Executive Compensation in the United Kingdom – Past, Present, and Future

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Executive compensation is a constant work in progress, influenced by the ebb and flow of corporate and financial crises, political agendas, and academic and popular commentary. Against the background of a flurry of new provisions, this article begins by taking a step back and provides a high-level perspective on the fundamental issues and drivers of the contemporary executive compensation debate. Building upon this basis, the article then moves to explore the rules on executive remuneration in the UK, looking first at earlier approaches before shifting to a more detailed exploration of the most recent reforms. The article concludes with a critical analysis of the current framework and, more generally, the merits of regulating executive compensation. It suggests that it is unclear whether executive compensation has correctly been identified as a field for regulatory intervention, and, if there is such a case, that the UK's latest measures are insufficient to address the problem.

A. INTRODUCTION

Executive compensation (or "remuneration") is one of the most widely discussed – and most controversial – corporate governance issues of recent times. It has become the most visible sign of an ongoing international trend to strengthen "shareholder democracy"[1] as evidenced by shareholders regaining certain decision-making powers from company boards. Executive

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[1] For instance, in 2003, the EU identified the establishment of "real shareholder democracy" as one if its medium to long-term political goals. European Commission, "Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward" COM(2003) 284, 14.

compensation is also closely related to other hot-button issues, short-termism and risk-taking, which have remained at the forefront of corporate governance debates since the last financial crisis.[2]

The UK has long been a leader in the regulation of executive compensation, pioneering, among others, "say on pay", that is shareholder votes relating to this matter. However, numerous other jurisdictions – in Europe and elsewhere – have increasingly followed or even surpassed its lead. For example, even the US, with its traditionally strong focus on business friendly corporate laws, has introduced say on pay, while certain European jurisdictions already have binding shareholders votes on executive pay and have introduced or attempted to introduce salary caps and executive-employee pay ratios.[3]

This article, however, takes for the most part a narrower view, focusing mainly on the UK's general executive compensation regime.[4] First, the article provides a brief introductory overview of the main issues that surround the executive pay debate. On this basis, the article goes on to outline the regulation of executive remuneration in the UK, from tracing earlier approaches to discussing the most recent reforms, which have entered into force in late 2013. Finally, the

[2] See "Kay Review of UK Equity Markets and Long-Term Decision-Making" (July 2012) ("Kay Review").
[3] For recent overviews, see Hay Group, "Executive reward snapshot: more shareholders are getting a say on top pay" (2013) <http://www.haygroup.com/downloads/ww/HG280_Say%20on%20Pay_v05.pdf> accessed on 12 September 2014; Towers Watson, "Executive Remuneration: European Corporate Governance Developments" (2013) < http://www.towerswatson.com/DownloadMedia.aspx?media={4943B8FF-1E4A-4129-8E95-79E30BBC9824}> accessed on 12 September 2014. Moreover, note that the EU is currently considering introducing harmonized executive remuneration rules. Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC and Directive 2013/34/EU' COM(2014) 213 final. These rules would be implemented in addition to already existing EU remuneration rules for financial institutions, for further background and analysis on which see E Ferran, "New Regulation of Remuneration in the Financial Sector" (2012) 9 *European Company and Financial Law Review* 1.
[4] The discussion will not extend to requirements that apply solely to the banking and financial industry.

article concludes with a reflective analysis of the revised UK framework, providing a critical analysis of the latest reforms' potential impact and merits.

B. THE EXECUTIVE COMPENSATION DEBATE

1. The Problem

There is no doubt that executives of large public companies receive substantial and continuously increasing remuneration packages. The average total pay of FTSE 100 Chief Executive Officers (CEOs) for the period from 1998–2010 has risen 13.6% per year from an average of £1 million to £4.2 million, far outpacing the 1.7% average annual increase in the FTSE 100 index and average remuneration levels for other employees for the same period.[5] More recently, in 2011, the median increase in total remuneration awarded for CEOs in FTSE 100 companies amounted to 10%, following a 13% increase in 2010. In addition, during the same year, half of the FTSE 100 CEOs were awarded increases of more than 10%, with one quarter receiving increases in total remuneration of 41% or more.[6]

Yet, it is clear that executive remuneration is controversial not just based on the high amounts or increases of remuneration packages. One of the most frequently cited concerns is that there is a lack of alignment between executive pay and company share performance. Nevertheless, for the UK, empirical data only provides partial support for this thesis. Several

[5] Department for Business Innovation and Skills ("BIS"), "Executive remuneration discussion paper" (2011) 11 <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31660/11-1287-executive-remuneration-discussion-paper.pdf> accessed 17 September 2014.
[6] Manifest, "Executive Pay – Where Are We Now?"(2012) <http://www.mm-k.com/content/documents/Executive-Summary.pdf>; see also B Groom, "Gap widens between UK executive pay and results", *Financial Times*, 23 January 2014 <http://www.ft.com/cms/s/0/92a3db66-835b-11e3-aa65-00144feab7de.html#axzz2u5gCboqv> accessed 17 September 2014.

studies confirmed a relation between pay and performance but also identified an asymmetric relationship between them. While performance and executive pay were linked, a stronger relationship was detected between pay and strong performance than between pay and weak performance.[7] However, company underperformance was also linked to a significant increase in the probability of CEOs losing their jobs.[8] Moreover, most recently, yet another study concluded that pay and performance are more strongly aligned than previously thought.[9]

