of the company (usually exercised by the remuneration committee).

74. However, the Government understands that a small minority of directors' service contracts stipulate in advance exactly what a director could be entitled to in variable remuneration under different performance scenarios. In future, no contract will be able to guarantee that a director has the right to participate in a particular type of remuneration scheme or to specify the level of remuneration that a director could receive in particular circumstances as this will be dependent on shareholders agreeing the policy for remuneration and therefore the scope of potential reward, on an annual basis.
75. Some existing service contracts and other arrangements³² will therefore need to be amended to ensure that provisions relating to variable remuneration do not conflict with the shareholders' ability to approve remuneration policy on an annual basis. Companies will have until the legislation is effective to amend contracts and other arrangements to accommodate this. Subject to parliamentary time and process, the Government proposes that the legislation take effect from 1 October 2013.
76. Companies will need to avoid entering into any new arrangements with respect to remuneration which could give an individual director legal entitlements which may subsequently come into conflict with the remuneration policy agreed with shareholders.
77. Should the company agree a contractual term which is inconsistent with the remuneration policy approved by shareholders, it is proposed that similar consequences to those which currently apply for unauthorised payments for loss of office should be applicable.³³ This would mean that the directors who entered into or authorised the contract are liable to account for the company for any loss, and the director who receives any payment must hold it on trust for the company.

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

³² A director's relationship with the company will be governed by a network of contractual and discretionary arrangements. Some of these will have effect throughout the appointment (for example, the director's service contract), and others for a shorter period (for example, the duration of the performance cycle in the case of an LTIP award). Discretionary arrangements may take various forms - either as a self-standing benefit (such as medical insurance) or as an element of a wider contractual framework (for example, the treatment of a director's LTIPs in the event of him leaving the company). In this paper:

- (a) the term "service contract" means the contract of service (or contract for services) under which the director is engaged; and
- (b) the term "other arrangements" means the director's entire relationship with the company, including the network of documentation (whether contractual or discretionary) relating to annual bonuses, deferred bonuses, LTIPs, pension participation and all other benefits.

³³ This follows the approach taken in section 222 of the Companies Act 2006 where companies make a payment contract for loss of office without the relevant approval from shareholders.

Impact on recruitment

78. Under the new regime, companies that recruit a director in-year will be able to offer that individual a remuneration package which is consistent with the policy that has had prior approval from shareholders.
79. The Government recognises that during the recruitment process companies are often involved in negotiating a pay deal with the individual being recruited. In future, this negotiation will be constrained by the limits of the company's approved remuneration policy - although the company may have a large degree of freedom if it has secured shareholder approval for a policy that allows for such flexibility.
80. It is generally accepted that external recruits tend to come at a higher cost to companies than internal promotions.³⁴ Generous packages offered to external hires – who are in a strong position to negotiate higher pay – drive up average pay and this is compounded by benchmarking practices. The fact that it may become more difficult for companies to offer over-inflated packages with generous sign-on bonuses will therefore be a positive step and may help to slow-down the wider impact this has on pay ratcheting, as well as encouraging better in-company succession planning.

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

Interaction with other votes

81. Premium listed companies which are UK incorporated are already required, by the Listing Rules, to seek binding shareholder approval before a long-term incentive scheme (LTIP), in which one or more main board directors are eligible to participate, is adopted.³⁵ Companies are required to set out the terms of these schemes in a circular to shareholders,³⁶ which is then subject to an ordinary resolution at a general meeting.
82. As part of this circular, companies typically include an indication of how performance will be measured and retain the discretion to grant different types of share-based awards (e.g. conditional shares, market-value options, nil-cost options) and to vary, adjust or waive performance conditions for different individuals and different years. The circular will also tend to explain eligibility to participate, maximum levels of award for individuals and share dilution limits. Companies generally seek shareholder approval to renew or introduce new LTIPs approximately every five years and investor guidelines recommend a maximum ten year renewal cycle.
83. The introduction of an annual binding shareholder vote on remuneration policy will need to complement the existing shareholder voting arrangements for LTIPs. The

