

# BENEFITS & COMPENSATION INTERNATIONAL

TOTAL REMUNERATION AND  
PENSION INVESTMENT



# Disclosure and Shareholder Approval of Executive Remuneration Packages

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In the second half of the 20th century, much of the disclosure and development of executive remuneration structures was led from the USA, where tax-favoured incentive stock options were legislated into its tax code shortly after the Second World War. The UK equivalent only arrived in 1984, so it is not surprising that executive compensation using stock and stock options is much more developed in the USA than in the UK or, indeed, in Europe.

Where the European Union (EU) has led, and the USA is following, is in the disclosure of executive total remuneration packages and the giving to shareholders of voting rights on those packages. Starting in the UK with the Directors' Remuneration Report Regulations 2002 (the UK Regulations), shareholders were given the non-binding vote on the approval of the remuneration report, which had to contain a certain minimum level of information specified by statute. This UK lead has been followed by other European countries and Switzerland, Germany, Hungary, Portugal and Spain now also have advisory votes on remuneration policy. Italy, the Netherlands, Denmark, Norway and Sweden have gone further and given shareholders binding votes on remuneration policy. While Europe has forged ahead, the USA has spent much time considering a vote on 'say-on-pay' and finally the legislation was enacted, effective 21 July 2010, as a very small part of the much larger Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>1</sup>

This article looks at the statutory obligations of UK-listed companies to prepare a remuneration report and submit it to an annual advisory shareholder vote and at

the newly enacted US equivalent; and then considers how the UK and Europe have moved ahead in attempting to regulate pay of executives in the financial services sector.

## THE UK LEGISLATION

The UK Regulations consist of just 22 paragraphs and follow the principle of 'Comply or Explain'. For example, if a company does not wish to introduce performance conditions for its long-term incentives, it must state why it has not introduced performance conditions.

Paragraph 1 introduces the UK Regulations.

Paragraph 2 requires disclosure of the names of the Remuneration Committee members and those who advise the Committee and whether those advisers were appointed by the Committee and the nature of any other services that such advisers have provided to the company.

Paragraph 3 requires the Remuneration Report to contain a statement of the company's policy on directors' remuneration for the following year and for subsequent financial years. Under the policy statement, details of performance targets for share options and other share awards must be given in a detailed summary, together with reasons for the choice of such performance conditions, and the methods for assessing whether any such performance conditions are met with an explanation as to why those methods were chosen. If any changes to terms and conditions of stock awards and stock options are proposed, then a description and explanation is required as is the reason for any award

without performance conditions attaching. The policy statement must explain the relative importance of those elements of remuneration that are, and those that are not, related to performance. Finally, the policy statement must summarize and explain the company's policy on duration of contracts with directors and notice period and termination payments due under such contracts.

The Directors' Remuneration Report Regulations have been amended just once so far, in 2008. A new Paragraph 4 was introduced requiring the Report to contain a statement of how the pay and employment conditions of employees of the company and the group were taken into account when determining the remuneration of directors for the relevant financial year.

Paragraph 5 contains a requirement for the publication of a line graph showing the total shareholder return on a holding of shares in the company and that of a broad equity market index over a five-year period.

Paragraph 6 requires details of the dates of all contracts of directors, the unexpired term and details of any notice period, provisions for compensation payable upon early termination of the contract and details of provisions allowing the shareholder to calculate the liability of the company in the event of early termination of the contract.

The remaining disclosure requirements are subject to audit and require a detailed explanation of each director's emoluments and compensation paid or receivable for the financial year just ended.