Apart from concerns related to performance, executive pay is often compared to compensation received by other employees. During 1998–2010, UK employee remuneration has only grown by 4.7%, lifting the multiple of CEO pay from 47 times average worker pay to a multiple of 120.[10] Thus, in addition to the size of pay and performance questions, there is an added issue that touches upon employee incentives and productivity, leading to complicated broader societal issues of distributive justice and fairness.[11]

Nevertheless, whether these developments alone should be the basis for regulatory intervention is not self-evident. Many investment bankers, hedge fund and private equity fund

[7] P Gregg et al, "Executive Pay and Performance in the UK" (2010), AXA Working Article Series No 5, Discussion Article No 657 <http://www2.lse.ac.uk/fmg/workingPapers/discussionPapers/DP657_2010_ExecutivePayandPerformanceintheUK.pdf> accessed 17 September 2014; B Bell and J van Reenan, "Firm Performance and Wages: Evidence from Across the Corporate Hierarchy" (2011) <http://cep.lse.ac.uk/conference_papers/04_11_2011/BellVReenen_FirmPerformanceandWages.pdf> accessed 17 September 2014. See also I Gregory-Smith and B May, "Heads I win, Tails you lose? A career analysis of executive pay and corporate performance" (2012) University of Edinburgh Research Article <http://homepages.ed.ac.uk/mainbg/images/Heads%20I%20win_Dec_2012.pdf> accessed 17 September 2014.

[8] Bell and van Reenan, supra n 7, 22.

[9] B Bell and J van Reenan, "Extreme Wage Inequality: Pay at the Very Top" (2013) Centre for Economic Performance, Occasional Article No 34 <http://cep.lse.ac.uk/pubs/download/occasional/op034.pdf> accessed 17 September 2014. The study also found that the link is stronger and more symmetric for companies in which institutional investors play a larger role.

[10] BIS, supra n 6, 11.

[11] See Charlotte Villiers, "Controlling Executive Pay: Institutional Investors or Distributive Justice?" (2010) 10 *Journal of Corporate Law Studies* 309.

managers, athletes, actors, and other celebrities receive compensation that dwarfs pay levels of executives, often without any public questioning about linkages with performance. For example, footballer Wayne Rooney's yearly salary – still on the lower end compared to some other individuals in the public eye – has been reported as £15.6 million.[12] While the exact multiple between his pay and some of his current employer Manchester United's other employees, such as physical therapists or administrative staff, is unknown, his pay is more than three times higher than the 2012 average pay of a FTSE 100 executive director.[13] Yet, these realities have not stirred substantial concerns nor triggered governmental regulation of non-executive pay.

One possible explanation why executives of quoted companies are being singled out is that they work for companies that involve broad public investment, either directly through individual shareholdings or indirectly via institutional investors such as pension schemes. However, this does not explain the case of footballers such as Wayne Rooney, who is employed by Manchester United plc, a public company that is – like various other football clubs – listed on a stock exchange. Nevertheless, executive remuneration and performance is perhaps more easily measurable and, in addition, executives do not normally benefit from public sympathies and emotional attachment that can be observed with celebrities in sports and other fields.

[12] G Rose, "Wayne Rooney: Manchester United's forward's £70m deal", *BBC Sport*, 21 February 2014 <http://www.bbc.co.uk/sport/0/football/26246939> accessed 17 September 2014.
[13] J Treanor and S Neville, "Executive pay among FTSE firms keeps soaring" *The Guardian*, 11 June 2012 <http://www.theguardian.com/business/2012/jun/11/executive-pay-soars-survey-shows> accessed 17 September 2014.

2. The Agency Cost Approach

In the corporate governance literature, executive pay is routinely analysed by drawing from agency theory.[14] Shareholders, as principals, delegate the bulk of the management of their companies to directors and managers, who act as agents, giving up considerable amounts of control and information in the process. This situation, in turn, enables the agents to act in their own self-interest, diverting benefits to themselves to a degree that is not justified in view of a company's long-term success. Both pay levels and design of remuneration packages are seen as potentially affected by these agency costs and a sign of diverging shareholder and managerial interests. Specifically, pay levels can be insufficiently linked to firm performance, resulting in "excessive" or inefficiently high rewards relative to performance. In addition, remuneration packages that over-emphasize short term results can lead executives to neglect long-term value maximization and even contribute to manipulated financial results.[15]

Following the logic of agency theory, initiatives to influence executive pay are often framed as agency cost-reducing measures, aiming to shift back control to shareholders. Implicit in this approach is the assumption that remuneration awards in companies are tainted by conflicts of interest or are evidence of insufficient board oversight. According to this view, executives have captured the directors who set their pay, using their influence to successfully demand ever-increasing compensation. Seen this way, the only remaining restraint is the threat of negative

[14] See generally M C Jensen and W H Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure" (1976) 3 *Journal of Financial Economics* 305.
[15] The most complete account in this respect is provided in L Bebchuk and J Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Harvard University Press, 2006).

perceptions by outsiders, which in turn leads companies to attempt to hide details of the level and performance-sensitivity of executive compensation.[16]

Other commentators, however, refute the notion that managerial power extends to their own remuneration. From this perspective, remuneration setting policy is largely free from conflicts of interest and subject to market-based "arms-length" negotiation.[17] Alternatively, those sceptical of government regulation of executive pay suggest that the way forward should lie in "light touch" reforms that are "limited, targeted and [do] not distort boards' ability to design effective and innovative pay packages and the complexities of pay design".[18]

