UK Corporate Governance Reforms: More Regulations on Executive Pay in the UK

AUTHOR

As a review of the UK Government’s latest initiatives on executive compensation, both for listed and private companies, one cannot do better than draw upon an excellent summary produced by the widely respected communications firm Headland.

With their kind permission, we reproduce below a synopsis of their recently published summary, along with commentary based on Pearl Meyer’s years of experience in the field of executive remuneration consulting.

According to Headland, “[The UK] Government has announced key measures to tackle the ‘unacceptable face of capitalism’ following a consultation on its plans to reform Corporate Governance.”

The UK government plans to implement by June 2018, the following¹:

**Pay ratio reporting for quoted companies**

By March 2018, [the UK] government will introduce secondary legislation requiring quoted companies to:

- Report annually on the ratio of CEO pay to the average pay of their UK workforce, along with a narrative explaining changes to that ratio from year to year and setting the ratio in the context of pay and conditions across the wider workforce. Government proposes that the pay ratio should be calculated based on the CEO’s total annual remuneration relative to the average total remuneration of the company’s UK workforce. A draft statutory instrument will be published later this year.

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¹ All subsequent text, with the exception of designated Pearl Meyer commentary, is reproduced from the Aug. 29, 2017 “Briefing Note: Corporate Governance Reforms” with permission from Headland Consultancy.
• Provide a clearer explanation in remuneration policies of the range of potential outcomes from complex, share-based incentive schemes.

**Corporate Governance Code changes for listed companies**

[The UK] Government has tasked the Financial Reporting Council (FRC) with introducing new requirements in the UK Corporate Governance Code to ensure employees’ interests are better represented at board level in listed companies. Government proposes that the Code includes measures on:

- **Employee engagement**: Specific provision requiring premium listed companies to adopt, on a “comply or explain” basis, one of three employee engagement mechanisms: a designated non-executive director; a formal employee advisory council; or a director from the workforce.

- **Shareholder views**: Specific steps that premium listed companies should take when they encounter significant shareholder opposition to executive pay policies and awards (and other matters). The FCA will also consider whether measures should apply to all premium listed companies or only to FTSE 350 premium listed companies.

- **Remuneration committees**: Give remuneration committees a broader responsibility for overseeing pay and incentives across their company and requiring them to engage with the wider workforce to explain pay policy.

- **Remuneration committee chairs**: Ensure that chairs of remuneration committees should have served for at least 12 months on a remuneration committee, unless there is a clear and valid explanation why this may not be appropriate or possible in a particular case.

- **Executive share rewards**: Extend the recommended minimum vesting and post-vesting holding period for executive share awards from three to five years to encourage companies to focus on longer-term outcomes in setting pay.

The FRC intends to consult on amendments to the Code in the late Autumn.

**Pearl Meyer commentary:**

Strengthening remuneration committees and ensuring they are of the highest quality are recommendations which make sense and were expected. The concept of pushing remuneration out towards vesting in five years likewise makes some sense, although that’s less easy to implement in practice. “Works Councils” and workers on the board seems an unlikely initiative to win favour with the business community and is expected to fall away.
Public register of listed companies facing shareholder objections to executive pay

[The UK] Government has commissioned the Investment Association to implement its own proposal to maintain a public register of listed companies encountering shareholder opposition to pay awards of 20 percent or more. It will also hold a record of what these companies say they are doing to address shareholder concerns.

This will be the first such register in the world and will be established this Autumn. If no evidence of “active and effective steps to respond” is found, government will consider further action “at a future point”.

Pearl Meyer commentary:

Much of this was expected, as we reviewed the outcome of the Investment Association’s Working Party findings late last year. What is unexpected is the bold move to pay ratios given the technical feasibility of creating a like-for-like comparison of CEO and average employee pay.

In the US, disclosure of a CEO Pay Ratio will become a reality beginning in 2018 for most public companies. The requirement was one of the most controversial compensation-related measures incorporated into the Dodd-Frank Act, and took more than eight years to become effective. Both investors and analysts have indicated that disclosure will have little to no impact on their decision-making or review of companies and their governance practices. Instead, the ratio will simply serve as material for negative publicity, with labour union advocates voicing the most concern.

Share buybacks

[The UK] Government will take forward its manifesto commitment to commission an examination of the use of share buybacks to ensure that they cannot be used artificially to hit performance targets and inflate executive pay.

The review will also consider concerns that share buybacks may be crowding out the allocation of surplus capital to productive investment.

The Government will announce more details shortly.
Pearl Meyer commentary:

The use of share buybacks to concentrate ownership and distribute surplus cash that cannot be used for lack of projects with sufficiently high expected returns is one tool in the armoury of financial management, and regulating this seems an unnecessary move towards state oversight of management. Successful organisations which create high return investment opportunities face the opposite dilemma: a need for capital and a drought of dividends. Will these be “regulated” when shareholders want more dividends?

Raising corporate governance standards in large privately-held businesses

Recognising the high impact of the UK’s largest private companies, [the UK] government plans to encourage high standards of corporate governance, irrespective of their legal status, by introducing:

- **Voluntary corporate governance principles:** [The UK] Government will invite the FRC to work with the IoD, the CBI, the Institute for Family Businesses, the British Venture Capital Association, and others to develop a voluntary set of corporate governance principles for large private companies under the chairmanship of a business figure with relevant experience.

- **Mandatory disclosure of corporate governance arrangements:** [The UK] Government will introduce secondary legislation to require companies of a significant size to disclose their corporate governance arrangements in their Directors’ Report and on their website, including whether they follow any formal code. This requirement will apply to all companies of a significant size unless they are subject to an existing corporate governance reporting requirement. The Government will also consider extending a similar requirement to Limited Liability Partnerships (LLPs) of equivalent scale.

Government’s initial definition of “large privately-held business” is: companies with more than 2,000 employees unless they are subject to an existing corporate governance reporting requirement. The Government will also consider extending a similar requirement to Limited Liability Partnerships (LLPs) of equivalent scale.

Pearl Meyer commentary:

This is a potentially seismic change for private companies, and in particular large foreign-owned private enterprises. In the past, talent has flown from the listed sector into privately backed organisations, partly as a result of the freedoms from regulation. With this one move, that loophole may be closed and successful private companies will find themselves burdened with the requirements of the listed sector.
Next steps

▪ The FRC intends to consult on amendments to the UK Corporate Governance Code in the late Autumn [2017].

▪ A draft statutory instrument on publication of pay ratio data will be published later this year.

▪ The Government intends to lay before Parliament draft secondary legislation, where required, before March 2018. Where necessary, there will be consultation on the detail of the secondary legislation.

▪ The work on developing voluntary corporate governance principles for large private companies will commence in the Autumn [2017].

▪ The current intention is to bring the reforms into effect by June 2018 to apply to company reporting years commencing on or after that date.

About the Author

Simon Patterson is a managing director and head of the firm’s London office. He is actively engaged as advisor to the remuneration committees of several FTSE 100 companies and consults widely on executive compensation, incentive compensation design and performance measurement.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer’s global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.