

## UK Government Announces its Proposals for Enhanced Shareholding Voting Rights on Executive Remuneration and Publishes a Consultation on Revised Remuneration Reporting Requirements

### 1. Introduction

The Government has announced its proposals for the reform of executive remuneration in UK incorporated quoted companies. On 20 June 2012, the Secretary of State for Business, Innovation and Skills delivered a [statement](#) to the House of Commons announcing a package of measures intended to address failings in the corporate governance framework for executive remuneration. The measures focus on (a) giving shareholders more power to hold companies to account over the structure and level of directors' remuneration through the introduction of binding votes on a company's future remuneration policy, and (b) increasing transparency in remuneration reporting to make it clear what directors are earning and how this links to company strategy and performance.

The statement indicated that the Government would bring forward amendments to the Enterprise and Regulatory Reform Bill to introduce the new shareholder voting regime<sup>1</sup> and undertake further consultation on how companies must report on directors' remuneration in order to increase transparency in remuneration reporting.

On 27 June 2012, the Government published the aforementioned [amendments](#) to the Enterprise and Regulatory Reform Bill and at the same time published a [consultation](#) on the form and content of the directors' remuneration report, together with draft regulations which, when finalised, will replace the current regulations<sup>2</sup>. The consultation will remain open until 26 September 2012.

The new proposals apply to the remuneration of both executive and non-executive directors of UK incorporated "quoted" companies – that is, companies whose equity share capital is

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<sup>1</sup> Section 57 of the Enterprise and Regulatory Reform Bill already provides for the deletion of section 439(5) of the Companies Act 2006, which currently prevents directors' remuneration from being conditional on a shareholder vote on the directors' remuneration report.

<sup>2</sup> See Schedule 8 of the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).

included in the FSA's official list (i.e., not AIM listed companies) or is officially listed in another EEA state or is admitted to dealing on either the NYSE or the Nasdaq. The Government estimates that the proposals will affect approximately 1,200 companies.

It is proposed that the reforms will take effect for companies whose financial years end after October 2013.

## **2. Enhanced Shareholder Voting Rights**

The Government had previously consulted on proposals to enhance shareholders' voting rights in relation to executive remuneration in a [consultation](#) published on 14 March 2012. As discussed in more detail in our Alert Memo dated 28 March 2012, the main proposals on which the Government sought views were (a) introducing a binding vote on future remuneration policy, (b) increasing the level of shareholder support required on future remuneration policy to up to 75%, (c) maintaining the annual advisory vote on how the company's remuneration policy has been implemented in the previous year, and (d) introducing a binding shareholder vote on exit payments to directors in excess of one year's base salary.

The proposals announced on 20 June 2012 take account of the [responses](#) to the consultation and do not include some of the more controversial initiatives put forward by the Government, such as increasing the required level of shareholder support above 50% or introducing a binding vote on exit payments to directors that exceed one year's base salary.

The key measures arising out of the consultation and announced on 20 June 2012 are set out below.

### *2.1 The introduction of a binding vote on future remuneration policy*

To facilitate the new shareholder voting regime, the Government proposes amending the remuneration reporting regulations (as discussed further below) to require that the directors' remuneration report is divided into two distinct parts: (a) a forward-looking report setting out the company's remuneration policy, including its approach to exit payments (the "[policy report](#)"); and (b) a report describing how the remuneration policy was implemented in the reporting year and setting out actual payments to directors (the "[implementation report](#)").

Under the Government's proposals, the policy report will be subject to a binding shareholder vote in order to give shareholders more control over the structure and level of directors' remuneration and encourage improved dialogue with the companies they own.

The vote will be held annually unless the company decides to leave its remuneration policy unchanged, in which case it must be held at least every three years. Once the policy is approved, the company will only be able to make payments within the limits it allows and any proposed changes to the approved policy during the year will be contingent on a further

shareholder vote. The Government believes this will encourage companies to set out and stick to a clear, long-term remuneration strategy and help put downward pressure on pay ratcheting.

The binding vote will require the support of a simple majority of shareholders voting to pass. In its response document, the Government noted there was little support for increasing the threshold for votes on remuneration above 50% of votes cast on the grounds that it would place a disproportionate focus on remuneration compared to other issues and would empower minority shareholders, potentially allowing the wishes of the majority to be ignored.

Where the remuneration policy is not approved by shareholders, the company will have to continue using the existing policy until a revised policy is agreed. Companies will have the option to either convene an extraordinary general meeting to put forward a revised policy or wait until the next annual general meeting to do so.