While the situation in the UK and the US is not directly comparable, it is worth noting that there are several US studies suggesting that pay and performance are mostly aligned.[19] There is also some support for the proposition that compensation practices are set with shareholder interests in mind and evidence that pay increases can be explained with increased firm size and complexity.[20]

[16] ibid.
[17] S M Bainbridge, *Corporate Governance after the Financial Crisis* (Oxford, Oxford University Press, 2012), 116–118.
[18] G Ferrarini et al, "Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe" (2010) 10 *Journal of Corporate Law Studies* 73, 111.
[19] See, eg S N Kaplan, "Executive Compensation and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges" 2012 *Journal of Applied Corporate Finance* 8.
[20] See X Gabaix et al, "CEO Pay and Firm Size: An Update After the Crisis" (2014) 124 *Economic Journal* 40; Bainbridge, supra n 17, 117-8 (citing additional studies).

C. THE UK RULES ON EXECUTIVE COMPENSATION

1. Best Practices and Statutory Law

The UK has long struggled with executive pay compensation. There has been a long-standing movement, driven both by private and governmental initiatives, towards reducing perceived agency costs and market failures in this area.[21] Contemporary regulatory efforts can be traced back to the last two decades of the last century, when executive compensation rose quickly through both periods of economic expansion and contraction and executives benefited from large pay increases, particularly in recently privatized utilities, sometimes coinciding with worsening conditions for staff and consumers.[22] As a result, investor and public concerns about misalignments between executive compensation and performance surfaced, with some underperforming companies being perceived to be handing out "rewards for failure."

Against this background, and further spurred by threatened Government action, a number of important corporate governance initiatives emerged. Relating to remuneration, the most notable among these is the industry-led Greenbury Report, published in 1995. Building further on principles developed in the landmark 1992 Cadbury Report,[23] the Greenbury Report proposed a new code of voluntary best practices for directorial pay for listed UK companies.[24]

[21] See, eg BIS, supra n 5.
[22] A Dignam, "Remuneration and Riots: Rethinking Corporate-Governance Reform in the Age of Entitlement" (2013) 66 *Current Legal Problems* 401, 408.
[23] Committee on the Financial Aspects of Corporate Governance, "Report of the Committee on the Financial Aspects of Corporate Governance" (December 1992).
[24] See "Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury" (1995) ("Greenbury Report"). Although the Report's focus was mainly on directors and large companies, it also noted that its principles would in large part apply equally to other senior executives and as smaller companies.

The Greenbury Report's basic premise was simple: Companies should "provide the packages needed to attract, retain and motivate directors of the quality required" while, at the same time, "avoid paying more than is necessary for the purpose".[25] In support thereof, the Report recommended that remuneration committees, comprised of non-executive directors, should be put in charge of setting remuneration, emphasizing that performance-related pay elements should be carefully designed to align directors' and shareholders' interests.[26] The Report further proposed disclosure mechanisms and obligations beyond what was already required by statute.[27] Moreover, adopting a voluntary form of say-on-pay, the Report suggested that shareholders should be given the opportunity to approve remuneration policies at any general meeting where the board decided that such a vote would be appropriate.[28] Moreover, companies were invited to present long-term incentive schemes available to directors and senior executives to their shareholders with a view to an advisory vote to secure their approval.[29]

2. The 2002 Regulations

Subsequently, many of the Greenbury Report's key recommendations were incorporated in the Combined Code on Corporate Governance, now the UK Corporate Governance Code, which applies to listed companies and is published under the auspices of the Financial Reporting

[25] ibid, section C1, paras 6.5–6.7.
[26] ibid, sections C and D.
[27] Companies were to provide shareholders annually with comprehensive information regarding their executive directors' remuneration policy and the entire remuneration packages of individual directors. See ibid, section B 2 and paras 5.3–5.12. At the time, the Companies Act 1985 mandated that, among others, a company disclose the aggregate compensation paid to directors during the relevant year as well as details of compensation paid to the highest paid member of the board.
[28] Greenbury Report, supra n 24, paras 5.28–5.32.
[29] ibid, para 5.33.

Council.[30] However, apart from mandatory specific disclosure and shareholder approval requirements incorporated in the Listing Rules,[31] which also adopted the Greenbury Report's major recommendations, remuneration best practices remained largely just that: non-binding soft law that was subject to the UK Corporate Governance Code's comply-or-explain framework. Companies were free to adhere to these practices or explain why they have not.

Yet, the best practice approach to executive compensation did not yield the desired results. Remuneration disclosure remained often vague, lacking the detailed information necessary to make an informed assessment, including clarity about the relationship between rewards and performance. Moreover, remuneration committees continued to include non-independent members. Finally, only a small number of companies chose to give their shareholders a vote on remuneration reports, despite shareholder concerns relating to executive compensation.[32]

In view of low levels of compliance, combined with renewed scrutiny of executive pay levels in the wake of the late 1990s bull market, the Government decided to take action. The Department for Business Innovation & Skills[33] issued the Directors' Remuneration Report Regulations 2002, elevating directors' remuneration provisions to statutory level.[34]

[30] The UK Corporate Governance Code (September 2014).
[31] On which, see supra n 35 below.
[32] See Department of Trade and Industry, "Directors' Remuneration: A Consultative Document" (1999) Chapter 2 <http://webarchive.nationalarchives.gov.uk/+/http://www.dti.gov.uk/cld/payfinal.pdf> accessed 17 September 2014; see also Villiers, supra n 11, 317-8.
[33] At that time still known as the Department for Trade and Industry.
[34] Directors' Remuneration Report Regulations 2002 (SI 2002/1986) ('2002 Regulations'), amending the Companies Act 1985.