#### **EFFECT OF THE UK REGULATIONS**

The key point is that the unaudited section requires the Remuneration Committee to set out its policy for pay in the future and shareholders can vote on that policy. Shareholder representative bodies in the UK are well organized and, in order to buttress their positions, can speak on behalf of members with significant company shareholdings. The Association of British Insurers and the National Association of Pension Funds have long issued guidelines on executive remuneration and employee share incentive arrangements. Many of the large investment managers and insurance companies have their own guidelines, issued to companies, in which they make equity investments. As a result, there is a general consensus on what levels of pay, notice periods and executive pension design should be. If Remuneration Committees do not toe the line without a good explanation of the actions they have taken instead, the chances are that the Remuneration Report will be voted against and the company will then change its policy to make it acceptable to shareholders. A good example was the first vote against a FTSE 100 company in 2003. GlaxoSmithKline (GSK) had a policy of giving its directors a contractual notice period of two years of payments, including an annual incentive, as well as basic salary. This was a standard feature of contracts for US executives and the Chief Executive Officer (CEO) of GSK was based in the USA. However, UK institutional investors had made clear their limits for a one-year notice period, under which payments should be subject to mitigation and without an annual incentive being paid during the notice period. Shareholders made it very clear why they were voting against the GSK

Remuneration Report and the company modified its policies to bring them into line with UK norms.

The standard approach in the UK FTSE 100 is now to have a basic salary set at a median level of comparator companies, annual and long-term incentives subject to performance testing that can increase total remuneration towards the upper quartile of the comparator group if company performance is such that an upper quartile result is delivered to shareholders as well, a pension that is related only to basic salary, and notice periods of 12 months or shorter.

As a result, Remuneration Committees now spend time with investors in the company explaining how the company's vision, mission and business strategy are supported by the remuneration strategy of the company and the topic is frequently raised at Annual General Meetings (AGMs). By and large, companies comply with the guidelines and their remuneration reports receive overwhelming support at the AGM. Shareholders, directors and company employees have a very clear explanation of the components of the total remuneration of the directors of the company and the purpose of each component, together with detailed metrics about the performance measures attached to those elements that are related to performance.

#### **THE CURRENT POSITION IN THE USA**

Dodd-Frank has set a framework for Accountability and Executive Compensation requiring the Securities and Exchange Commission (SEC) to issue rules that direct US stock exchanges to prohibit the listing of securities that are not in compliance with the Compensation section of Dodd-Frank, by amending the Securities and Exchange Act of 1934. At least once every three years a public corporation is required to submit to shareholder vote approval of its executive compensation ('Say on Pay' or 'SOP'). Then, once every six years it must be submitted to shareholder vote whether the required approval of executive compensation should be more often than once every three years ('Say When on Pay' or 'SWOP'). The SOP and SWOP requirements of Dodd-Frank are effective for proxies, consents or authorizations for the first annual or other meeting of the shareholders occurring on or after 20 January 2011. TABLE 1 on page 17 shows the different positions of the UK and the USA.

Shareholders must be given an opportunity to have a non-binding vote on any 'golden parachute' compensation to executives. This vote can be held annually as part of the annual shareholders' meeting or, if not covered by a prior annual vote, must be held in conjunction with the specific corporate transaction triggering the required disclosure, i.e. a table disclosing the compensation payable to executives as a result of the transaction (Golden Parachute Table). The SEC has not issued final rules for the golden parachute votes,<sup>2</sup> so US public corporations have been reluctant to include these proposals in their 2011 proxies. In addition, Institutional Shareholder Services (ISS) has issued a policy with respect to golden parachute votes that are likely to have a chilling effect on public corporations' willingness to include such votes as a routine matter in their proxies.<sup>3</sup> Under ISS policies, if a corporation includes the Golden Parachute Table in its Compensation Discussion & Analysis section of its proxy, the information disclosed in that table will carry more weight in ISS's overall SOP recommendation. Thus,

companies that are disclosing certain ISS ‘problematic’ pay practices might receive a vote against on their SOPs from ISS, where it could be passed if the Golden Parachute Table information were excluded. These problematic pay practices include:

- severance in excess of three times basic salary plus target bonus,
- severance triggered by a ‘liberal’ change-in-control (CIC) definition or a single-trigger (just the occurrence of the CIC event), and
- provision of an excise tax gross-up for the executive.

Dodd–Frank imposes a disclosure obligation on institutional shareholders. Institutional investment managers subject to §13(f) of the Securities and Exchange Act of 1934 must report at least annually how they voted on any SOP, SWOP or Golden Parachute Vote.

