MACFARLANES

BEIS COMMITTEE RECOMMENDATIONS ON REMUNERATION

The House of Commons Business, Energy and Industrial Strategy Committee (the Committee) recently published its report on corporate governance (available here). Following on from the recent green paper, the report proposes a series of reforms "designed to require directors to take more seriously their duties to comply with the law and the UK Corporate Governance Code" (the Code). They propose doing that by expanding the role and powers of the Financial Reporting Council (FRC) to enable it to "call out" poor practice and engage with companies to improve performance. They envisage the FRC establishing a corporate governance rating system which stakeholders and the public will be able to access. The report also contains a number of specific recommendations to the FRC that it consider improvements and changes to the Code. A number of these relate to listed company executive remuneration.

The Committee concludes that in a global market based economy where UK companies compete for talent, it would not be helpful for the government to intervene directly to limit the level of executive pay. Nor does the Committee believe that the government should use the tax system to further redistribute income for high earners. But they conclude that "high and unwarranted executive pay is an issue that needs to be addressed for the benefit of society as a whole" and that levels of pay for those at the top should not increase at a rate that vastly exceeds increases for ordinary employees and in a way which is inconsistent with value creation. They therefore take the view, consistent with recent government policy, that effective corporate governance, rather than government intervention, is a better way to tackle excessive pay. They note that, as pointed out by a number of responses to the green paper, the rate of increase in listed company executive pay has reduced materially since the financial crisis and the introduction of the binding shareholder vote on the directors' remuneration policy. Notwithstanding that, they propose the following further reforms:

- Long-term incentive plans (LTIPs) should be phased out as soon as possible.
    - No new LTIPs should be agreed from the start of 2018 and existing agreements should not be renewed. Although not clear, it appears that their preference is that no further grants should be made under existing LTIPs.
    - To incentivise long-term decision making, companies should instead use deferred stock awards - free share awards without performance conditions, vesting over a period of at least five years "without large steps". The suggestion in the paper is for awards to vest at a rate of 15 - 20 per cent per year, although the Committee accepts the need for some flexibility. That vesting schedule differs from the schedule proposed by the Investment Association executive remuneration working group in their report last year. They reported a consistent view that deferred stock should vest between years three to five and their current remuneration principles reflect that, stating that there should be no vesting before the third anniversary.
    - This proposal seems to be driven more by the policy aim of reducing pay levels, rather than the failure of performance conditions to drive correct behaviour and align executives with shareholders. The section in the report on pay and performance does not really address that point in any depth.
    - The intention is obviously that the number of shares subject to awards will be materially reduced compared to an LTIP where the pay-out is subject to satisfaction of performance conditions, the thinking being that recipients will accept the smaller upside as there is less uncertainty as to the receipt of the shares. If these proposals are implemented and companies move to deferred stock, it will be interesting to see how award levels change and whether shareholders will readily accept that performance conditions should be jettisoned.
    - The Investment Association executive remuneration working group considered that a fifty percent discount to existing LTIP award levels would be appropriate, but also noted that some investors did not favour the removal of performance conditions. Ultimately, it is shareholders' views which will count, as companies wishing to move to deferred stock awards for directors will need shareholder approval.
- They therefore recommend that the FRC consults with stakeholders with a view to amending the Code so that its remuneration guidelines provide for:
    - a simpler structure based primarily on salary and deferred stock; and
    - "limited use of" short-term performance related cash bonuses, which should have clear criteria, be aligned where possible to wider company objectives or corporate governance responsibilities and be genuinely stretching - "providing incentives rather than just reward".

- They favour the proposal in the green paper requiring a binding vote on executive pay in the event a company's advisory vote receives a vote against in excess of 25 per cent of votes cast. They recommend the FRC include that requirement in the Code and that the requirement should be included in legislation "at the next opportunity".

- They recommend that the Code should be amended to provide for employee representation on remuneration committees.

- They recommend that any chair of a remuneration committee should normally have served on the committee for at least one year previously, and that the chair of a remuneration committee should be expected to resign if their proposals do not receive the backing of 75 per cent of voting shareholders.

- They recommend that the Code should require that a company's people policy should include its overall approach to rewarding employees at all levels and that further details of remuneration levels should be published.

- They recommend the FRC work with other stakeholders to require the publication of the pay ratios between the CEO and senior executives and all UK employees (with similar requirements to be imposed by the government on public sector and third sector bodies over a specified size).

Note that a further requirement is that some corporate governance provisions should apply to private companies. It remains to be seen which of the above recommendations on pay will be included in those requirements, although that may be considered likely given that one of the main arguments against restricting listed company executive pay is that it pushes talent towards private companies.

All of these are just recommendations and, even if the FRC chooses to take them all on board, the Code currently operates on a "comply or explain" basis. So with the exception of the proposal in relation to a binding vote on pay, which the Committee proposes should become law, companies will still have the flexibility to decide whether or not to adopt these proposals. However, given the increased focus on corporate governance, particularly in the area of executive pay, and the proposed rating system, failing to comply with the Code is likely to attract increased criticism.

CONTACT DETAILS
If you would like further information or specific advice please contact:

ROBERT COLLARD
PARTNER
SHARE SCHEMES AND INCENTIVES
DD +44 (0)20 7849 2696
robert.collard@macfarlanes.com

APRIL 2017

This note is intended to provide general information about some recent and anticipated developments which may be of interest.
It is not intended to be comprehensive nor to provide any specific legal advice and should not be acted or relied upon as doing so. Professional advice appropriate to the specific situation should always be obtained.

Macfarlanes LLP is a limited liability partnership registered in England with number OC334406. Its registered office and principal place of business are at 20 Cursitor Street, London EC4A 1LT.
The firm is not authorised under the Financial Services and Markets Act 2000, but is able in certain circumstances to offer a limited range of investment services to clients because it is authorised and regulated by the Solicitors Regulation Authority.
It can provide these investment services if they are an incidental part of the professional services it has been engaged to provide. © Macfarlanes April 2017