Executive Pay Shareholder Voting Rights - TUC Response

BIS Consultation

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Introduction

The TUC welcomes this opportunity to respond to the BIS Executive Pay shareholder voting rights consultation. The TUC represents over six million workers in 54 trade unions. Many of our members are employed by companies whose policies and practices on directors' remuneration will be affected by the results of this consultation. We also have significant membership in the public sector. This consultation comes at a time when average pay increases for workers in the private sector have been running significantly behind inflation, leading to substantial pay cuts in real terms. In the public sector, workers have been subject to a two-year pay freeze, with pay rises for the next two years capped at 1%, constituting a 13%[1] real terms decrease over this Parliament. With inflation continuing to outstrip pay settlement, the TUC expects to see wages falling in real terms across the economy during 2012 for a third consecutive year.

Yet directors at FTSE 100 companies saw their total earnings rise last year by a median increase of 16% (or 49% if the mean, rather than median is used)[2]. The stark contrast between the real terms cuts in pay of ordinary workers and the very significant real terms increases of those leading Britain's companies provides a sober context for the Government's latest proposals on executive pay. The Coalition Government has made much in recent months of the need for 'fairness', with the Prime Minister saying in January "I want us to build an economy and a society where those people [hard-working families] feel, 'This is fair'"[3]. The growing pay gap between top and bottom at Britain's companies has no place in a fair society, and addressing this is a key test of the Government's proposals.

Shareholders remain at the heart of the Government's approach to executive pay

In the forward to the consultation document, the Secretary of State refers to the package of measures announced in January to address executive pay: greater transparency, shareholder empowerment, employee engagement and more diversity in boardrooms, arguing that 'together, these reforms will create a more robust framework within which executive pay is set, agreed and reported on'.

The TUC would agree that all these elements should play a part in addressing excessive executive pay. However, a major weakness in the Government's overall approach lies in its proposals on employee engagement on executive remuneration. Rather than adopting any of the proposals set out in its own consultation document, which included worker representation on remuneration committees and a mandatory employee vote on remuneration reports, the Government chose

[1] TUC calculation based on OBR figures

[2] IDS, October 2011

[3] http://www.telegraph.co.uk/news/politics/david-cameron/9000153/David-Cameron-wont-let-the-socialists-have-fairness-all-to-themselves.html

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instead to exhort employees to make use of the existing provisions of the Information and Consultation of Employees (ICE) Regulations.

The ICE Regulations have been in force in the UK since April 2005 for undertakings with at least 150 employees and since April 2007 for undertakings with at least 50 employees. Where employers do not have compliant systems for informing and consulting their workforce, under the ICE Regulations employees may trigger a formal request to have a system put in place. Ten per cent of the workforce must be shown to support the request before the employer needs to respond. If a 'valid request' is successful, workforce representatives and the employer must then agree an 'I&C agreement' setting out the terms and scope of the information and consultation arrangements to be adopted. If agreement cannot be reached within six months, Standard Information and Consultation Provisions will automatically apply by default. These require that the employer must inform/consult elected employee representatives on:

• business developments (information only)

• employment trends (information and consultation); and

• substantial changes in contractual relations or work organisation, including redundancies and business transfers (information and consultation "with a view to reaching agreement").

Since these rights have come into force, relatively few I&C agreements have been established at workplaces. This is partly because in non-unionised workplaces, which might have most to gain from the provisions, there is very little awareness that the provisions exist. In addition, in a workplace that is not already organised, obtaining ten per cent of the workforce's support can be quite an onerous challenge. In workplaces that are unionised, the vast majority will enjoy collective bargaining rights that are substantially stronger than an I&C agreement, and so will have little or nothing to gain from the ICE Regulations.

There is nothing in the ICE regulations that gives workers the right to discuss workforce pay, let alone executive pay with their employer. Given the lack of awareness of the ICE Regulations, the barriers therein to establishing information and consultation rights, the limited number of I&C agreements that currently exist and the fact that the ICE Regulations do not give employees the right to information on their own pay arrangements, let alone the pay of company directors, the TUC is extremely sceptical of the likelihood of the ICE Regulations being used effectively for employees to feed in their views on the remuneration of company directors.

The TUC believes that a far more effective way for the workforce to feed in their views on executive pay is worker representation on remuneration committees. By failing to include this policy in its proposals, we believe that the Government has wasted an important opportunity to shake up the constituency of remuneration committees and make a real difference to the quality of their discussions.

Worker representation on remuneration committees would bring important benefits:

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• Workers would bring a fresh perspective and common sense approach to discussions on remuneration, in contrast to the current culture that presides on remuneration committees.

• The Government has acknowledged the importance of taking into account both company pay differentials and consulting with workers about directors' pay. The best way to ensure that these issues are considered properly in decision making is for workers to be represented on remuneration committees.