Dodd–Frank dictates several other required executive compensation disclosures. Shareholders must be informed of the relationship between the executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the stock and dividends of the issuer and any distributions (which may include a graphic representation of such information), together with:

- the median of the annual total compensation of all employees of the issuer except the CEO or any equivalent position;
- the annual total compensation of the CEO or any equivalent position; and
- the ratio of the amount of the median of the annual total to the CEO’s total compensation.

The company is required to disclose to shareholders whether any employee or member of the board of directors is permitted to purchase financial instruments, designed to hedge or offset any decrease in the market value of equity securities that are part of the compensation package. A member of the board of directors’ Compensation Committee must be an independent member of the board of directors. If the Compensation Committee utilizes the services of a compensation consultant or legal counsel, the Committee must at least consider the independence of such advisers as are provided by the rules that will be issued by the SEC. Within nine months of the enactment of Dodd–Frank, Federal regulators must lay down regulations for a covered company (generally public corporations operating as banks and financial institutions) to disclose to the appropriate Federal regulator all incentive-based compensation arrangements with adequate information for the regulator to be able to determine whether the compensation package:

- could lead to material financial loss to the company; and
- provides the employee/officer with excessive compensation, fees or benefits.

In addition to these disclosure obligations, Dodd–Frank mandates that US public corporations develop and

implement a policy providing for the recovery of erroneously awarded compensation based on financial information required to be reported under US securities laws in the event that the corporation is required to prepare an accounting restatement, i.e. a mandatory ‘clawback’ policy. The policy must be disclosed to shareholders and must require the company to recover improperly awarded compensation from any current or former executive officer who received incentive compensation (including stock options) during the three-year period preceding the date on which the corporation is required to prepare the accounting restatement of the excess over what would have been paid under the accounting restatement. The SEC has not yet issued rules on how companies will need to comply with this clawback requirement. As drafted, the requirements appear to remove all discretion from the company’s ability to evaluate whether or not to seek reimbursement of such erroneously paid compensation. This could lead to some interesting results that are not in shareholders’ best interests. For example, if the accounting restatement only had a minor impact on the particular financial metric utilized and the compensation of a former executive was excessive only by US\$10,000, the company would have to pursue reimbursement, even though the legal fees associated with the recovery could dramatically exceed the amount to be recovered. In addition, as drafted, this clawback requirement would apply regardless of the culpability of the executive in the events necessitating the restatement.

#### LIKELY EFFECT ON CORPORATE GOVERNANCE

The SEC has been charged with developing the regulations that will implement the Dodd–Frank requirements. These requirements concerning executive compensation, while important to human resource practitioners, are not as important as some of the other provisions of Dodd–Frank that deal with financial reform. As a result, the SEC has taken a judicious approach to implementation of the executive compensation related requirements. So, for the 2011 proxy season, public companies in the USA will not be saddled with all the Dodd–Frank executive compensation requirements. Instead, the main executive compensation related requirements with which public companies will have to comply are:

- shareholder approval of executive pay in the form of a vote on the executive compensation disclosures at least once every three years and a vote on the frequency of the vote on the executive compensation disclosures at least once every six years;<sup>4</sup>
- a prohibition on brokers voting uninstructed shares regarding proposals for director elections, executive compensation or any other significant matter determined by the SEC.

The SEC has yet to propose rules for the following provisions of Dodd–Frank:

- each member of the committee must be independent;
- public companies will only be able to select advisers (compensation consultants, attorneys, etc.) after taking into account considerations to be issued by the SEC regarding the independence of advisers;

- the SEC must put forward a rule laying down how public companies are to disclose the relationship between their performance and executive compensation;
- disclosure of the median of the annual total compensation of all employees, except the CEO, and the ratio of such amount to the CEO's annual total compensation;
- the SEC is to draw up rules regarding how such a clawback provision must be complied with and applied to executive compensation; and
- the hedging of company securities by employees and directors must be disclosed.

Shareholders in the USA have been focused on public company corporate governance for the past decade. As a result, many public companies have had discussions with their shareholders concerning at least some aspects of their corporate governance practices and the shareholders' views of them. With the advent of the implementation of the Dodd–Frank requirements, the slow trickle of companies trying to be good corporate citizens and adopt corporate governance practices viewed favourably by shareholders is likely to accelerate.