³⁴ External hires come at a greater cost not just because of their previous experience: the recruiting company has to make the package sufficiently attractive for the potential hire to leave their current role, and if they are the favoured candidate, the individual has substantial bargaining power. Research in the US found that median compensation - salary, bonus and equity incentives - for external CEOs was 65% higher than for those promoted from within, Home-Grown CEO, AT Kearney (2011) www.atkearney.com/images/global/pdf/Home-Grown_CEO.pdf

³⁵ Listing Rules: 9.4 Documents requiring prior approval <https://fsahandbook.info/FSA/html/handbook/LR/9/4> The Listing Rules specify limited exceptions from the need to obtain shareholder approval.

³⁶ Listing Rules: 13.8.11 Employees' share scheme

Government envisages that the proposed forward looking policy statement in the annual remuneration report will explain how the company proposes to use its discretion to determine the actual performance criteria, targets and potential levels of award for individual directors in the year ahead (within the broad framework for LTIPs which shareholders have already approved, or are being asked to approve).

84. The outcome of the binding vote on proposed remuneration policy would have no direct impact on the shareholder vote approving a new LTIP, or on the status of an LTIP that has already been approved by shareholders. It would however, give shareholders an opportunity to approve the details of how such schemes will operate in practice for directors for the year ahead.

85. The Government and the UKLA will work together to ensure that on the matter of shareholder voting and remuneration reporting, the requirements of the Listing Rules and company law are as consistent as possible.

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

3. Level of shareholder support

Background

86. In most cases, remuneration reports are supported 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, resolutions on pay attract higher average levels of dissent than any other resolutions at AGMs (10% on pay versus 3% for all other resolutions³⁷) and the average figures disguise a small but significant number of cases where a large proportion of shareholders withhold support for remuneration proposals.
87. It is also common for shareholders to 'abstain' on remuneration votes to signal their discontent without going so far as to vote against management. This figure is important as it 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 FTSE 250 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 one third of shareholders failed to back the report.³⁸
88. Within the overall figures, there is strong evidence of activism among the largest institutional shareholders and this is confirmed by data which show that major investors are more likely to vote against remuneration reports than other company resolutions and that some of the largest UK investors abstained or voted against over half of the remuneration reports on which they had a vote in 2010.³⁹ However, the proportion of shares owned by domestic institutional investors (such as insurance companies and pension funds) who have traditionally devoted significant resources to corporate governance issues, has declined significantly - from over 50% in 1990 to around 25% today.
89. Although shareholder activism on pay appears to be growing⁴⁰ and some institutional investors have stated their intention to be more challenging on this issue,⁴¹ the increasingly diverse and fragmented nature of shareholders in the UK means that the likelihood of seeing 50% or more votes cast against any resolution can be reasonably expected to remain extremely low.

³⁷ Average levels of dissent (i.e. votes against and withheld) in the FTSE350, taken from ISS Voting Results Report, Europe 2011 www.issgovernance.com/docs/2011EuropeanVotingResultsReport

³⁸ www.investegate.co.uk/article.aspx?id=201101271446042105A

³⁹ PIRC analysis of publicly disclosed voting data

⁴⁰ www.independent.co.uk/news/business/news/investors-staging-record-numbers-of-pay-revolts-2375159.html

⁴¹ 'Fidelity backs Government on executive pay reforms' www.telegraph.co.uk/finance/jobs/9023255/Fidelity-backs-Government-on-executive-pay-reforms.html; 'ABI: dividend should come before bonus' www.cityam.com/news-and-analysis/abi-dividend-should-come-before-bonus; 'NAPF tells banks to show restraint on pay' www.thisismoney.co.uk/money/news/article-2100624/National-Association-Pension-Funds-tells-banks-restraint-pay.html#ixzz1nETcLCOO