The 2002 Regulations, creating a partial overlap with pre-existing Listing Rules requirements,[35] made it mandatory for quoted companies incorporated in Great Britain to prepare for each financial year a directors' remuneration report.[36] In essence, in addition to details on the remuneration committee's role and membership, the report had to contain a detailed explanation of a company's policy on directors' remuneration, including a summary of any performance condition with regards to entitlements to share options or under a long-term incentive scheme, notice periods, termination arrangements, details as to service contracts with directors, the specific remuneration of each individual director over the most recent financial year, and significant payments to former directors.[37] At every annual general meeting, shareholders had to be given the opportunity to pass a non-binding say-on-pay resolution, indicating whether or not they approved the directors' remuneration report.[38] Thus, the board's former discretion with regards to holding this vote was replaced with a positive obligation to give shareholders the right to periodically voice their opinion on directors' compensation.

Looking back after more than a decade after introduction of the 2002 Regulations, their success appears highly questionable. Commentators noted that the combined system of mandatory disclosure and advisory vote, coupled with reliance on remuneration committees, has not succeeded in curbing rising pay levels and had little effect on the alignment of compensation

[35] In its most recent incarnation (before changes that took effect in December 2013), Rule 9.8.8 R of the UK Listing Rules contained a requirement for UK incorporated companies with a premium listing on the London Stock Exchange to disclose their remuneration policy and information on each director's pay. This rule was recently amended in order to avoid overlap with the 2013 executive compensation reforms (on which, see section B 3 below). Moreover, Rule 9.4 still requires that shareholders of companies with premium listings approve directors' long-term incentive schemes.
[36] Today, section 420 of the Companies Act 2006 contains boards' statutory obligations in this regard.
[37] 2002 Regulations, Schedule 7A. Additionally, Companies Act 2006, ss 215-22 mandate shareholder approval for certain payments for directors' loss of office.
[38] 2002 Regulations, s 7; Companies Act 2006, s 439.

and performance.[39] On the contrary, broadened disclosure of compensation levels is sometimes thought to have led to increases in executive compensation and legitimized excessive pay.[40]

Notably, UK shareholders have rarely voiced their displeasure with remuneration policies, engaging mostly in rare and extreme cases. Only recently, in the 2012 "shareholder spring" annual general meeting cycle were shareholders more actively in using their advisory vote against directors' remuneration. However, even during this time, average levels of dissent were at 11.7%, up from 9.6% in 2011 and down from the peak of 16% in 2002.[41] Moreover, companies that saw negative votes tended to be smaller companies and typically involved shareholders targeting executives perceived not to act in the best interests of shareholders for reasons other than their pay levels.[42]

In line with these observations, empirical studies on the effects of say on pay tend to paint a neutral to cautiously positive picture. A leading examination of say on pay in the UK between 2000–2005 suggested that shareholder votes had no impact on the level and growth of average CEO pay but found that it influenced underperforming companies with controversial pay practices (such as generous severance payments) or unusually high executive remuneration.[43] Recent examinations of the impact of say on pay in the US yielded similar results, finding no effect on the level or composition of CEO pay but suggesting that these votes

[39] See Dignam, supra n 18, 411-2; Villiers, supra n 11, 319-23; Jeffrey N. Gordon, "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in" (2009) *Harvard Journal on Legislation* 323.
[40] Dignam, supra n 18; see also B E Hermalin and M S Weisbach, "Information Disclosure and Corporate Governance" (2012) 67 *Journal of Finance* 195.
[41] Dignam, supra n 18, 436.
[42] ibid, 435.
[43] F and D A Maber, "Say on Pay Vote and CEO Compensation: Evidence from the UK" (2011) <http://articles.ssrn.com/sol3/articles.cfm?abstract_id=1420394> accessed 10 September 2014.

are sensitive, among others, to excessive CEO compensation and financial performance.[44] One study also found that boards react to rejection votes by subsequently reducing abnormal pay levels.[45] Thus, say on pay does not appear to have an effect on pay levels overall, but seems to be able to address excesses at individual firms with problematic corporate governance practices.

3. The 2013 Reforms

The skeptical views of previous regimes regulating remuneration are shared by the UK Government. Long critical of executive pay practices, this stance was likely reinforced by the near collapse of the financial industry during the last financial crisis and subsequent corporate governance reports that suggested a connection between the crisis, risk-taking, and executive pay practices.[46] Thus, citing "compelling evidence of a disconnect between pay and performance in large UK listed companies," unstainable "ratcheting-up of executive pay," and overly lengthy and complex remuneration disclosure documents, the Government initiated more stringent legislative action.[47]

[44] P Iliev and S Vitanova, "The Effect of the Say-on-Pay Vote in the U.S." (2013) <http://ssrn.com/abstract=2235064> accessed 10 September 2014.
[45] M B Kimbro and D Xu, "Shareholders have a Say on Executive Compensation: Evidence from Say-on-Pay in the United States" (2013) <http://ssrn.com/abstract=2209936> accessed 10 September 2014. A recent broad cross-country study also yielded positive results, suggesting that say on pay is associated with a lower level of CEO compensation, resulting partly from lower compensation growth rates, higher performance sensitivity, and higher firm value. R Correa and U Lel, "Say on Pay Laws, Executive Compensation, CEO Play Slice, and Firm Value around the World" (2013) International Finance Discussion Article <http://articles.ssrn.com/sol3/articles.cfm?abstract_id=2243921> accessed 10 September 2014.
[46] See D Walker (Walker Review), "A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations" (2009).
[47] BIS, "Directors' Pay: Consultation on revised remuneration reporting regulations" (2012) Foreword from the Secretary of State and section 1 (Background)

