BIS Shareholder Voting Rights Consultation

Policy Exchange's response

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Executive Summary

- Policy Exchange supports the government's desire to make the remuneration policies of UK corporates more responsive to shareholders and reduce rewards for failure. In this note we respond to the BIS consultation on shareholder voting rights and exit payments.
- The Government proposes that shareholder votes on future remuneration policy should be made binding and that the threshold of votes needed to pass such a policy should be raised. We believe that to do both is an overreaction. Many shareholders want to retain the right to warn a company if its policy is wrong and then allow them to change it. Our proposal is to keep the vote as an advisory one, with a higher threshold of 65%. However, this is subject to two caveats. First should the company fail to secure a 50% approval (which is very rare) then the vote immediately becomes binding. Second, in the event of an advisory vote failing in two consecutive years, it also becomes binding. This is a two strikes and out policy. The advantage of this is that it gives shareholders a chance to warn companies but it allows companies time to respond.
- We support an advisory vote on past year implementation of remuneration policy, but with a 65% rather than 75% threshold. This is to avoid the possibility of a large minority shareholder blocking the wishes of the majority.
- The Government suggests all remuneration is subject to shareholder votes annually even for new recruits. We believe this may significantly reduce company flexibility in recruiting people, particularly when a struggling company wants to attract a successful CEO or other director. We believe shareholders should be given the right to approve guarantees and other such payments.
- The Government proposes to cap exit payments to one year's salary unless otherwise approved by a shareholder vote. The argument is that this is a way of reducing rewards for failure. In our opinion the proposal is clumsy and likely to be ineffective. It may well cause salaries to be inflated as executives seek to protect themselves from dismissal. It may also give companies too much power in the event of takeovers or personality clashes where the executives have been performing well but are no longer wanted.

- We believe clawback, properly implemented, is a much more powerful way to end rewards for failure. All companies should defer a large amount of executive compensation which would be available for clawback in the event of failure. It is already working in financial services. In our view the government should target this instead of an artificial cap on exit payments.

BIS Shareholder Voting Rights Consultation: Policy Exchange's response

The Department for Business Innovation and Skills (BIS) in its first consultation on executive remuneration has asked for views on proposals relating to votes on remuneration policy and exit payments. Policy Exchange is due to publish a full note on Executive Remuneration next month, partly in response to the BIS consultation. As this first consultation comes to an end prior to our full note being published we are submitting this short note on our views on the particular proposals contained in the first consultation.

We have broken down our response into the two key areas:

- Votes on remuneration proposals and
- The cap on exit payments.

Rather than answer every question raised in the consultation document we have chosen instead to focus on the key issues.

Votes on Remuneration Policies

The first proposal is to have an annual binding vote on remuneration policy. BIS suggest that in the event a company loses this vote that it either maintains existing policy or returns to shareholders with amended proposals within 90 days. It also proposes to raise the threshold for approval. Finally it proposes to have an advisory vote on the past year's remuneration policy with a 75% threshold for approval.

The argument for binding votes rather than advisory ones is that companies can and do ignore significant votes against the policy. This has been a source of frustration for many shareholders when they have expressed concern over remuneration policy. However, the number of companies that actually lose votes currently is tiny. Indeed as BIS point out in their consultation note none of the FTSE100 failed to secure 50% or more support in 2011. That may be because there are insufficient shareholders that want to take an active approach. Indeed, BIS highlight the rising number of overseas shareholders and we would also add hedge fund managers, whose concern is more often the performance of the shares rather than the behaviour of the management per se. Nevertheless, the dissension against remuneration policies of some companies has been rising and BIS does point out that the number of FTSE 100 companies losing votes would have risen to 5 with a 75% threshold and 2 with a

65% threshold. It is understandable therefore that BIS has considered raising the threshold for approval.

In our discussions with a number of institutional shareholders it was felt by many that the current system is already quite effective. Indeed, it was argued that as low as a 20% dissension against a remuneration policy was deemed to be damaging to the remuneration committee, often triggering a change in policy. Equally a number argued that shareholders were more likely to vote no in an advisory vote than a binding vote, as it was felt a way of putting a shot across the bows of a company. It was often argued that the amount of time investors put into consultations with companies was already considerable and the prospect of having to do it all over again 90 days after the first vote might be counterproductive.

There is also a case for saying that either you change the vote from advisory to binding or you raise the threshold for approval. To do both, in our view, is overkill. We believe that it is right to hold companies more closely to account but shareholders need to still be able to express their dissatisfaction with companies and then let companies respond.

Our proposal would be to keep the vote on future remuneration an advisory one but with three tweaks. First we would raise the threshold for approval of the advisory vote. We would suggest 65% rather than 75% because under UK law it is possible for a shareholder to hold up to 29.9% of a company as a minority shareholder without launching a full bid for a company. A 75% threshold could therefore give one minority shareholder a veto right over all other shareholders, which we would regard as inequitable.

Second there would be two ways in which the advisory vote would become a binding vote. If the company failed to gain a minimum of 50% support for the advisory vote it would automatically become binding triggering the 90 day review process suggested by BIS. This reflects the fact that to lose the vote by such a margin would have to reflect a policy that is unacceptable to a majority of shareholders. Given how rare such votes are it would likely have to be a remuneration policy containing serious flaws.

The other way in which a vote would become binding would be via a two strikes policy. In other words should a company fail to reach the 65% threshold in one year it would be an advisory vote but if it failed again the following year it would become binding. Such a two strikes policy is already used in Australia. The advantage of such an approach is that it enables shareholders to warn companies that they are unhappy with the policy but also give the company an opportunity to work with shareholders to amend the policy over the following year.