Proposal

90. The evidence on voting patterns and feedback from shareholders has led the Government to question the level of support that should be required for a vote on remuneration policy to be carried and the level of dissent required before the company has to act. Shareholders have expressed their frustration that companies are currently able to proceed with remuneration proposals even where a large minority of shareholders are opposed. The Government is therefore minded to consider the **requirement to secure a higher level of shareholder support, beyond the current majority threshold, on votes cast on future remuneration policy.**

Consequences of increasing the level of shareholder support required

91. The benefit of increasing the level of shareholder support required, beyond a simple majority, 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. This measure would also give more power to those shareholders that are engaged on this issue of pay and may in turn encourage more shareholders to play an active role.
92. In 2011, no FTSE 100 company failed to secure 50% support in the vote on the remuneration report, but five companies would have failed to pass the vote had 75% approval been required (two of which had seen at least one quarter of shareholders vote against in the previous year also) and two would have failed had 65% support been required.
93. For matters that are less routine or of particular importance, such as changes to the articles of a company, dis-applying 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.⁴² To be passed at a meeting, this type of resolution must be supported by 75% of those votes cast.
94. The special resolution provides a useful, pre-existing model for certain issues to require a higher level of support from shareholders and could be applied to the vote on remuneration policy. However, the Government recognises that in a small number of UK quoted companies, a single shareholder owns 25% or more of the total share value and could potentially, singlehandedly reject a special resolution on remuneration policy. A threshold of between 50% and 75% may therefore be more appropriate, although would entail more complex legislative changes to implement.

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

⁴² A special resolution of the members (or of a class of members) of a company means a resolution passed by a majority of not less than 75%, as defined in section 283 of the Companies Act 2006. A resolution passed on a poll taken at a meeting is passed by a majority of not less than 75% if it is passed by members representing not less than 75% of the total voting rights of the members who (being entitled to do so) vote in person, by proxy or in advance on the resolution.

4. Advisory vote on the implementation of remuneration policy

Background and proposal

95. The Government has considered but decided not to pursue the option of giving shareholders a binding vote on *all* remuneration issues. The prospect of a shareholder veto on payments already made and vested presents serious practical and legal difficulties, the results of which may ultimately be counter-productive if it means that shareholders are unwilling to exercise their powers.
96. However, it is important that shareholders have the opportunity to have a say on the actual payments made to directors. The Government therefore proposes to maintain an **annual advisory vote on the backwards looking section of the remuneration report** (including actual sums paid in the previous year). This will allow shareholders to signal whether they are content with how the previously approved policy has been implemented, particularly where the remuneration committee has exercised its discretion.
97. The fact that shareholders will have been engaged on agreeing the remuneration policy in advance, which will include potential payouts, should theoretically mean that the eventual outcome is less of a surprise. But where the money paid to directors is, from the perspective of shareholders, unjustified by the performance of the company, the advisory vote allows them to say as much.

Content of the remuneration report

98. To inform the advisory vote, the Government intends to require a section of the remuneration report to explain how policy has been implemented in the previous financial year, including the level of actual awards made.
99. Although companies are already required to provide details on what has been paid out to directors in the previous year, responses to the Government's discussion paper on executive remuneration highlighted that:

- *"We need more transparency. We need more coherent and pared down remuneration reports, which do not blind shareholders with the science."* **RailPen Investments**
- *"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."* **National Association of Pension Funds**
- *"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."* **CBI**

100. In revised regulations, to be brought forward later this year, the Government will stipulate that the section of the report which describes how the remuneration policy has been implemented should include the following:

- Single figure for the total pay of each individual director
- How pay awards relate to company performance and the policy agreed by shareholders at the start of the year
- How spend on executive pay relates to other dispersals, such as dividends, tax, business re-investment and general staffing costs

101. Within the report, companies will have to clearly quantify and justify all awards made to directors. The Government believes that this will give shareholders sufficient data and contextual information to judge whether remuneration policy has been implemented in an appropriate manner.