(a) Overview

Following lengthy discussion and consultations, a new framework, which applies to UK incorporated quoted companies,[48] came into force effective as of October 1, 2013. Its goals are four-fold: to restore a stronger, clearer link between pay and performance; to reduce rewards for failure; to promote better engagement between companies and shareholders; and to empower shareholders to hold companies accountable through binding votes.[49]

The 2013 reforms aim to achieve these goals by using a two-tiered approach.[50] First, the new rules require at least once every three years a *binding shareholder vote* on a company's general *policy* for annual directorial remuneration.[51] Second, companies are required to hold an annual, non-binding *advisory vote* by shareholders on the company's ongoing *implementation* of its directorial remuneration policy, as reported on by the board at the end of each year.[52] Moreover, increased shareholder participation is combined with greater corporate remuneration disclosure

<https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/31358/12-888-directors-pay-consultation-remuneration-reporting.pdf> accessed 17 September 2014.

[48] These are companies whose equity share capital is included in the Financial Conduct Authority's official list (that is not Alternative Investment Market listed companies) or is officially listed in another state in the European Economic Area or is admitted to dealing on either the New York Stock Exchange or NASDAQ. Overseas companies are not included in the scope of the new provisions but, if they have a premium listing on the London Stock Exchange, still have to comply with the UK Corporate Governance Code – including its section D on Remuneration – or explain non-compliance; see Listing Rules 9.8.7 and 9.8.6R (5)-(6).

[49] BIS, supra n 47, Foreword from the Secretary of State.

[50] See, generally, The Large and Medium-sized Companies and Groups (Accounts and Reports) Amendment Regulations 2013 (SI 2013/1981) ('2013 Regulations'), revoking and replacing Schedule 8 of the Companies and Groups (Accounts and Reports) Regulations 2008; Enterprise and Regulatory Reform Act 2013 (2013/240), amending the Companies Act 2006.

[51] Enterprise and Regulatory Reform Act 2013, s 79(4), amending the Companies Act 2006 by inserting a new section 439A (Quoted companies: members' approval of directors' remuneration policy).

[52] See ibid, s 79(3), amending Companies Act 2006, s 439.

requirements and civil consequences for those who authorize and receive unapproved payments.[53]

(b) The Three-Part Directors' Remuneration Report

In line with the new framework's bi-furcated approach, a company's reporting on remuneration needs to be divided in distinct parts, two of which are – at different intervals – subject to a shareholder vote. A company's directors' remuneration report for a financial year must consist of (1) the annual statement; (2) the annual report on remuneration; and (3) the directors' remuneration policy.[54]

The *first part* of the directors' remuneration report is the *annual statement*, a personal reflection by the chair of the remuneration committee or, if there is no such person, another director nominated by the board to make the statement. The annual statement summarizes for the relevant financial year the major decisions on directors' remuneration and substantial changes relating to directors' remuneration made during the past year. The annual statement should also include the context in which those changes have occurred and decisions that have been taken.[55] The statement gives chairmen and their companies the opportunity to provide context and set the tone for the remainder of the directors' remuneration report.

[53] The provisions apply to 'directors' in general, although companies may make distinctions between executive and non-executive directors and taking into account that some requirements may not be applicable in relation to non-executive directors; see 2013 Regulations, supra n 50, ss 2(3)–(4).
[54] The directors' remuneration policy may be omitted from the overall directors' remuneration report if the company does not intend and is not required to seek approval for it in a given financial year; see Companies Act 2006, s 439A (as amended).
[55] 2013 Regulations, supra n 50, Schedule 8, s 3.

The *second part* of the remuneration report consists of the *annual report on remuneration*, which includes an account as to how the directors' remuneration policy has been implemented in view of the payments made to directors. As previously mandated, shareholders continue to have an annual advisory vote on this section of the directors' remuneration report.[56] Since it is advisory only, the vote's outcome will not affect the validity of any remuneration paid to directors. The purpose of this vote is solely to give shareholders an opportunity to signal whether they are content with a company's application of their remuneration policy.

In terms of disclosure, the key innovation in this part is that it has to include a single total remuneration figure for every director for the current and preceding financial year, presented in the form of a table and broken down into salary and fees, benefits, money or assets received or receivable as a result of the achievement of performance measures or targets, pension related benefits, bonus, and earnings from any long-term incentive scheme.[57] Moreover, the report must show for each director total pension entitlements, scheme interests (such as those relating to shares and options) awarded during the financial year, payments to past directors, payments for loss of office, and an outline of directors' shareholding and share interests in the company.[58]

Contrary to what the Government had initially proposed, there is no new prerequisite to compare performance directly with CEO pay. A proposal to this effect was modified in light of comments received. Instead, the annual report on remuneration has to contain a graph

