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Binding Shareholder Say-on-Pay Vote on Route to Reality in the UK: US Companies Take Note

In 2002, the UK began requiring an advisory shareholder vote on the annual executive and non-executive director compensation practices of UK-incorporated quoted companies ("UK Companies"). Eight years later, in July 2010, the US followed suit when President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), providing for an advisory say-on-pay vote for most large US public companies.[1,2]

The UK government has now gone one step further by proposing to reform the approval process for director remuneration,[3] including through the introduction of a binding shareholder vote for all UK Companies that must occur not less frequently than every three years.[4] The new UK proposal does not stem from guidelines or mandates adopted by any European or other supra-national body. Rather, the proposal was the initiative of the UK government made at the national level in consultation with companies, shareholders, institutional investors and other interested parties. The UK approach, if ultimately

[1] Other countries also currently require say-on-pay votes, including the Netherlands (2004), Australia (2005), Sweden (2006), Norway and Denmark (2007), and Belgium (2012). The vote is non-binding in Australia, but in Denmark, Norway, and Sweden the vote is binding. In the Netherlands, the vote is binding but limited only to new remuneration policies or changes to existing policies. The frequency of votes in other of these countries varies, but in Australia, Norway, and Sweden the vote is mandated on an annual basis. Other jurisdictions have passed laws allowing for advisory say-on-pay votes, including Germany (owing in part to a European Commission recommendation that EU countries adopt say-on-pay) and Canada. Switzerland currently allows for advisory votes but is holding a referendum this year as to whether to require an annual binding vote.

[2] Over 3,100 companies in the US have been required to conduct these votes.

[3] Directors of UK Companies are under similar scrutiny in regard to pay levels as named executive officers whose pay is reported in US proxy statements. UK Companies typically have the CEO and other highly paid company officers sit on their boards of directors, and their compensation thus gets reported as director remuneration. Additionally, board chairs typically play a more active role in the UK, and their pay packages typically reflect their roles.

[4] To be considered "UK-incorporated," a company must have a registered office in England, Wales, Scotland or Northern Ireland. To be quoted, a company must have its equity share capital included in the Financial Services Authority's (the "FSA's") official list (*i.e.*, not AIM-listed companies). The advisory vote requirement currently applies to approximately 1,200 UK Companies.

implemented as expected, could be a powerful example for US investors seeking to drive change in executive compensation practices.[5]

We discuss below the current state of say-on-pay in the US and the UK reforms.

Update on Say-on-Pay in the US

Results of the 2012 proxy season say-on-pay votes have been generally positive, with companies receiving an average of 91% shareholder support at meetings held through mid-year, compared to 92% in 2011.[6] Results have been similarly positive for companies that struggled in 2011: 25 of 29 companies that had failed say-on-pay votes in 2011 had favorable vote outcomes in 2012, and companies with less than 70% support in 2011 attracted 14% or more in additional support in 2012.[7] The reasons for these improved outcomes seem to be more active engagement with shareholders, responsiveness to shareholder concerns in the 2012 compensation discussion and analysis (CD&A) and changes to compensation policies designed to result in stronger correlation between pay and performance.

Nevertheless, the 2012 proxy season has also seen an uptick in the number of companies with failed shareholder votes. The number reached 54 as of mid-year,[8] compared to only 40 for the entire 2011 proxy season.[9] Some commentators attribute these failures to an increasing disconnect between pay and performance, often fueled by negative recommendations from proxy advisory firms like ISS. Other commentators note that the failures correlate more closely to shareholder dissatisfaction with corporate performance (wholly aside from whether pay levels were appropriate for the performance actually achieved), or are attributable to high absolute or relative pay levels, above-median benchmarking or use of disfavored types of compensation.[10]

There appears to be a consensus among companies, practitioners and institutional shareholders that companies have reacted to the current US say-on-pay regime by

[5] The UK approach to say-on-pay has set an example for US reform in the past. Notably, as the Treasury Department delivered its draft "say-on-pay" legislation to Congress back in 2009, the then-advisory vote requirement in the UK was used to justify the proposal. Even looking back to 2007, Congressman Barney Frank, then-Chairman of the US House of Representatives' Financial Services Committee, sponsored H.R. 1257, the Shareholder Vote on Executive Compensation Act, which would have amended Section 14 of the Securities Exchange Act of 1934 to require companies to conduct a non-binding advisory shareholder vote on executive compensation plans. The bill passed the House of Representatives, but it was never put to a vote in the Senate. Nonetheless, there was a House hearing on March 8, 2007, and the resulting report reflected that the UK say-on-pay experience was being considered.