US public corporations understood that this was a likely path for the country to go down. As a result, many have started making changes to their corporate governance practices and compensation plans in the last few years. For example, over the past three years, the use of relative performance measures in performance unit plans climbed from 57% in 2007 to 79% in 2010, according to Exequity research. A survey from another consulting firm found that among the top 250 public companies in the USA the incidence of companies using performance shares rose from 50% in 2007 to 62% in 2010; meanwhile the prevalence of the use of stock options dropped from 82% in 2007 to 73% in 2010<sup>5</sup>.

The National Association of Stock Plan Professionals has found that the prevalence of performance-based plans has grown from 30% of companies in 2004 to 71% of companies in 2010<sup>6</sup>. These trends look somewhat similar to what occurred in the UK after say-on-pay was mandated<sup>7</sup>. If the USA continues to follow the trend in the UK, US public corporations will begin shifting from the use of relative performance metrics, like relative total shareholder return (Relative TSR), to absolute performance metrics. Indeed, conversations one of the authors has had with public companies and institutional shareholders indicate that certain US institutional shareholders have already begun suggesting that US public corporations embrace this change. If this occurs, US public company executives can expect to receive compensation with absolute performance metrics that have been discussed with, and/or approved by, shareholders. Therefore, with shareholder acknowledgement of, and buy-in to, these compensation designs, we would expect that compensation could increase quite dramatically for US public company executives over the next decade, similar to what transpired in the UK after shareholder viewpoints were taken into account when developing compensation schemes<sup>8</sup>.

So, what impact will the new Dodd–Frank requirements regarding executive compensation have on corporate governance? As stated above, due to the SOP and SWOP votes, US public companies are likely to adopt more performance-based compensation and could be expected to move towards utilizing absolute performance metrics. So far, the majority of the SWOP proposals put out by US public companies have recommended a triennial SOP vote. It remains to be seen if this trend continues since we are still early in the proxy filing process. Furthermore, we will need to see how shareholders actually vote regarding their preference for the frequency of SOP votes. A number of institutional investors and proxy advisers have already expressed their preference for an annual SOP vote, so it is unclear whether they will ignore the company

**TABLE 1** Say-on-Pay in the UK Compared with the USA

	UK	USA
Year legislation adopted	2002	2010
First year of compliance	2003	2011
Binding nature of say-on-pay vote	Non-binding	Non-binding
What is being approved?	Remuneration Report	All the executive compensation disclosures included in the proxy
Party responsible for disclosure being voted on	Remuneration Committee	Management
Vote applies to remuneration/compensation	Prospectively	Retrospectively
Say-on-pay frequency	Annual vote	Annual, biennial or triennial vote
Vote on frequency	Not applicable	At least once every six years
Binding nature of vote on frequency	Not applicable	Non-binding

recommendations for a triennial vote. In addition, since both the SOP and SWOP votes are non-binding on companies in the USA, it remains to be seen what companies will actually feel comfortable adopting. This will probably depend on the specific vote outcomes on the frequency and SOP votes as well as any conversations companies have with their significant shareholders.

As for the requirement regarding the independence of compensation committee members, we believe it will have only a marginal impact since the vast majority of public companies have moved to having independent directors sit on their compensation committees as a result of statutory requirements such as Internal Revenue Code §162(m), not to mention the evolving views of what constitutes good corporate governance in the USA, i.e. having a compensation committee composed entirely of independent directors.

The requirement for companies to at least consider the independence of their advisers may also have only a marginal impact. A large number of public companies anticipated such a requirement and in response to earlier shareholder criticism had already adopted policies whereby their compensation committees would be advised by independent compensation consultants with no significant ties to other work for the company. Over the last two years a number of independent compensation consulting firms have sprung up in the USA to service this increased demand for independent consultancies, with many of these firms being formed by well-known partners of major, multi-line global consulting firms. Where this independence requirement could cause a significant change in corporate governance is in the area of legal counsel servicing compensation committees. Today, it is common for a company's outside law firm to appear before, advise and represent the compensation committee in addition to its other role. The Dodd-Frank requirement regarding the independence of compensation committee advisers does not *require* that such advisers be independent, merely that committees consider the independence of such advisers in accordance with the factors that the SEC will set. Thus, this requirement could cause a shift in the provision of legal services to compensation committees in the USA and could usher in a new speciality of independent legal adviser to compensation committees, but only time will tell if public companies will adopt such an approach.