Consequences of the vote

102. No individual director's payout would be contingent on the outcome of the advisory vote, although it would send an important message to the board on whether shareholders are happy with how remuneration had been managed.

103. However, shareholders have expressed frustration that some companies have seemingly failed to take on board the outcome of the existing advisory vote. This has led many to suggest that there should be a formal requirement for companies to report on how they have done so. In response to our discussion paper on executive remuneration, major investors and investment bodies said:

- *“There may therefore be scope for further clarification of the nature and purpose of the advisory vote and the role of withheld votes. This could include a requirement that companies discuss in their Remuneration Report the outcome of the previous year's vote and what steps they have taken to understand and address the concerns of shareholders on occasions where there has been a high level of dissent.”* **Association of British Insurers**
- *“Committees need to try and understand why so many shareholders have failed to provide explicit support, particularly in cases where the combined against and abstain votes are significant.”* **Jupiter Asset Management**
- *“Provisions should be incorporated in the UK Corporate Governance Code or in relevant regulations whereby remuneration committees would be required to explain how they have responded to the votes cast (and withheld, if appropriate) at the previous AGM in respect of the remuneration report.”* **Standard Life**
- *“Perhaps, additionally, the remuneration committee should report to the market on the steps it intends to take after its first meeting after the AGM in the case of such a vote.”* **Hermes**

104. The Government agrees with shareholders that companies should have to demonstrate how the results of the advisory vote have been taken into account.

105. When presenting remuneration policy proposals for the year ahead, companies will be required to report on how shareholders voted on all pay resolutions in the previous

year, how shareholder views have subsequently been sought and how the company has responded and adapted its remuneration policy accordingly.

106. Additionally, in the event that a company fails to secure support from 75% of votes cast on the advisory vote on implementation of pay policy, the Government proposes that the company should be required to issue a statement to the market (for example, via a regulatory news service) within 30 days, detailing:

- The number and proportion of shareholders voting for, against and abstained
- The main issues shareholders have raised (and which materially affected the voting outcome)
- How the company proposes to work with shareholders to address these issues

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

Interaction with other votes

107. The advisory vote will give shareholders the opportunity to express their views on how the company has operated within the parameters of the remuneration policy agreed in advance by shareholders. The advisory vote will therefore play an important function as it will allow shareholders to comment on how effectively the remuneration committee has used its discretion. Where a company and its shareholders have engaged effectively on agreeing a robust remuneration policy with clear links to performance, and the remuneration committee has built trust among shareholders, the Government would expect to see high levels of support in the advisory vote.

108. In the event that shareholders are routinely dissatisfied with how the remuneration policy is applied and how the remuneration committee has exercised the powers afforded to it, shareholders will have the opportunity (as they do now) to vote against the re-election of directors.

5. Binding vote on exit payments

Background

109. Individual cases of directors who have left companies with substantial exit packages have attracted widespread criticism from shareholders and the public who see this as 'payment for failure'. Given the significant rewards that directors typically accrue over the course of their career, including sizeable pensions, the Government sees no clear case for them to receive exit payments that represent an extremely generous package in comparison to other employees' termination packages.
110. Nonetheless, the practice of paying large exit payments to departing directors has become embedded in corporate practice. Shareholders currently have limited leverage on this issue because they have no direct role in negotiating or agreeing directors' service contracts and other arrangements, and it is these documents which make provision for such payments to be made.
111. Over the last ten years, best practice on corporate governance has evolved to address this issue. The Companies Act 2006 requires that compensation payments to directors for loss of office (other than those paid as part of an existing legal obligation) should be put to a shareholder vote. It also requires such approval for contracts of more than two years in length (five years in length under predecessor legislation).⁴³
112. Reporting regulations require that details of service contracts and notice periods of directors be included in the annual remuneration report,⁴⁴ 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."*⁴⁵
113. The trend towards shorter contractual notice periods has been a positive step and the Government recognises the work of shareholders and companies to move to one year notice periods as the standard. Although almost all companies now adopt one year rolling contracts and all are required to disclose the severance terms of these contracts within their remuneration reports, there continue to be examples of substantial exit payments for outgoing directors.
114. The existing mandatory shareholder vote on compensation payments applies only to payments made over and above that which the director is contractually entitled to. It therefore excludes payment in lieu of notice made as part of the director's contract (or damages paid for breach of contract). It also excludes payments which arise pursuant