[6] http://www.metrocorpcounsel.com/articles/19656/say-pay-analyzing-second-year-shareholder-votes

[7] http://www.semlerbrossy.com/wp-content/uploads/2012/06/SBCG-Say-on-Pay-2012-06-20.pdf

[8] http://www.thecorporatecounsel.net/Blog/2012/06/the-latest-on-ceodirector-background.html

[9] http://www.thecorporatecounsel.net/Blog/2011/07/8-year-study-audit-and-non-audit.html

[10] See, for example, http://www.semlerbrossy.com/wp-content/uploads/2012/06/SBCG-SOP-2012-06-27.pdf.

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communicating more about their pay programs, including in their proxy statements and supplemental materials, and reaching out to shareholders about their pay practices. Companies have also made a notable shift away from certain disfavored pay practices like tax gross-ups and certain perquisites.

Current UK Regulatory Scheme and Proposed Changes

Since 2003, UK Companies have been required to include in their annual report a detailed directors' remuneration report, which is approved by an ordinary resolution (50% of votes cast) of shareholders.[11] The vote is currently advisory only and the report is required to include various forward-looking statements concerning a company's policy on directors' remuneration, including:

- a summary of performance conditions that apply to options and other long-term incentive awards;
- why these performance conditions were chosen and the methods to be used in assessing whether they are met; and
- a summary of the company's policy on the duration of directors' service contracts and notice periods and termination payments under such contracts.

However, the UK government has expressed concern about the effectiveness of the existing shareholder vote requirement, on the basis that, as it is advisory, it does not force companies to address directly shareholder concerns.

Last month the UK government announced a package of measures to address these failings, including a binding shareholder vote and increased disclosure of director remuneration.[12] The proposed measures, part of an Enterprise and Regulatory Reform Bill, would completely overhaul the approval process for remuneration of both executive and non-executive directors of UK Companies. On June 27, 2012, the government published a consultation on director remuneration reporting requirements, along with draft regulations setting out the proposed form and content of a new directors' remuneration report.[13]

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[11] As an example of the current UK disclosure regime, the 2011 Remuneration Report for British Petroleum can be found here: http://www.bp.com/assets/bp_internet/globalbp/globalbp_uk_english/set_branch/STAGING/common_assets/downloads/pdf/IC_DRR11_directors_remuneration_report_2011.pdf. See also footnote 3 above.

[12] BIS, "Directors' Pay: Guide to Government Reforms," June 20, 2012, available at http://www.bis.gov.uk/assets/biscore/business-law/docs/d/12-900-directors-pay-guide-to-reforms. It remains to be seen whether there will be backlash to the binding vote, either through companies choosing not to initially incorporate in the UK or through UK Companies re-incorporating elsewhere. At present, backlash has been limited to business leaders accusing the government of meddling in corporate affairs. (See, for example, http://online.wsj.com/article/SB10001424052702304765304577478172485959522.html).

[13] BIS Consultation on Revised Remuneration Reporting Regulations, June 27, 2012, available at http://www.bis.gov.uk/assets/biscore/business-law/docs/d/12-888-directors-pay-consultation-remuneration-reporting (the "Consultation").

There are three main aspects to the proposed legislation:

- introduction of a requirement that each company put its director remuneration policy, including its approach to termination payments, to an annual binding shareholder vote, except that companies that choose to leave their policies unchanged are permitted to provide for a vote only every three years (i.e., a forward-looking perspective);
- continuation of an annual advisory vote on how each company's remuneration policy was implemented in the previous year, including the actual compensation paid to directors (i.e., a backward-looking perspective); and
- new remuneration disclosure requirements.

The proposed legislation is currently being debated by Parliament.[14] It is expected that the reforms will be enacted and apply to UK Companies for fiscal years ending after October 2013.

1. New Forward- and Backward-Looking Disclosure and Associated Binding and Advisory Votes

To increase shareholder engagement and company accountability on the issue of director remuneration, but in recognition of the legal and practical difficulties of unwinding payouts already made,[15] the directors' remuneration report will now be split into two distinct parts, each subject to its own vote:

[14] The amendments to the Enterprise and Regulatory Reform Bill will be considered by the Public Bill Committee and may be further debated by the House of Commons, after which the bill will go to the House of Lords for a similar committee and debate process. Once the two Houses reach agreement, the bill can be passed into law. Once the legislation has been finalized, the Financial Reporting Council ("FRC"), an independent body responsible for promoting high-quality corporate governance in the UK, will consult on whether to amend the UK Corporate Governance Code to address a number of issues relating to executive remuneration.