The Government has indicated that the Financial Reporting Council (“FRC”) will consult on potential changes to the Corporate Governance Code, including that where a substantial minority of shareholders vote against the policy report, the company should publish a statement saying what it will do to address shareholder concerns. The Government is in favour of such changes as they would improve transparency and publicly hold directors to account.

## 2.2 *Advisory vote on implementation*

Alongside the binding vote on the policy report, shareholders will continue to have an annual advisory vote on how the policy has been implemented, including actual sums paid to directors. Significantly, the implementation report must include a single total figure of remuneration received by each director in the reporting year. The single figure will cover all types of reward received by directors in the previous year including fixed and variable elements (including bonuses and long term incentives where the reporting year is the last financial year of the performance cycle) as well as pension provision. The single figure will reflect actual remuneration earned rather than potential remuneration awarded. The FRC’s Financial Reporting Lab has developed a methodology for how the single figure should be calculated to provide consistency between companies as to what is included in the figure and how it is calculated.

Like the binding shareholder vote, the advisory vote will also require the support of a simple majority of shareholders voting to pass. The vote is intended to allow shareholders to signal whether they are content with how the approved policy has been implemented. If the company fails the advisory vote it must put the remuneration policy back to directors the following year for re-approval in a binding vote.

Again, the Government has indicated that the FRC will consult on potential changes to the Corporate Governance Code, including that where a substantial minority of shareholders vote against the advisory vote, the company should publish a statement saying what it will do to address shareholder concerns.

### 2.3 *Exit payments*

The Government has retreated from its initial proposal to introduce a binding shareholder vote on individual exit payments. It had originally proposed introducing a binding vote on the entire exit package offered to a director (to the extent it exceeded one year's salary) as a means of preventing rewards for failure and increasing shareholder engagement. However, almost all respondents to the consultation felt that one year's base salary was too low, particularly as it could deprive directors of long-term incentives that they had partly earned and which had already been approved by shareholders. It was also pointed out that companies need to be able to respond quickly and appropriately to the departure of a director and a threshold of one year's salary would make this difficult as a shareholder vote would be required in nearly all cases.

Under the proposals announced on 20 June 2012, only the company's approach on exit payments would be subject to a binding shareholder vote (as part of the policy report). Any exit payment must be within the limits approved in the policy report, although individual exit payments will not be contingent on shareholder approval. The existing regime relating to shareholder approval for payments made to directors as compensation for loss of office under sections 216 to 222 of the Companies Act 2006 will cease to apply to quoted companies.

In the interests of enhanced disclosure, whenever a director leaves, the company must promptly publish a statement explaining to shareholders exactly what payments the director has received. Exit payments will also have to be reported in the implementation report and be subject to the advisory vote. In this way, the Government intends that shareholders will be able to signal whether they are content with exit payments that have been made.

### 2.4 *Consequences of making a payment in contravention of the restrictions*

As discussed above, the company is restricted from making remuneration payments or exit payments that are not consistent with the most recent remuneration policy to have been approved by shareholders. Where any such payment is made in contravention of these restrictions, it is held by the recipient on trust for the company (or such other person making the payment). In addition, where the payment is made by the company, any director who authorised the payment is jointly and severally liable to indemnify the company for any loss resulting from it.

## 2.5 *Impact on existing arrangements*

The restrictions on making remuneration payments or exit payments that are not consistent with the company's most recent remuneration policy to have been approved by shareholders will not apply to such payments made by a company before the earlier of (a) the end of the first financial year of the company to begin after the coming into force of the legislation<sup>3</sup>, and (b) the date from which the first directors' remuneration policy to be approved by shareholders under the new regime takes effect.

In addition, the Government's proposed amendments to the Enterprise and Regulatory Reform Bill contain a grandfathering provision, such that the restrictions on making remuneration payments or exit payments that are not consistent with the company's most recent approved remuneration policy will not apply to any such payments that are required to be made by the company under an agreement entered into before 27 June 2012 or as a result of any obligation arising before that date. However, an agreement entered into, or any other obligation arising, before 27 June 2012 that is modified or renewed on or after that date will be treated as having been entered into or (as the case may be) as having arisen on the date on which it was modified or renewed and so will lose the protection of the grandfathering provision.

## 3. **Increased transparency through revised remuneration reporting regulations**

In order to support the new shareholder voting regime, on 27 June 2012 the Government published a consultation to seek views on its proposals to increase transparency in remuneration reporting and in particular on draft regulations which will determine the form and content of directors' remuneration reports.