⁴³ Shareholder vote on notice periods, section 188 of the Companies Act 2006; shareholder vote on compensation for loss of office, sections 215-222

⁴⁴ Paragraph 6 of Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (S.I. 2008/410)

⁴⁵ www.ivis.co.uk/ExecutiveContractsAndSeverance.aspx

to discretions in bonus or LTIP plans. As a result, companies have a great deal of latitude over what is paid out before triggering the need for shareholder approval.

115. Directors, like all employees, are entitled to payment in lieu of notice or compensation for breach of contract where their employment has been terminated early without the full notice period being served. This is unless they have been found guilty of gross misconduct or other failings in duty which are usually set out in their contract.
116. Increasingly, directors' service contracts contain a 'PILON' (payment in lieu of notice) clause specifying how much the departing director would be entitled to in the event their contract is terminated without notice. The payment may be made as a lump sum, although shareholders prefer payments to be phased (with instalments being reduced by any future earnings received during the notice period.) If the service contract does not contain a PILON, it is for the parties to negotiate appropriate damages for breach of contract where the proper notice period has not been given (and even where there is a PILON clause, the company may choose *not* to exercise it and to negotiate damages for breach of contract instead).
117. PILONs within service contracts seldom entitle a director to payments in respect of annual bonuses and LTIPs on leaving. Instead, these are dealt with separately under other arrangements which generally give the remuneration committee discretion regarding the treatment of awards.
118. Owing to the complexity of executive remuneration, compensation arrangements on termination can be correspondingly complex. They can include any bonus that would have been earned that year and long-term incentives that are within their performance cycle. In some cases, performance-related elements of pay are automatically forfeited when a director's contract is terminated early, in others they are pro-rated for performance and service; or they may be paid out at the level the director could have expected had they remained in post. The level of discretion available to the remuneration committee when determining overall compensation arrangements typically gives committees a high degree of flexibility to differentiate between 'good' and 'bad' leavers. How this discretion is used is of particular concern to investors.⁴⁶
119. In response to the Government's discussion paper on executive pay, major investors 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... Given many awards of this nature are contractual... the most effective and consistent way of enabling greater scrutiny and accountability of such arrangements is for contractual terms to face shareholder approval." **Co-operative Asset Management**

⁴⁶ Corporate Governance Survey, The Share Centre, November 2011, Prepared by Richard Davies Investor Relations Limited

“(we) see continuing use of “contractual entitlements” as an excuse for payment for failure as no longer acceptable. Instead, companies should take a more robust line against such payments when they occur and ensure that when negotiating contracts provisions allow sufficient flexibility in times of failure.” **Aviva Investors**

“We believe that remuneration committees should report explicitly on all potential severance payments to executive directors, including contractual entitlements and entitlements under the incentive plans (including change of control provisions). At the moment, such entitlements are often obscure and disclosure varies significantly among companies.” **F&C Asset Management**

120. Existing legislation governing compensation for directors does little to limit payment for failure. Both shareholders and business leaders have called for the existing framework to be updated to provide for greater scrutiny of contractual terms and other arrangements, and for more transparency around exactly how much directors could receive in the event of early termination of their contract.