[56] See Companies Act 2006, s 439.
[57] 2013 Regulations, supra n 50, schedule 8, ss 4-12. This figure should cover only remuneration actually received by a director during the previous year, and is calculable by reference to an official formula developed by the Financial Reporting Council's Financial Reporting Lab based on consultation with investors and industry. See Financial Reporting Lab, "Lab project report: a single figure for remuneration" (2012) <www.frc.org.uk/Our-Work/Publications/Financial-Reporting-Lab/A-single-figure-for-remuneration.aspx> accessed 17 September 2014.
[58] 2013 Regulations, supra n 50, schedule 8, ss 13-7.

comparing the company's share performance to a broader index (consistent with previous regulations) and a novel CEO remuneration table that compares, for a period up to ten years, annual changes with respect to total remuneration, and measures annual bonus awards and long-term incentive vesting rates against the maximum opportunity that could have been achieved.[59]

However, the annual remuneration report addresses the growing pay gap between executives and ordinary employees. Companies now have to produce a table that indicates (i) the percentage change in respect of the CEO's salary and fees, taxable benefits, and annual bonus as compared to the preceding financial year and (ii) the percentage change of these amounts as compared to the preceding financial year in respect of the employees of the company – or employees of the group, in case of the CEO of a parent company – taken as a whole.[60]

The annual remuneration report must also contain a graph or table that outlines the actual expenditure of the company, and the difference in spend between those years, on remuneration paid to or receivable by all employees of the group, distributions to shareholders by way of dividend and share buyback, and any other significant distributions and payments.[61] Finally, the company must report on how it intends to implement the approved directors' remuneration policy in the following financial year.[62]

The *third part* of the remuneration report is the *directors' remuneration policy*. This part is subject to the new requirement that companies obtain binding shareholder approval. Shareholders get to vote on the directors' remuneration policy at the annual general meeting

[59] ibid, s 18.
[60] ibid, s 19. Where the company believes that a comparison with employees as a whole is inappropriate, it may use another comparator group of employees.
[61] ibid, s 20.
[62] ibid, s 21.

held in the company's first financial year to begin on or after October 1, 2013.[63] Thereafter, the policy must be proposed for shareholder approval at least every three years, or sooner if the company wishes to amend the policy.[64]

If at an annual general meeting the advisory vote on the second part of the remuneration report, the implementation report, is not approved, the company will be required to put forward its remuneration policy for approval at the following year's annual general meeting or a meeting convened specifically for the purpose of gaining approval. Alternatively, it may operate according to the last approved remuneration policy and, if it deems necessary, seek separate shareholder approval for any specific payments that are inconsistent with the approved policy.

Substantively, the directors' remuneration policy has to set out the policy of the company with respect to the making of directorial remuneration payments and payments for loss of office. Among others, it has to include a future policy table that describes the components of the remuneration package for the directors, the company's approach to remuneration for director appointments in the future, a description of obligations contained in existing and future service contracts, forward-looking illustrations of each directors' pay under the directors' remuneration policy in the first year after its adoption, and the policy on payments for loss of office.[65] This part must also include a statement on how pay and employment conditions of employees other

[63] The remuneration policy must be approved by an ordinary resolution of the company's shareholders, which means that a simple majority (50% plus one vote) of votes cast is necessary.
[64] Enterprise and Regulatory Reform Act 2013, s 79(4), amending the Companies Act 2006 by inserting a new section 439A (Quoted companies: members' approval of directors' remuneration policy). The period of three years between votes does not apply in cases of proposed interim changes to an existing remuneration policy. A vote on those changes should be held either at the company's next annual general meeting or at a specially convened general meeting.
[65] 2013 Regulations, supra note 50, schedule 8, ss 25-36.

than directors of the company (or group) were taken into account in setting the policy for directors' remuneration as well as a statement of consideration of shareholder views.[66]

(c) Consequences of Unapproved Remuneration Payments

The force of the binding nature of shareholders' revised say on pay lies in the provisions that prohibit companies from making remuneration and loss of office payments to directors that are in breach of their approved directors' remuneration policy.[67]

Contractual arrangements that contradict the policy will only be binding if the relevant payment is specifically authorized by way of a shareholder resolution, to be based on a memorandum setting out the amount and particulars of the proposed payment.[68] An obligation to make a payment that would be in contravention of these provisions has no effect. Such payments are held by the recipient on trust for the company or other person making the payment, and any director who authorized the payment is jointly and severally liable to indemnify the company on whose behalf the payment was made for any loss resulting from it.[69]

Special rules apply in the context of control transactions. If a payment for loss of office is made in contravention of the approved directors' remuneration policy to a director of a quoted company in connection with a transfer of shares in the company, or in a subsidiary of the company, resulting from a takeover bid, the payment is held by the recipient on trust for persons who have sold their shares as a result of the offer made. In such cases, the expenses incurred by

[66] ibid, ss 38-40.
[67] See Enterprise and Regulatory Reform Act 2013, s 80, amending the Companies Act 2006 by inserting after section 226 a new Chapter 4A.
[68] See Companies Act 2006, ss 226B-226E (as amended).
[69] ibid. However, if a director shows that he or she has acted honestly and reasonably, a court, having regard to all the circumstances of the case, is empowered to decide that the director should be relieved of liability.

the recipient in distributing that sum amongst those persons shall be borne by the recipient and not retained out of that sum.[70]

