E-ALERT | European Tax and Employment

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PAY GOVERNANCE UPDATE - UK AND EUROPE

Pay governance developments in the financial services sector have been extensive and widely reported over the last three years. Less attention has been paid to wider developments in the field that could have significant consequences for public companies in other sectors. This client update discusses the findings of the UK High Pay Commission, published in November, and considers how those findings are likely to accelerate and intensify pressure for change being promoted by the UK Government and by Europe.

HIGH PAY COMMISSION REPORT

The UK High Pay Commission (an independent inquiry into pay in the private sector, supported by the Joseph Rowntree Charitable Trust) published its final report, Cheques With Balances, on pay on 22 November 2011. The report finds that the pay of some top executives has increased by more than 4,000% in the last 30 years, undermining productivity and "damaging" trust in British business. By contrast, the average wage in the UK today is currently £25,900 - up from £6,474 in 1980 - a three-fold increase. The report criticized "stratospheric" senior employee pay increases that have seen wealth flow upwards to the top 0.1 per cent of the population.

HPC chairman Deborah Hargreaves said: "There's a crisis at the top of British business and it is deeply corrosive to our economy. When pay for senior executives is set behind closed doors, does not reflect company success and is fuelling massive inequality, it represents a deep malaise at the very top of our society.

"That's why we are saying there must be an end to the 'closed shop' that sets top pay and that pay packages should be clear, open and published to shareholders and the public."

A poll of more than 2,000 members of the public to mark publication of the report found that four out of five believed pay and bonuses for top executives were out of control.

In addition, the report contains a number of recommendations for reforms to corporate governance and disclosure requirements, the most significant of which are addressed below:

- Radical simplification of executive pay, to comprise basic salary and "one additional performance-related element ... where absolutely necessary". For this purpose, the HPC favours performance share plans under which awards vest (at 20% per annum) in years 6 to 10 following grant.
- Disclosure of the top ten pay packages earned by executives below board level.
- Presentation of directors' remuneration reports in a standard format, including a single total remuneration figure for each executive (with the method of calculation of this figure also disclosed).
- Full disclosure of all voting decisions in respect of listed company shares made by institutional investors and fund managers, including on resolutions relating to directors' remuneration.
- Inclusion of employee representatives on remuneration committees.
- Publication of annual statements setting out the distribution of a company's income over three years, disclosing the year-on year percentage changes to items including total expenditure on executive pay and benefits, staff costs, dividends, reinvestment and tax.

- Open advertisement of vacancies for non-executive directors, and adoption of other measures to encourage greater diversity amongst non-executives.
- Reduction of conflicts of interest involving remuneration consultants, initially by requiring disclosure of all services provided to the company by firms of remuneration consultants who advise the remuneration committee.
- Publication by listed companies of "fair pay reports" setting out the ratio of highest to median pay within the company and changes in this ratio over three years.
- Establishment of a permanent national body to monitor, comment and report on high pay.

The HPC suggests that, initially, companies should be invited to comply voluntarily with an amended UK Corporate Governance Code. However, legislative enforcement later has not been ruled out.

DEPARTMENT OF BUSINESS, INNOVATION AND SKILLS DISCUSSION PAPER

Many of the report's suggestions - particularly those relating to greater disclosure requirements - closely reflect proposals contained in a discussion paper published by the Department for Business, Innovation and Skills (BIS), the consultation period for which closed on 25 November 2011. In the foreword, Vince Cable, the Business Secretary, says, "*the general disconnect between pay and long-term performance suggests that there is something dysfunctional about the market in executive pay or a failure in corporate governance arrangements. We want to understand this better, gather evidence about what is causing it and how it can be addressed*."

Improving Transparency: Related Consultation on Narrative Reporting

Reflecting the concern that current disclosure requirements are inadequate, the discussion paper suggests a number of possible solutions, including (as suggested by the HPC) disclosure of: a single figure summarising total remuneration for each director (and an explanation of how that figure has been calculated); and the remuneration of senior managers below board level. Companies might also be required to compare executive pay with pay levels across the organisation, and to disclose the percentage of profit expended on executive pay each year.

Role of Shareholders

The discussion paper recognises the importance of empowering shareholders to scrutinise and, if appropriate, to challenge executive pay. Ideas discussed include: making shareholder votes to approve executive pay binding; seeking views on possible further measures to prevent rewards for failure (the paper tentatively suggests shareholder votes to approve the contracts of newly appointed directors, or to approve termination payments); and appointing shareholder representatives to nomination committees.

The Role of the Remuneration Committee

The paper explores the idea of including independent (non-director) members on public company remuneration committees in order to draw on relevant expertise and to obtain fresh views from outside the corporate sphere (possibly from the public sector, academia, consultancy or advisory backgrounds). Alternatively, the Government might require employee representation on remuneration committees - or offer employees a non-binding vote to approve remuneration committee proposals before they are presented to shareholders.

The Structure of Remuneration

Pay structures have become increasingly complicated over recent years, largely in pursuit of closer linking of pay and company performance. Suggestions include:

- The use of more appropriate and better tailored performance measures, in place of, or in addition to, the widely used total shareholder return and earnings per share measures.

- Deferral of a larger proportion of pay over more than three years, to encourage a longer-term view by executives of company performance.
- Less frequent revisions to share incentive plans and other variable components of remuneration. In particular, the paper suggests that a substantial proportion of executive pay in the form of shares that must be held for several years before realisation (without complex performance targets), might better focus directors on achieving the long-term maintenance and growth of share value.
- Possible clawback mechanisms in executive remuneration arrangements, as required in some circumstances by regulations applying to financial services firms and as already suggested (but not required) in the UK Corporate Governance Code

DIVERSITY

Lord Davies' report, published in February this year, recommends that public companies should aim for 25% female board member representation by 2015. Vince Cable, Business Secretary, commented at the time: "I strongly welcome Lord Davies' report and am committed to promoting gender equality on the boards of UK listed companies…"

The ABI's report on board effectiveness, published in September 2011, recommends that public companies should publish clear statements explaining how they intend to achieve greater diversity in the boardroom - and suggests that public companies should advertise more widely for non-executives, to tackle cronyism.

The ABI's report found that the number of women in FTSE 100 boardrooms has increased from 13.4% in 2010 to 14.2% in 2011. Although the overall increase looks slow, of the new non-executive directors appointed in 2011, 22.7% were women in the FTSE 100 and 17% were women in the FTSE 250. The ABI also notes that disclosure by public companies clearly needs to improve, since currently only 19.2% of FTSE 100 companies provide a material statement on board diversity.

Earlier this year, Viviane Reding, EU Justice Commissioner, met with chief executives and chairs of boards of publicly listed companies to discuss the under-representation of women in the boardroom. She challenged all publicly listed companies in Europe to sign up to the "Women on the Board Pledge for Europe" and voluntarily commit to increasing women's participation on corporate boards to 30% by 2015 and to 40% by 2020. In July this year, at the European Parliament's vote on the report on women and business leadership, Ms Reding commented that "if there has not been credible progress by March 2012, I stand ready to take the necessary legislative steps at EU level".

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