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# UK Binding Say on Pay - a Proposal Worth Critiquing

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UK-incorporated quoted (or, in U.S. terms, public) companies have reason to fear that binding say on pay (***BSOP***) could become a reality for general shareholder meetings held on and after October 1, 2013. That proposal comes from the UK's Department for Business, Innovation and Skills (***BIS***), and is set forth in a consultation document released on March 14th.[1] From a business perspective, the BIS proposal threatens to result in a regime under which one failed shareholder vote could derail a company's ongoing operations and management incentives.

Because governance initiatives in one country have been going global at an increasingly rapid rate, companies ought to consider commenting on the BIS proposal before its April 27th deadline. Highlights of the BIS proposal and some preliminary thoughts appear below.

### Purpose of the BIS Proposal

"While [executive pay] is primarily an issue for companies and their shareholders, the Government has a role to provide an effective corporate governance framework for executive remuneration; particularly where shareholders lack the information and powers they need to hold companies to account."[2]

### Executive Summary

The UK government's overall approach on executive pay is driven towards greater transparency for shareholders on remuneration, empowering shareholders and promoting engagement through enhanced voting rights, an increase in diversity, increased employee engagement and an ongoing dialogue between itself and investors and businesses to promote best practice on pay-setting. Against that background, the BIS proposal presents the following four key initiatives that are discussed further below:

1. requiring companies to provide shareholders with "a proposed pay policy for the year ahead, including potential payouts and performance measures that will be used", and implementing that policy only if shareholders pass the associated BSOP resolution;

2. seeking a new BSOP vote within 90 days after shareholders reject the first proposed pay policy, or falling back on the last policy approved by shareholders;

3. triggering a company disclosure about how it will address shareholder concerns with executive remuneration if the annual advisory say-on-pay vote fails to secure support from a threshold up to 75% of the votes cast; and

4. giving shareholders a BSOP vote on any exit payment exceeding one year's base salary.

## Q-1: Why Binding Say on Pay (BSOP), and what is being proposed?

The BIS proposal explains that quoted companies have failed in "a small but significant number of cases" to respond adequately to shareholder concerns that were expressed in a large proportion of votes withholding support for advisory say on pay proposals.[3] The BIS has consequently made the BSOP proposal in order to make public companies more responsive to shareholder concerns raised in the prior year and more open to the proper engagement of shareholders during the process of preparing the remuneration report for the current year.[4] As proposed, the BSOP vote –

> would give shareholders an opportunity to approve variable remuneration, including: salary increases; the level and criteria for performance related pay for the year ahead; material changes in a director's benefits and pension arrangements; material changes to service contracts and any other discretionary payments.[5]

In order to facilitate the BSOP vote, the BIS proposes to require that UK companies divide their future remuneration reports into two distinct sections, with one focused on prior year decisions (for the advisory SOP vote), and the other focused on proposed future policy (for the BSOP vote).[6] In terms of frequency, the BIS proposal anticipates annual BSOP votes, but notes that an alternative involves requiring BSOP votes "only where there are substantial changes proposed, as in the Netherlands."[7]

## Q-2: What will a failed BSOP vote trigger?

Here is the full text of the BIS proposal:

> In the event that [shareholder] engagement is ineffective in persuading shareholders of the appropriateness of the proposed policy and the binding vote on remuneration policy is lost, the company would have to fall back on the last policy to be approved by shareholders. Alternatively, if the company wished to proceed with a new policy for the forthcoming year, it would be necessary to hold a further general meeting where shareholders would be asked to vote on new proposals, as set out in a revised policy section of the remuneration report which would be circulated in advance to shareholders. In order to ensure that this is done without delay, the Government proposes to require that any such meeting should be held within 90 days of the AGM *[annual meeting]* at which the original resolution failed to secure shareholder support.[8]

Note that the BIS proposes to prohibit UK public companies from recruiting new directors through offers of individual remuneration that are more generous than those allowable in accordance with the policy most-recently approved through a BSOP vote (unless the company has secured sufficient flexibility from shareholders beforehand).[9]

A few of the open, unsettling questions in relation to these proposals include the following:

- What BSOP vote will be considered "ineffective" – a vote that is less than 50% of those cast, or the heightened requirement of up to 75% described under Q-3 below?
- What will happen if the company fails in its first BSOP vote, given that it cannot revert to the remuneration policy that most recently had received a favorable BSOP vote?
- Is 90 days a feasible period within which a company could develop a new remuneration policy, propose it to shareholders, engage them in dialogue, and hold a meeting at which the revised policy is presented for a vote? If not, what are the alternatives?

- Is the proposed BSOP remediation structure a nuclear solution that could derail sound business operations through the uncertainty and remediation pressures that it would trigger?