D. AN APPRECIATION OF THE 2013 REFORMS

1. Goals, Costs, and Benefits

Stating its expectations for the latest reforms, the Department for Business Innovation & Skills suggested that, based on the extended three-year horizon for remuneration policies, the new rules would encourage companies to take a longer-term strategic approach. In addition, the Government's expectation is that increases in transparency and shareholder influence will lead to greater and more efficient shareholder engagement and lower monitoring costs for shareholders. These factors, combined with reductions in capital costs and share volatility for companies, should improve firm performance.[71] At the same time, the Government expects the additional requirements to carry little additional costs, as it believes that expenses would be transitory in nature and that the changes are in line with existing best practices.[72]

Whether the new framework will result in the envisaged changes is as of yet an open question. Nevertheless, the Government's analysis of both costs and benefits may well be overly optimistic. The Government's own final impact analysis, which considered costs and benefits of the new regulations, does not provide meaningful guidance in this respect. Noting that while 'the benefits to business and shareholders as a result of pay schemes being better designed and

[70] ibid.
[71] BIS, "Improved transparency of executive remuneration: impact assessment" (2012) paras 46-60 and 73 <https://www.gov.uk/government/publications/improved-transparency-of-executive-remuneration-reporting-impact-assessment> accessed 17 September 2014.
[72] ibid.

more closely aligned with performance are considered to be significant', the analysis also states that the relevant costs and benefits of shareholder votes on directors' remuneration proposals 'are not currently monetisable.'[73]

In terms of costs, however, even if it turns out that – after a phase of transitory costs – there are no additional and longer-term direct monetary expenses, companies will have less flexibility as compared to the previous regime. Remuneration committees cannot make any extraordinary awards that are not in line with it remuneration policy without prior shareholder approval, making it more difficult to attract or retain the most sought after board members and managers. Perhaps the effect of this is part of the desired "dampening" of pay levels, but it remains a potentially serious threat that should be acknowledged and monitored closely.

On the benefits side, one question is whether the changes in disclosure rules will have the desired effects. Greater transparency will likely only be felt by institutional investors and their adviser, as readily conceded by the Government.[74] Whether the differences in data and structure of reported remuneration information will ultimately have any significant and positive consequences is doubtful. Given the criticisms pointing to the potentially negative impact of increased disclosure it even seems possible that the reforms may have the opposite effects of what was intended, thereby facilitating higher pay levels.[75]

[73] BIS, "Enterprise and Regulatory Reform (ERR) Bill: final impact assessment (IA)" (2012) 5 <https://www.gov.uk/government/publications/enterprise-and-regulatory-reform-err-bill-final-impact-assessment> accessed 17 September 2014.
[74] BIS, supra n 71, para 73.
[75] See n 40 above and accompanying text.

2. The Effects (and Wisdom) of Say on Pay

Another major question flowing from the 2013 reforms is the effect of binding shareholder votes on remuneration. The reputational factor inherent in advisory votes – coupled with other formal and informal tools available to shareholders, such as the right to appoint and dismiss directors – may already have influenced boards to some extent. Thus, making say on pay votes binding would not result in major changes.[76] Additionally, if shareholder behavior under the previous regime is any indication, we should not expect to see continuing and substantial resistance, in the form of withheld shareholder approvals, in the near future – at least not after an initial phase during which the novelty of these votes may act as a stimulus on shareholder engagement. Based on studies of advisory say on pay, the best result to hope for is that shareholder votes will act as a mitigating factor on excessive or ill-designed pay on a case-by-case basis, albeit without a broader impact on overall remuneration levels.[77]

Still, a survey of over forty large companies, conducted before the reforms came into effect, indicated that there was a trend towards salary freezes and bonus freezes or reductions for executive directors in 2013, while any planned increases were estimated to be lower than in previous years.[78] Although many companies indicated planning to change the design of pay and incentives, ultimately only 15% of the respondents thought that executive pay would be more than 10% lower in their companies over the next three to five years, with the majority expecting

[76] Correa and Lel, supra n 45, even found that only advisory say on pay votes, but not mandatory ones, tightened the sensitivity of executive pay performance.
[77] On the effectiveness of advisory say on pay, see above section B 3.
[78] PriceWaterhouseCoopers, "2013: A Year of Restraint" (2013) <http://pdf.pwc.co.uk/executive-pay-2013-a-year-for-restraint.pdf> accessed 17 September 2014.

pay to stay at current levels and 25% of the respondents estimating that pay would rise within this timeframe by 10% to 25%. Thus, should these early reactions be indicative of future trends, the goal of lowering salaries seems unlikely to be met as a consequence of the new regime.

More fundamentally, reliance on shareholders to fix pay and other corporate governance issues is highly questionable. UK institutional investors have so far not proven to be willing to act as pro-active and engaged stewards,[79] not to mention that they normally pursue their own, short-term oriented goals.[80] Additionally, insofar as institutional shareholders rely on proxy vote advisors, shifting power to shareholders means shifting power to these advisory firms, raising a host of new accountability and conflict of interest issues.[81] At the same time, individual shareholders, even if willing to act, remain constrained by the well-known issues stemming from collective action problems, information asymmetries, and rational apathy.