The draft regulations propose that the remuneration report is split into two distinct parts:

- the policy report setting out all elements of a company's remuneration policy and key factors that were taken into account in setting the policy. This part of the report will only be required to be produced when there is a shareholder vote on the policy (which must occur at least every three years); and
- the implementation report on how the policy was implemented in the past financial year, including actual payments to directors set out as a single figure for the total remuneration each director received in the reporting year and details on the link between company performance and remuneration.

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<sup>3</sup> The legislation is currently expected to be enacted by October 2013.

### 3.1 *The policy report*

The Government proposes that the policy report includes the following information:

- a table setting out how the company structures remuneration and the policy for each element of that remuneration package. For each element of remuneration the table should include information about how the element of remuneration supports the company's short and long-term strategic objectives, how the element of remuneration operates, the maximum potential value, a summary of performance metrics (or an explanation of why no performance metrics apply) and what decisions the remuneration committee has made about that element of remuneration for the future and why. The Government does not expect companies to be forced to disclose performance metrics where doing so would harm shareholder interests;
- a narrative explanation of whether remuneration policy for directors differs from remuneration policy for other employees and if so an explanation of why;
- all existing contractual provisions in directors' service contracts that relate to remuneration;
- scenarios for what directors will get paid for performance that is above, on and below target;
- information on the percentage change in profit, dividends and the overall spend on remuneration, to give shareholders a better understanding of how spend on remuneration relates to a wider range of factors including dividends and profits;
- the company's approach to exit payments, including the principles on which exit payments will be made (including how they will be calculated; whether the company will distinguish between types of leaver or the circumstances of exit and how performance will be taken into account) and details of any contractual provision agreed prior to the introduction of the regulations that could impact on the exit payment;
- information about how the remuneration of employees was taken into account, including whether comparison metrics were taken into account and if so what the metrics were, and the percentage increase in remuneration of the workforce against the percentage increase in the remuneration of the CEO;
- a statement on whether, and if so how, the company sought employee views on the remuneration policy; and
- information about how shareholder views were taken into account in setting the remuneration policy.

### 3.2 *The implementation report*

The Government proposes that the implementation report includes the following information:

- single total figure of remuneration for each director, which will be calculated in accordance with the methodology developed by the FRC's Financial Reporting Lab;
- details of performance against metrics for long-term incentives and annual bonuses. Again, the Government does not expect companies to disclose performance metrics where doing so would harm shareholder interests;
- details of total pension entitlements (for defined benefit schemes);
- details of exit payments made during the year, including the level of compensation paid broken down into the key elements, an explanation of how each element was calculated and an explanation of how the decisions made relate to the policy on exit payments;
- detail on variable remuneration awarded during the year, including the type of award, basis of award, face value, vesting maximum if above face value, percentage of the award that would vest at threshold performance, date the performance period ends and a summary of the performance criteria;
- total shareholdings of directors, including share ownership requirements and whether they have been met and the total numbers of shares and share options that each director owns (a) outright, (b) subject to deferral and (c) subject to performance conditions;
- a graph comparing company performance (in particular, total shareholder return) and CEO remuneration;
- more detailed information about the provision of advice from any consultant on remuneration of directors, including who provided the advice, how they were selected, whether they provided other services to the company and the total cost of advice on remuneration and the basis on which they were paid; and
- information on 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.

### 3.3 *Audit requirements*

The current regulations require those parts of the directors' remuneration report that relate to payments made to be audited. In recognition of the fact that audit is a costly process for companies, the Government proposes limiting the sections of the implementation report that are subject to audit to those areas of the report where it is necessary to provide shareholders

with the assurance that the information provided is free from material error. The areas identified as falling within this category are:

- single total figure for remuneration;
- detail of performance against metrics for variable awards included in the single figure;
- total pension entitlements (for defined benefit schemes);
- exit payments made; and
- detail on variable remuneration awarded in year.

### 3.4 *Next steps*

The consultation will remain open until 26 September 2012. It is anticipated that the regulations will come into effect from October 2013 alongside the primary legislation on binding votes in the Enterprise and Regulatory Reform Bill. The Government's aim is that the draft regulations will provide a framework within which companies and shareholders can set, agree and implement remuneration policy and the Government suggests that the regulations will need to be supplemented by clear guidance on the level of detail and type of information that should be reported. The Government believes that this should be jointly agreed by the business and investor communities and should be in place before these proposals take effect.

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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 the "Practices" section of our website at <http://www.clearygottlieb.com>.

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