## RECENT DEVELOPMENTS IN EUROPE

The response in Europe to the banking crisis has been to legislate against certain pay practices in financial organizations. The UK legislation has been led by the Financial Services Authority (FSA) under powers given by the Financial Services Act 2010 and is being introduced at EU level by the amendment of the Capital Requirements Directive. The Financial Services Act 2010 was enacted on 8 April 2010. Sections 4-6 of the Act contain a number of provisions concerning remuneration. The UK Treasury can now require regulated companies to disclose remuneration-related matters. The FSA has also been granted new powers and duties, which came into force on the same date. Sections 4-6 reinforce the key principles of the FSA's Code, notably the need to align remuneration practices with effective risk management, and generally do not require changes to the Code. However, there are two provisions within the Act relating to remuneration, which required the FSA to consult on changes to the Code.

First, the FSA has been given express powers to prohibit employees (or groups of employees) from being remunerated in a specific way. For example, bonuses that are guaranteed for a period in excess of one year are not permitted. Remuneration contracts that breach prohibitions on forms of remuneration under the Code can be rendered void and the Act enables the FSA to provide for recovery of any payments made or other property transferred. Another example is that of hedging of shares in the employer company. The FSA requires that companies ask employees not to use personal hedging strategies, nor take out insurance contracts that undermine risk alignment. This contrasts with Dodd-Frank where such hedging is permitted if disclosed.

Secondly, under §6 of the Act, FSA rules must ensure that the remuneration policies of companies subject to its Code are consistent with the Financial Stability Board's compliance standards.

In some respects, therefore, the legislative environment in Europe is similar to that which in the USA led to Dodd-Frank. What is interesting is that the UK had its 'say-on-pay' and disclosure legislation many years before the USA. The USA is catching up fast but the UK and the EU remain leaders in this contentious area and some standard US practices continue to be unacceptable in Europe. Ω

### References

- <sup>1</sup> The full title is: an Act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.
- <sup>2</sup> The SEC has issued proposed rules for the Golden Parachute Vote as part of SEC Release No. 33-9153, *Shareholder Approval of Executive Compensation and Golden Parachute Compensation*, October 18, 2010, available at: [www.sec.gov/rules/proposed/2010/33-9153fr.pdf](http://www.sec.gov/rules/proposed/2010/33-9153fr.pdf)
- <sup>3</sup> See ISS's 2011 US Compensation Policy, Frequently Asked Questions, Vote on Golden Parachutes (Updated: December 14, 2010), available at: [www.issgovernance.com/policy/2011/USCompensationFAQ](http://www.issgovernance.com/policy/2011/USCompensationFAQ)
- <sup>4</sup> SEC Release No. 33-9153, *Shareholder Approval of Executive Compensation and Golden Parachute Compensation*, October 18, 2010, available at: [www.sec.gov/rules/proposed/2010/33-9153fr.pdf](http://www.sec.gov/rules/proposed/2010/33-9153fr.pdf)
- <sup>5</sup> 'The 2010 Top 250, Long-Term Incentive Grant Practices for Executives', Frederic W. Cook & Co., Inc., October 2010.
- <sup>6</sup> 'Trends and Analysis from the 2010 Stock Plan Design Survey, A Review of U.S. Equity Compensation Plan Trends', Barbara Bakso, Mike Kesner and Tara Tays, National Association of Stock Plan Professionals, August 10, 2010.
- <sup>7</sup> 'Say on Pay: Six Years On – Lessons from the UK Experience', Railpen Investments and PIRC Limited, September 2009, p. 22.
- <sup>8</sup> *Ibid.*, pp. 16-22.