Such an approach would meet the government's desire to ensure that companies are more responsive to shareholders and would maintain the advantages of the current system and avoid putting an unnecessary additional workload onto investors.

BIS also propose having an advisory vote on how the remuneration policy has been implemented, with a 75% threshold for approval. The proposal is for a section of the remuneration report to explain how policy has been implemented and the level of the awards made. We think this is sensible as it increases transparency, gives shareholders the opportunity to express disapproval with the historic policy but still approve the future policy if it has been sufficiently amended. As per our comments relating to advisory votes on future remuneration policy we would suggest a 65% threshold for this vote.

Ensuring Remuneration packages are consistent with policy

The Government proposes ensuring directors' service contracts are amended to take into account the requirement to seek shareholder approval of remuneration policy. We think this is sensible and see little reason for companies, shareholders or directors to oppose this.

One area where we feel the Government's proposals do have a flaw is that inter year hires would have to be consistent with existing remuneration policy and more importantly that no contract could specify the level of directors remuneration in particular circumstances as this would depend on shareholder approval. This policy though understandable could have adverse consequences on new recruitment. Often external hires have to be bought out of existing contracts and incentive plans. That can mean guaranteed bonuses being paid which would seem to be inconsistent with the policy. We would like to see shareholders given the right to approve such contracts within the remuneration policy.

While the Government's proposals might seem sensible at first sight it could be particularly problematic for struggling companies trying to attract a top quality CEO to turn the company around. In such circumstances companies may need to pay guarantees to attract people from current successful companies. We would urge some degree of flexibility to be incorporated into the legislation in this area.

The Government also proposes that companies should provide more details on how long term incentive plans (LTIPs) will operate for directors in that particular year as part of the remuneration policy. This seems sensible as LTIPs have become one of the more opaque areas of executive compensation. Indeed, some investors we have spoken to have said it has often taken them considerable time and effort to understand how a particular LTIP works and what the consequences of the plan might be. More clarity is therefore to be welcomed in this area.

Binding Votes on Exit Payments

We consider strengthening shareholder sanctions on companies for remuneration policies that shareholders have concerns about to be a good move. Nevertheless, we have concerns about the Government's proposals on capping exit payments to one year's salary unless otherwise sanctioned by a shareholder vote. BIS propose that this is made part of every director's contract with effect from October 2013.

As BIS note the Companies Act 2006 requires compensation payments to directors for loss of office (other than those paid out as part of an existing legal obligation) should be put to a shareholder vote. Those contractual obligations can be significant. BIS point out that there are frequently PILON (payment in lieu of notice) clauses included in contracts, which specify how much directors can receive when their contract is terminated without notice. Other compensation can include payment or part payment of bonuses to which the director may have been due and sometimes LTIPs that are within the performance cycle. While some contracts allow performance related pay to be automatically forfeited when contracts are terminated early, in others they are pro-rated for performance and service; or they may be paid out at the level the director could have expected had they remained in office. As BIS note the level of discretion available to remuneration committees when determining overall compensation arrangements typically gives those committees a high degree of flexibility to differentiate between good and bad leavers. BIS argue that this discretion is often of concern to investors.

Part of the argument to curtail this is that directors have an asymmetric bias in their compensation payments. If they succeed they get bumper payouts when all goes well but can still walk away with a payout if it goes badly. We fully accept this argument and our full note next month is going to argue that payments for failure is one of the key areas that needs to be addressed. However, capping exit payments to one year's salary, unless otherwise approved by shareholders, regardless of circumstances strikes us as taking completely the wrong approach.

Companies may want to get rid of directors for all sorts of reasons. In some cases, there may be personality clashes, in others a company may have a new owner who wishes to put in place their own management team. In such circumstances is it right that the directors and company cannot come to an agreement on the exit payment? In those circumstances the directors may well have been performing perfectly well and may feel entitled to payouts on bonuses and LTIPs. Companies might well be able to use the new legislation to avoid such compensation.

BIS also propose that any compensation above this is to await approval at an AGM. That could lead to considerable delays in agreeing compensation and negotiating an exit for a director that either no longer wants to be at a company or the company no longer wants to be in place. Such requirements seem unduly burdensome and bureaucratic. BIS also argued that those serving out notice on gardening leave due to non-competition covenants should be captured by this legislation too. This too seems excessive. If companies want to enforce non-compete clause in the contracts of their directors they should have to pay for this, because it is keeping those directors out of the labour market. The companies can always waive the non-compete clause should they not want to pay out the compensation.

BIS acknowledge that this may put some upward pressure on salaries but argue that would be subject to shareholder scrutiny so it should be limited. This ignores the fact that if this is imposed across the UK corporate sector then all companies may change their remuneration policy, in a similar way to which investment banks raised salaries relative to bonuses post the bonus tax. We do not believe that a move to a higher fixed component and less performance related pay is necessarily the right way forward for the UK corporate sector.

The proposal as it stands still does not address rewards for failure because directors could walk away with their past compensation intact plus a one year salary payout. The right way to deal with this, in our view, is through appropriately targeted clawback mechanisms. Then if a director fails not only might he lose his contracted pay out in the event of termination previous compensation could also be clawed back. In our full proposal we intend to argue that all companies should operate a large deferred payment element to any remuneration package with clawback covenants that would trigger in the event of clear failure. It would be up to the remuneration committee to draft those clawbacks and shareholders to approve them.

The FSA has for some time now insisted that investment banks operate such schemes and we are beginning to see those clawbacks being implemented. Such a system is good not just because it punishes failure but also because it changes the asymmetry of payoffs that we referred to at the start of this section.

We believe that BIS should have consulted on clawbacks and exit payments at the same time and not separately. The proposal as it currently stands in the consultation should in our view be dropped in favour of a more rigorous clawback rule.