Proposal

121. The most effective way to mitigate against payment for failure is undoubtedly to ensure that remuneration is structured in such a way to reward genuine long-term performance and employs appropriate use of deferral, long-term shareholding and clawback mechanisms, and so the Government is working with companies and shareholders to promote good practice in the design of directors’ pay.
122. It is also clear that shareholder voting powers in this area need updating. As such, the Government proposes to amend the existing law on payments for loss of office and introduce a new provision which would **give shareholders a binding vote on any exit payment which exceeds the equivalent of one year's base salary**.
123. The Government proposes that this should apply where a director’s contract has been terminated early and without due notice, either by the company or by the director themselves.⁴⁷ The vote would be required to approve the entire exit package (to the extent the threshold of one year’s salary is exceeded), including payments made under the service contract and other arrangements. This would include benefits and performance related awards such as in-year bonus, deferred bonus where vesting is subject to further performance testing or ongoing service, and unvested LTIPs and share options.⁴⁸
124. Companies would be required to get approval from shareholders by way of an ordinary resolution at a general meeting. In advance of the meeting, the company would have to make available to its shareholders a memorandum detailing the amounts it proposes to pay, how they have been calculated and why they are deserved.
125. In Australia, where shareholders already have a right to vote on exit payments over one year’s base salary, companies also have the option of securing advance

⁴⁷ This will not affect directors who depart having served their notice, provided that payments made post-termination under other arrangements (e.g. LTIPs) do not exceed the threshold of one year’s base salary.

⁴⁸ Variable pay which has already vested and pension rights already accrued under normal service (with the exception of any pension enhancements triggered by termination) would not be affected.

approval to award compensation above this level.⁴⁹ However, the Government does not propose to adopt this approach in the UK and instead to require that approval is sought on a case-by-case basis *after* the individual's contract has been terminated.

126. The Government recognises that, when leaving their role as a company director, individuals may retain some form of link with the company for anti-competition or other purposes and considers it important that such cases are captured by the legislation. Directors serving out notice on 'garden leave', those who are being paid under ongoing non-competition covenants, and those who have been terminated as directors but remain employed in some other capacity should all be captured by the regime, as should directors whose contracts have been terminated as a result of a change in control.

127. These new provisions would apply solely to UK incorporated quoted companies. All other companies would continue to be subject to the existing regime for compensation payments to outgoing directors.⁵⁰

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

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

Consequences of the vote

128. The benefit of this measure will be to give shareholders a real say over payments for failure. It may also help to reduce drawn out negotiations between companies and departing directors. There is a possibility that these changes could place upward pressure on basic salary. However, any proposed increases in salary will in future need to be approved by shareholders and so subject to rigorous scrutiny.

129. Where a company wishes to seek permission from shareholders to pay a particular individual above the limit of one year's salary, this will necessarily mean some delay before such a payment could be made - particularly if the company chooses to wait until the next AGM. However, this will have the benefit of allowing for the company's performance over the course of the year to be confirmed and, where relevant, for any performance-related pay to be calculated and pro-rated accordingly.

130. In the event that a proposal failed to gain support from a majority of votes cast, the company would be unable to pay the individual any award beyond the basic limit. This will inevitably introduce a degree of uncertainty to the award of performance-related pay but the Government sees no reason why directors should be automatically entitled to any sum beyond base salary.

131. Statutory compensation for unfair dismissal, redundancy or discrimination claims - whether determined by an Employment Tribunal or agreed bona fide on termination

⁴⁹ S200A to S200E of the Corporations Act 2001

⁵⁰ Sections 215-222 of the Companies Act 2006

between the company and the director - would be excluded and unaffected by these proposals.

132. These proposals would not affect the existing requirement in the Corporate Governance Code for remuneration committees to take a robust line on reducing compensation to reflect departing directors' obligations to mitigate loss. The Government welcomes this practice and would expect companies to continue to undertake to reduce payment in lieu of notice in the event that the departing director secured other employment within the notice period.