• Workers' interests are inextricably linked to the long-term success of their company; they are therefore well placed to contribute to discussions on an appropriate remuneration strategy to serve the long-term interests of the company.

• Including workers on remuneration committees would engender a higher degree of buy-in from employees on pay arrangements at their company. This should contribute to employee engagement, which is shown to be linked to higher company productivity and performance.

• Research has shown that worker representation does help to curb directors' remuneration. One study showed that, among the largest 600 European companies, the presence of board level worker representation is correlated with lower CEO pay and a lower probability of stock option plans. A second study showed that, within large German companies, stronger worker representation on the board led to lower CEO pay and less use of stock-based remuneration[4].

• There is clear academic evidence that high wage disparities within companies harm productivity and company performance[5]. Combined with the evidence (cited above) that worker representation on remuneration committees is associated with lower rates of CEO pay, this makes a strong case for the inclusion of worker representatives on remuneration committees.

The TUC believes that the so-called risks and practical objections to this measure have been significantly overstated. In explaining to the House of Commons in January his decision not to propose worker representation on remuneration committees, the Secretary of State expressed strong support for workers becoming company directors, but said that there were problems with making it mandatory. However, while the TUC would share the Secretary of State's support for the

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[4] Board Level Employee Representation, Executive Remuneration And Firm Performance In Large European Companies, Sigurt Vitols, March 2010; and Arbeitspapier 163, Beteiligung der Arbeitnehmervertreter in Aufsichtsratsausschüssen, Auswirkungen auf Unternehmensperformanz und Vorstandsvergütung, Studie im Auftrag der Hans-Böckler-Stiftung, Sigurt Vitols 2008; both available from the TUC

[5] See, for example, Pedro Martins, Dispersion in Wage Premiums and Firm Performance, Centre for Globalisation Research Working Paper No. 8 April 2008; Olubunmi Faleye, Ebru Reis, Anand Venkateswaran, The Effect of Executive-Employee Pay Disparity on Labor Productivity, EFMA, Jan 2010; and Douglas M. Cowherd and David I. Levine, Product Quality and Pay Equity Between Lower-Level Employees and Top Management: An Investigation of Distributive Justice Theory, Administrative Science Quarterly, Vol. 37, No. 2, Special Issue: Process and Outcome: Perspectives on the Distribution of Rewards in Organizations June 1992

establishment of more worker directors (such as already exist on the board of FirstGroup plc[6], for example), it is not necessary for workers to be company directors to sit on remuneration committees. Health and safety committees and CSR committees are among those that provide precedents for important company committees that often include both board and non-board members in the UK. Establishing remuneration committees with non-board members would require no changes to company law (which does not actually require the establishment of remuneration committees) and would require only a minor change to the Corporate Governance Code. In fact, companies could include workers on their remuneration committees under the existing code if they so-wished, simply making use of the 'comply or explain' provisions to explain their actions.

Another objection that has been raised to mandating worker representation on remuneration committees is that it is not clear how workers would be selected in companies that employ a significant proportion of workers overseas would be arranged. The TUC believes it would be relatively straightforward to establish mechanisms for selecting worker representatives in companies that employ workers overseas; indeed, there are well-established precedents from processes such as, for example, appointing members of European Works Councils, that could be drawn on for this. There is no reason why worker representation on remuneration committees should present major practical obstacles for companies, regardless of the location of their workforce. If a company is listed in the UK and its board is drawn mainly from the UK, it is reasonable to expect it to reflect UK-established procedures for executive remuneration, which is why such a company would be expected to follow the Code of Corporate Governance or explain why it was not doing so.

As the consultation document notes, the Government's proposals are in keeping with the UK's shareholder-oriented system of corporate governance: 'Shareholders are at the heart of these reforms, just as they are at the heart of the UK's corporate governance system…Shareholder empowerment lies at the heart of the UK's corporate governance framework and these reforms are consistent with that approach'. The efficacy of these proposals is therefore a test for the whole of the UK's corporate governance system. If shareholders do not address excessive levels of and increases in executive pay, even with the extension to their powers that these proposals will give them, this will be a clear indication that they are not able to fulfil the legitimate expectations that their privileged role in corporate governance confers upon them; and that it is the corporate governance system itself that needs to change.

Consultation questions

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

[6] http://www.firstgroup.com/corporate/csr/csr_report_2011/our_employees/employee_engagement.php

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approach?

The TUC supports the introduction of an annual binding vote on remuneration policy. It is appropriate that where remuneration proposals for future pay are defeated, the results of this vote should be binding and that companies should be required to rethink their approach.