[15] The UK does not currently mandate that UK Companies have clawback mechanisms in place, but the 2010 revision to the UK Corporate Governance Code, published by the FRC, states that "consideration should be given to the use of provisions that permit the company to reclaim variable components in exceptional circumstances of misstatement or misconduct." Going even further, a September 2011 discussion paper on executive compensation issued by the Department for Business, Innovation and Skills invited comments on whether all UK Companies should be required to have clawback mechanisms in place; over half of the respondents agreed that they should. Currently, the FSA's Remuneration Code for financial institutions does mandate clawback mechanisms for UK financial services companies when performance turns out to have been miscalculated or misstated. In the US, of course, Section 954 of the Dodd-Frank Act provided for the adoption of mandatory clawback provisions for current and former executive officers of listed companies, but those provisions have not yet been implemented.

- an outline of the proposed remuneration policy for the current year, including performance measures and potential payouts in that year (the "policy report"); and
- an explanation of how the remuneration policy was implemented in the previous year, providing details of actual payouts and awards made (the "implementation report").

a. <u>The Forward-Looking Policy Report</u>

The proposed forward-looking policy report, which would inform a binding vote by shareholders on remuneration policy, would be included in the annual report when shareholders are being asked to vote on a proposed remuneration policy and would include the following:

- a pay policy table setting out the key elements of remuneration and information regarding each element under the following headings: Purpose (how each supports the achievement of the company's short and long-term strategies), Operation (how each operates, including whether clawbacks or malus adjustments are possible), Opportunity (maximum potential value), Performance Metrics (including relative weightings and time period), and Changes to Policy (what is proposed and why);
- information on employment contracts;
- scenarios showing what directors would get paid for performance that is above, on and below target;
- information on the percentage changes in the company's profits and dividends and in the company's overall spend on remuneration;
- the principles on which exit payments will be made, including how they will be calculated, whether the company will distinguish between types of departure or the circumstances of exit and how performance will be taken into account; and
- material factors that have been taken into account when setting the remuneration policy, specifically employee remuneration and shareholder views.

While the government does not prescribe the exact format for the pay policy table (beyond the headings), it does attach an example showing the level and type of disclosure it expects to be made.[16] In the policy report, UK Companies must also provide an explanation for how and why their directors' remuneration policy differs from that of their wider workforce. While the government considered requiring disclosure of the ratio of CEO pay to median employee pay, it ultimately decided not to require that information.

[16] Annex A to the Consultation, supra note 13, at 39.

As proposed, the vote on the remuneration policy will require an ordinary resolution (50% of votes cast approval threshold) to pass.[17] It will be held annually unless companies decide to leave their remuneration policy unchanged, in which case it must be held at least every three years. Any proposed changes to the approved policy during the year will be contingent on a further shareholder vote. The government nonetheless recognized that shareholders will still, for the most part, be approving remuneration policy statements and proposed remuneration structures and that, in most instances, the determination of actual awards and payouts will remain subject to the discretion of the company's remuneration committee or board of directors (subject to any relevant constraints in the approved policy).

In the event a company fails the binding vote, it must continue using the last policy approved by shareholders until a revised policy is approved. Companies will have the option of convening an extraordinary general meeting to advance a revised policy, or waiting until the next annual meeting to do so. The government has not yet addressed certain transition issues, including the consequences of a company's first required remuneration policy vote not being approved.

b. <u>The Backward-Looking Implementation Report</u>

The proposed backward-looking implementation report, which would inform an advisory shareholder vote, would be included in the annual report every year and would include the following:

- a "single total figure" of remuneration for each director, set out in a prescribed tabular format reflecting all elements of pay determined by prescribed methods of measurement;[18]
- a detailed description of performance compared to metrics for annual and long-term incentives paid in the year;
- total pension entitlements (for defined benefit schemes);
- exit payments made in the year;
- a detailed description of variable remuneration awarded in the year;
- total shareholdings of directors;
- a chart comparing company performance and CEO remuneration;

[17] The UK Secretary of State for Business, Innovation and Skills originally proposed a requirement for a super-majority of up to 75% of the votes cast, but this was eliminated from the final proposal on the grounds that it would place a disproportionate focus on remuneration compared to other issues and would give too much power to minority shareholders.

[18] Much of the remuneration disclosure being proposed for UK Companies echoes that currently required of US public companies. For example, the "Single Total Figure Table" proposed by the UK government bears more than a passing resemblance to the Summary Compensation Table in US proxy statements. See the Consultation, supra note 13, at 23.

- information regarding consultants who provided advice to the remuneration committee that "materially assisted" the committee in its decisionmaking, including their names, whether they provide other services to the company, how they were selected and their compensation; and
- a description of "shareholder context," including how shareholders voted on the most recent binding and advisory votes (as a percentage of votes cast), the percentage of the shareholder base that abstained, reasons for significant dissent (if known) and action taken by the remuneration committee in response to those votes.