Impact on service contracts

133. All contracts and other arrangements entered into after the date the proposed legislation comes into effect should not provide for any contractual entitlement to exit payments beyond one year's base salary and should make it clear that any exit payment in excess of one year's base salary is subject to shareholder approval. Any contract or arrangement that does so shall be considered void to the extent of the contravention.
134. Companies will have until legislation comes into effect to amend existing contracts and other arrangements to accommodate the new legislation (that is, to acknowledge that they are subject to a binding shareholder vote). Subject to parliamentary time and process, the Government proposes that the legislation take effect from 1 October 2013.
135. Companies may take the approach of buying directors out of their existing contractual rights in order to renew them in line with new legislation. This is a matter for individual companies but the Government would expect any such payments to be clearly disclosed in the remuneration report when reporting on payments made in the previous year. Companies and shareholders have some previous experience of adapting contracts to reflect changes in corporate governance standards, for example as standard notice periods have fallen gradually to one year and new requirements on the structure of pay have been introduced in the financial services sector.

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

136. The Government is aware that there are a small number of directors with contractualised rights to pension enhancements in the event of early termination of their contract. Where they entitle departing directors to automatic pension 'top-ups' (for example, to the equivalent level they would have reached had they served until their expected retirement date), these arrangements create the potential for substantial awards to departing directors.
137. In future, under the regime proposed in this consultation, it should not be possible to create an entitlement of this kind, as any payment upon early termination (above one year's base salary) will be subject to the shareholder vote described above and this will include pension top-ups. The Government recognises that any existing contractual arrangements of this kind will have a strong case for being honoured owing to the protection of pension rights under the Pensions Act 1995.

138. Although there is a clear attraction in enabling shareholders to have say on the granting of such substantial awards, as they represent a significant cost to companies, these arrangements are increasingly rare as final salary pension schemes are phased out, and overriding such rights would require complex legislation.

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

Binding vote on notice periods

139. Exit payments are first and foremost a product of the length of a director's notice period, as this dictates the amount to be paid in lieu of notice or in damages where there is a breach of contract. All UK companies are currently required to seek members' approval, by an ordinary resolution at a general meeting, for any directors' notice period that is more than two years in length.⁵¹ For listed companies, the UK Corporate Governance Code makes it clear that notice periods of one year are considered best practice and it is rare for listed companies to seek shareholder approval for a notice period or contractual term exceeding two years.

140. The Government has considered whether it would be appropriate to amend the existing legislation and bring it in line with good practice by requiring a vote on notice periods of more than one year.

141. However, following the introduction of the proposals described above, for quoted companies specifically, it would no longer be sufficient to obtain shareholder approval for a notice period of longer than one year as the resolution on exit payments of more than one year's salary would effectively limit what can be paid without shareholder authority. In fact, enabling shareholders to agree a two year contract and to later overrule that decision with a vote on exit payments would create a potential conflict in the legislation and could put shareholders in a difficult position.

142. Given that one year notice periods are now widespread good practice and that quoted companies will in future be required to seek approval for exit payments over one year's salary anyway, the Government is minded to leave the current provision unchanged, and to make it clear that for quoted companies, the vote on exit payments will effectively override any vote on notice periods. The provision on notice periods will be of relevance to non-quoted companies, to which it already does and will continue to apply.

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

⁵¹ Section 188 of the Companies Act 2006

Interaction with other votes

143. The requirement to seek approval for exit payments over one year's basic salary would be distinct from the requirement to put remuneration policy to a binding vote and from the requirement to report on payments in made in the previous year and each matter would require a separate resolution.