### Q-3: Will the Advisory Say-on-Pay rules also change?

Yes, mainly by requiring first that future remuneration reports disclose a total pay amount for each director, how pay correlates to company performance and the previously-disclosed remuneration policy, and how executive pay spending relates to "other dispersals, such as dividends, tax, business reinvestment and general staffing costs". [10]

In addition, if less than 75% of the votes cast support an advisory say-on-pay vote for the prior year's executive pay, then the company must "issue a statement to the market (for example, via a regulatory news service) within 30 days, "detailing the [advisory] shareholder voting results, the main issues they have raised […], [and] how the company "proposes to work with shareholders to address these issues".[11]

### Q-4: When will BSOP apply to Exit Payments, aka Severance?

The BIS basically proposes that shareholders should receive a BSOP vote "on any exit payment which exceeds the equivalent of one year's base salary".[12] In advance of the meeting at which this vote occurs, the company would have to provide shareholders with "a memorandum detailing the amounts it proposes to pay, how they have been calculated, and why they are deserved".[13]

The BIS proposal expressing rejects seeking advance shareholder approval of exit incentives (as allowed in Australia), and instead requires the BSOP vote only after the individual's contract has been terminated. [14]

### Q-5: How will BSOP affect current executive and pension rights?

BIS proposes to require the amendment of existing service contracts and other arrangements, and to hold directors liable for any loss to the company that arises from entering into new agreements that include terms that are inconsistent with the remuneration policy as approved by shareholders through their BSOP vote.

Similar rules apply with respect to exit payments, although the BIS proposal goes on to recognize that companies "may take the approach of buying directors out of their existing contractual rights in order to renew them in line with the new legislation".[15] Any buy-out payments would need to be "clearly disclosed" in the applicable remuneration report.[16]

### Q-6: What should employers do now?

The BIS comment period closes on April 27, 2012. Its proposal (i.e., the consultation document) invites comments in response to 12 questions that mainly focus on the costs and benefits of the proposals described above. Because governmental regulation of executive pay seems to be rapidly spreading across geographic boundaries, it would be worthwhile for employers to create a thoughtful record in response to the BIS proposal.

Employers should strongly consider whether to submit comments addressing all 12 of the BIS questions (as reproduced below in the Appendix below), and generally to oppose those that go beyond harmonizing the UK advisory say on pay rules with, for example, those of the US. From a disclosure perspective, it seems that more fulsome disclosure in the US has dramatically improved both shareholder engagement and company accountability for executive pay decisions and further evidence from the international community may again serve as instructive and influential in the UK government's ultimate decision in this regard.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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[1] A copy of the BIS Executive Pay Consultation (3/14/2012) is available here.

[2] BIS proposal ¶2.

[3] BIS Proposal ¶49, 51.

[4] BIS Proposal ¶49.

[5] BIS Proposal ¶56.

[6] BIS Proposal ¶57.

[7] BIS Proposal ¶64.

[8] BIS proposal ¶66.

[9] BIS proposal ¶79-80

[10] BIS proposal ¶100.

[11] BIS proposal ¶106.

[12] BIS proposal ¶122.

[13] BIS proposal ¶124.

[14] BIS proposal ¶125.

[15] BIS proposal ¶135.

[16] BIS proposal ¶135.

**APPENDIX**

***Summary of consultation questions***

(reproduced from page 35 of the BIS proposal)

1. The Government proposes to require an annual binding vote on remuneration policy. What are the costs and benefits of this approach?

2. In the event that a company fails the binding vote on remuneration policy, the Government proposes that it maintains its existing policy or returns to shareholders with amended proposals within 90 days. What are the costs and benefits of this approach?

3. The Government proposes that directors' service contracts and other arrangements should, if necessary, be amended to take account of the new requirement to seek shareholder approval ofremuneration policy. What are the costs and benefits of this approach?

4. The Government proposes that remuneration packages offered to in-year recruits should be confined by the limits and structures set out in the agreed remuneration policy. What are the costs and benefits of this approach?

5. The Government proposes that the report on future remuneration policy should provide more details on how approved LTIPs will operate for directors in that particular year. Do you agree with this approach?

6. The Government proposes to increase the level of shareholder support that should be required to pass the vote on future remuneration policy. Do you agree with this approach and if so, what would be an appropriate threshold?

7. The Government proposes to require companies to explain how the results of the advisory vote have been taken into account the following year and to issue a statement to the market sooner than this where there is a significant level of shareholder dissent. What are the costs and benefits of this approach?

8. The Government proposes to give shareholder a binding vote on exit payments of more than one year's base salary. Do you agree with this approach or would an alternative threshold for requiring a shareholder vote be more appropriate?

9. The Government recognises that the circumstances under which a director leaves their post are complex and diverse and so invites feedback on the appropriate scope and breadth of the proposed legislative measures.

10. The Government proposes that directors' service contracts and other arrangements should be amended to take account of the new requirement to seek shareholder approval for exit payments over one year's base salary. What are the costs and benefits of this approach?

11. The Government notes that a small number of directors could be entitled to generous pension enhancements if their contract is terminated early. It proposes not to legislate to override these rights, owing to the rarity of such arrangements and the complexity of legislation that would be required. Do you agree with this approach?

12. The Government proposes to leave unchanged the existing requirement in company law (section 188 of the Companies Act) to get members' approval for notice periods of more than two years. Do you agree with this approach?