The proposed "single total figure" for each director is comprehensive and would include all types of remuneration received in the previous year, including base pay, bonuses, certain long-term awards and benefits provided. The figure would reflect actual remuneration earned rather than potential remuneration awarded subject to further performance, including full bonuses awarded for the reporting period, the value of long-term incentives where the reporting year is the last financial year of the performance cycle and any awards granted where final value is not dependent upon performance in future years.[19] Stock-based awards would be valued based on fair market value on the vesting date and options based on intrinsic value (*i.e.*, fair market value of the underlying stock minus the strike price). For long-term incentive awards that have not vested prior to the date on which the remuneration report is approved by a board of directors, an estimate of the value of the benefit must be disclosed.

Companies must also be more proactive in reporting whether directors have met their performance objectives. To this end, UK Companies must include a line graph plotting both the company's total shareholder return and CEO remuneration over the last 10 years (or, if shorter, the period during which it has qualified as a UK Company).[20] In addition, companies would report additional information specifically about long-term incentive awards made in the year for which value is dependent upon performance in future years. The report would include the type of long-term award, the basis of the award as a function of base salary, the face value of the award, the vesting maximum if above face value, the percentage of the award that would vest at threshold performance, the date the performance period ends and a summary of performance criteria not otherwise disclosed.

[19] This disclosure approach should be of particular interest to US practitioners in light of the active debate in the US about whether the Summary Compensation Table should focus on realizable or realized pay.

[20] In the UK government's consultation on narrative reporting, there was no consensus on the best measure of performance for this purpose. Alternatives raised included total shareholder return, return on capital, return on assets, or a company's chosen key performance indicators. Because of the lack of consensus, the government has proposed using total shareholder return on the basis that it is a relevant and reasonable barometer for company performance over a long period. The government's proposal also provides an example of how a chart comparing CEO pay to total shareholder return might appear, which can be found in the Consultation, supra note 13, at 31.

Shareholders would continue to have a say on the implementation report through an advisory (non-binding) vote on actual sums paid in the previous year. If the company fails the advisory vote – by receiving less than 50% of the votes cast – the company must put its overall remuneration policy back to shareholders in a binding vote for approval the following year.[21]

2. New Disclosure and Votes on Termination Pay

Currently, termination payments to directors are subject to shareholder approval, unless they are paid in discharge of an existing legal obligation (such as a contractual payment in lieu of notice), as damages for breach of such an obligation, by way of settlement or compromise of any claim arising in connection with a director's termination of office or employment or by way of pension in respect of past services.

In an effort to respond to the perceived problem of "rewards for failure," the UK government also proposed to strengthen shareholder voting power in the area of exit payments. The government's proposal would require UK Companies to set out their approach to exit payments as part of the remuneration policy report, subject to the binding shareholder vote described above. Companies would disclose as part of the policy report how each element of remuneration will be factored in when calculating exit payments, whether the company will distinguish between different circumstances surrounding the director's departure and how performance will be taken into account in calculating exit payments. Through their inclusion in the implementation report, exit payments that have actually been made would be subject to the backward-looking advisory vote.

When a director leaves, a UK Company would also be required to promptly publish a statement setting out details of the termination payments made. This disclosure would be restated in the implementation report and must include the level of compensation received (broken down into key elements) and a description of how each element was calculated and how the decision took into account the approved policy on termination payments.

Looking to the Future in the US

US companies should keep an eye on developments in the UK. A binding approval regime of the type proposed for the UK would have a significant impact on US pay practices, constraining the flexibility of directors to react to changing situations and imposing a healthy quantum of new governance and legal considerations for US public companies.

A binding approval regime would further move pay decisions away from boards of directors, which are generally entrusted to manage the businesses of public companies, where such decisions have traditionally resided. In our view, there are good reasons for the historical allocation of responsibility for these decisions to boards of directors within very

[21] The FRC has announced that it will consult on potential changes to the UK Corporate Governance Code, including, for example, requiring companies to publish a statement saying what they will do to address shareholder concerns if a substantial minority of shareholders vote against the implementation report.

broad boundaries and subject to generally applicable limitations, such as heightened judicial review standards where a board is dominated by an interested party and the corporate waste doctrine. Those reasons include boards' inevitable possession of information that shareholders do not have, boards' opportunity to deliberate and form consensus on issues in ways that shareholders cannot, boards' flexibility to make quick decisions and the rights of shareholders to hold boards responsible in appropriate circumstances for bad decisions.

We look forward to watching the UK's experiment unfold. At a minimum, we believe that US policy-makers should defer consideration of such a significant change to US corporate governance until the consequences (intended and unintended) of the UK's experience are fully understood.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Corporate Governance" or "Executive Compensation and ERISA" under the "Practices" section of our website at http://www.clearygottlieb.com.

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