6. Summary of consultation questions

1. The Government proposes to require an annual binding vote on remuneration policy. What are the costs and benefits of this approach?
2. In the event that a company fails the binding vote on remuneration policy, the Government proposes that it maintains its existing policy or returns to shareholders with amended proposals within 90 days. What are the costs and benefits of this approach?
3. The Government proposes that directors' service contracts and other arrangements should, if necessary, be amended to take account of the new requirement to seek shareholder approval of remuneration policy. What are the costs and benefits of this approach?
4. The Government proposes that remuneration packages offered to in-year recruits should be confined by the limits and structures set out in the agreed remuneration policy. What are the costs and benefits of this approach?
5. The Government proposes that the report on future remuneration policy should provide more details on how approved LTIPs will operate for directors in that particular year. Do you agree with this approach?
6. The Government proposes to increase the level of shareholder support that should be required to pass the vote on future remuneration policy. Do you agree with this approach and if so, what would be an appropriate threshold?
7. The Government proposes to require companies to explain how the results of the advisory vote have been taken into account the following year and to issue a statement to the market sooner than this where there is a significant level of shareholder dissent. What are the costs and benefits of this approach?
8. The Government proposes to give shareholder a binding vote on exit payments of more than one year's base salary. Do you agree with this approach or would an alternative threshold for requiring a shareholder vote be more appropriate?
9. The Government recognises that the circumstances under which a director leaves their post are complex and diverse and so invites feedback on the appropriate scope and breadth of the proposed legislative measures.
10. The Government proposes that directors' service contracts and other arrangements should be amended to take account of the new requirement to seek shareholder approval for exit payments over one year's base salary. What are the costs and benefits of this approach?
11. The Government notes that a small number of directors could be entitled to generous pension enhancements if their contract is terminated early. It proposes not to legislate to override these rights, owing to the rarity of such arrangements and the complexity of legislation that would be required. Do you agree with this approach?
12. The Government proposes to leave unchanged the existing requirement in company law (section 188 of the Companies Act) to get members' approval for notice periods of more than two years. Do you agree with this approach?

7. How to respond

144. The Government is inviting written responses to the consultation. The deadline for responses is **Friday 27 April 2012**.
145. A copy of the consultation response form is available electronically at www.bis.gov.uk/consultations/executive-pay-shareholder-voting-rights. The form can be submitted by letter or email to:
- Barry Walker
Executive Pay Consultation
Department of Business, Innovation and Skills
1 Victoria Street
SW1H 0ET
020 7215 3930
executive.pay@bis.gsi.gov.uk
146. You may make copies of this document without seeking permission. Further printed copies of the consultation document can be obtained from:
- BIS Publications Orderline
ADMAIL 528
London SW1W 8YT
Tel: 0845-015 0010
Fax: 0845-015 0020
Minicom: 0845-015 0030
www.bis.gov.uk/publications
147. An electronic version can be found at www.bis.gov.uk/consultations/executive-pay-shareholder-voting-rights. Other versions of the document in Braille, other languages or audio-cassette are available on request.

Confidentiality & Data Protection

148. In the interests of transparency, the Department may choose to publish the responses to this consultation. Please state clearly if you wish your response to remain confidential.
149. Please note also that information provided in response to this consultation, including personal information, may be subject to publication or release to other parties or to disclosure in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004). If you want information, including personal data that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence.
150. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic

confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

Help with queries

151. Questions about the policy issues raised in the document can be addressed to:

Barry Walker
Executive Pay Consultation
Department of Business, Innovation and Skills
1 Victoria Street
SW1H 0ET
020 7215 3930
executive.pay@bis.gsi.gov.uk

152. A copy of the Code of Practice on Consultation is in Annex A.

What happens next?

153. Following this consultation, the Government will consider the evidence received and announce final proposals for enhanced shareholder voting rights in early summer.

154. Subject to parliamentary time being available, the Government intends to bring forward primary legislation in the next parliamentary session.

Annex A: The Consultation Code of Practice Criteria

Formal consultation should take place at a stage when there is scope to influence policy outcome.

Consultation should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.

Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.

Consultation exercise should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.

Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.

Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.

Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

Comments or complaints

If you wish to comment on the conduct of this consultation or make a complaint about the way this consultation has been conducted, please write to:

Sameera De Silva,
BIS Consultation Co-ordinator,
1 Victoria Street,
London
SW1H 0ET

Telephone Sameera on 020 7215 2888
or e-mail to: Sameera.De.Silva@bis.gsi.gov.uk

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Any enquiries regarding this publication should be sent to:

Department for Business, Innovation and Skills
1 Victoria Street
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Tel: 020 7215 5000

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