Thus, the executive remuneration debate goes to the heart of the corporate governance debate between board centrists and shareholder primacy proponents, which revolves around the perennial question of who should be in charge of the company. While this controversy is beyond the scope of this article, a more narrower point may be noted here: Corporate governance proposals should be mindful of the fact that shareholders are among those thought to have contributed to the financial crisis, even prompting the European Commission to state that "confidence in the model of the shareholder-owner who contributes to the company's long-term

[79] B R Cheffins, "The Stewardship Code's Achilles' Heel" (2010) 73 *Modern Law Review* 1004; but cf supra n 9 (citing evidence that the presence of institutional investors may improve alignment of pay and performance).
[80] Kay Review, supra n 2, 8 (citing evidence from the Institute of Directors); Villiers, supra n 11, 341 (concluding that "[s]hareholders are part of the problem of escalating salaries and resulting wealth inequalities").
[81] Bainbridge, supra n 17, 133-4.

viability has been severely shaken".[82] Giving these same shareholders, with their proven appetite for risk and quick profits, more power may lead to increased pressures on boards to justify their pay with short-term gains, eviscerating the thrust of ongoing efforts to curb short-termism.[83]

3. Business As Usual or Boardroom Revolution?

Not surprisingly, the industry feels that the new regulatory environment makes the UK a less attractive place to come and work. However, an interesting question flowing from this proposition is whether being less attractive for the executives who only respond to the absolute highest financial incentives is, in the long-term, such a bad thing. The public often asks why executives cannot do an equally good job with lesser but still high pay, fueled by other than solely monetary rewards but led by intrinsic motivation.

Indeed, although incentives are an established part of executive pay packages, the Kay Review questioned whether it is necessary or appropriate to pay directors bonuses at all, given that they are not common in certain other professions that including high levels of responsibility, without there being serious concerns as to whether they are making the maximum effort.[84] Indeed, bonuses, as they are used today, only work for executives if share prices – and thus profits – continue to perpetually increase. Since risk and returns are related, and companies

[82] European Commission, "Green Paper: Corporate Governance in financial institutions and remuneration policies", COM(2010) 284, 8.
[83] See also L A Bebchuck and H Spamann, "Regulating Bankers' Pay" (2010) 98 *Georgetown Law Journal* 247 (suggesting that say on pay in financial institutions may amplify risk-taking).
[84] Kay Review, supra n 2, 79. According to some economists, excessive remuneration may even 'crowd-out' intrinsic motivation, at which point it can only be overcome by additional substantial payments. B S Frey and R Jegen, "Motivation Crowding Theory" (2001) 15 *Journal of Economic Surveys* 589.

cannot endlessly sustain growth based on a given level of risk, it is not difficult to make the connection between excessive risk and remuneration.[85]

This leads us to the heart of the weaknesses of the current reforms. Having decided – whether correctly or not – that executive pay is in need of repair and a suitable area to be singled out for regulatory intervention, the Government should have taken more decisive and visionary steps. Instead, it opted to stay largely within the orthodox approaches to govern through 'therapeutic disclosure' of corporate information and reliance on (partly non-binding) shareholder action, attempting to fix what has been declared a serious problem with comparatively minuscule and unimaginative measures.

Transparency has been dialed down, by giving in to pressures that a direct comparison between CEO and firm performance should be removed. Similarly, clawback or "*malus*" mechanisms, which would allow companies to require executives to pay back amounts already received under an incentive scheme or reduce awards based on a firm's underperformance, have been omitted from the 2013 reforms.[86] However, these measures would address the issue of asymmetric elasticity between pay and performance, in particular if they would be extended in order to allow reductions not only in bonus awards but also base salaries.[87]

Alternative measures that could have been taken – assuming again that executive pay represents an instance of market failure – include the Swiss model of separate shareholder votes

[85] Bainbridge, supra n 17, 119.
[86] However, the revised the UK Corporate Governance Code has now introduced a best practice that requires companies with premium listings to adopt bonus clawback mechanisms. See UK Corporate Governance Code, s D.1.1. This provision applies for reporting periods beginning from 1 October 2014.
[87] As base salaries are paid unrelated to performance, good performance is rewarded but under-performance is not sanctioned – in other words, there is much more upside than downside for executives. Gregg et al, supra n 7, 26-7. Thus, this problem could be most effectively addressed by introducing mechanisms that may reduce base pay.

on base salary and bonus plans and a complete prohibition on paying exit payments. Moreover, other recent ideas for curbing excessive executive remuneration include measures such as curbing financial disclosure requirements, removing remuneration disclosure, prohibiting performance-based pay,[88] controlling salary by using pay ratios and remuneration caps,[89] or increasing employee and other stakeholder participation in the remuneration setting process.[90]

Whether or not these measures are appropriate is an open question. Yet, given the Government's self-declared goals and ambition in the area of executive pay, its incremental approach with repackaged old proposals and small tweaks is hardly working. Thus, a decision has to be made: Does the Government, and society at large, wish to let companies continue with business as usual, letting them set executive pay as they see fit, which – justifiably or not – tends to result in higher pay, or should there be substantial changes in this area? If the latter is the goal, what is needed are decisive steps, much closer to a boardroom revolution than what we have seen thus far.

E. CONCLUSION

Companies in the UK have shown little sign of making voluntary adjustments to executive pay. After decades of operating under a hybrid system of voluntary and mandatory practices and regulations, the UK Government's latest set of reforms has changed and heightened disclosure requirements and introduced a mandatory, binding shareholder vote on directorial remuneration policies. Whether the case for regulatory intervention has been made, is unclear. However, if we

[88] Dignam, supra n 18, 437.
[89] ibid; Villiers, supra n 11, 338-9.
[90] Villiers, supra n 11, 340.

accept that there is such a case, the newly introduced reforms seem weak at best. In short, the latest UK framework represents a lukewarm attempt to fix something that may or may not be broken.