One benefit of introducing a binding vote is that could encourage companies to increase the quality of their engagement with shareholders. However, it is currently extremely rare for companies to lose the vote on their remuneration report, even where there is substantial discontent among shareholders about their remuneration policies, and some investors have indicated that making the vote binding will make them even less likely to vote against remuneration reports. This reluctance of shareholders to vote against remuneration reports is likely to limit the practical impact of making introducing a binding vote on remuneration. There is also a danger that if shareholders' reluctance to vote against remuneration proposals continues, a binding vote could have the effect of legitimising poor remuneration practices. This proposal, and indeed all the proposals in this consultation document, is dependent on shareholders raising their game in relation to directors' remuneration in order to be effective.

The consultation document says that 'it will be for companies and their shareholders to determine how much detail is desirable'. The TUC believes that if the binding vote is to be effective, it will be necessary for a significant amount of detail to be included in companies' proposals. Otherwise, there is a danger that companies could produce anodyne statements that it is difficult for shareholders to disagree with, which then pave the way for inappropriate remuneration payments.

The TUC does not support the option of introducing a binding vote only where there are substantial changes proposed, as is the case in the Netherlands. As the consultation document notes, there is a difficulty in assessing what constitutes 'substantial' change. In addition, the TUC believes it is appropriate that each remuneration report is considered fully by those entitled to vote on it; danger if the binding vote were limited to substantial changes there is a danger that incremental changes could be introduced without attracting appropriate scrutiny.

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

The TUC believes that this is a sensible approach, giving clarity to the consequences of a report being defeated at a company's AGM.

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

The amendment of any directors' service contracts that conflict with the new proposals is for the proposals to work. Otherwise, companies could avoid implementation of the proposals through the design of directors' contracts, which would render the proposals ineffective and create an uneven playing field on directors' pay.

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

It is essential that remuneration packages offered to new recruits are consistent with the company's agreed remuneration policy – otherwise the remuneration policy would in effect apply to some board members but not others. 'Golden hellos' offered to encourage recruitment of external directors have helped to drive up executive remuneration levels across the board and it is important that their use should be addressed.

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

At present, it is often extremely difficult if not impossible to work out exactly what individual directors will gain under what performance conditions from an LTIP scheme in a particular year. If the vote on future remuneration is to be effective in relation to LTIPs, it will be vital to ensure absolute clarity on both performance criteria and potential payments in the disclosure, and this will need to be addressed within the Regulations.

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

To date, as noted above, shareholders have shown themselves to be very reluctant to vote against remuneration reports. Since the advisory vote was introduced in 2003, only 18 remuneration reports have been defeated by shareholders at AGMs, despite thousands of votes taking place over this period. Worryingly, some investors have indicated that making the vote binding will make them less likely to vote against remuneration reports, even where they have concerns.

The TUC believes that this demonstrates that shareholders alone are not effective arbiters of executive remuneration, and believes that it is essential that other mechanisms for addressing executive pay are introduced. We believe that workers should be represented on remuneration committees to bring some common sense to discussions and ensure that remuneration committees take greater account of the levels of and increases in pay throughout the rest of the company when setting directors' pay. We also believe that mandatory disclosure of pay ratios between top and median and top and bottom should be introduced.

Given that the Government has chosen to leave shareholders in the driving seat over executive pay, the reluctance of shareholders to take a stand against excessive levels of remuneration is a major problem if the proposals are to go beyond window dressing. Raising any voting threshold above a simple majority requires strong justification. However, if the Government does not raise the level of shareholder support required above 50%, there is a significant risk that their proposals for addressing executive pay will have very little practical effect.

As the consultation document notes: 'the increasingly diverse and fragmented nature of shareholders in the UK means that the likelihood of seeing 50% of more votes cast against any resolution can be reasonably expected to remain extremely low'. This gloomy prediction is entirely consistent with the evidence as to what has happened in practice since the introduction of the advisory vote in 2003.

There is evidence, however, that raising the threshold to 75% would make a significant difference to the 'bite' of shareholder votes on executive pay. According to PIRC research, 85 companies failed to secure a vote in favour of at least 75% (looking at votes for and against only) since the advisory vote was introduced in 2003. For 2011, a total of 31 (6.5%) companies failed to achieve 75% vote in favour of their remuneration report (looking at votes for and against only), compared to the three actual defeats that occurred last year. 85 cases is still a very small proportion of the thousands of remuneration reports that have been voted on since 2003; however, the fact that more companies failed to achieve the 75% threshold of support last year than have had their remuneration reports defeated under the current system since it was introduced in 2003, makes a strong case in favour of raising the threshold.

The Government has put shareholders at the centre of their approach to tackling executive pay. Raising the threshold of support to 75% is necessary to make this approach work in practice. Without this measure, there is a danger that the Government's proposals will fail to have any practical impact on the levels and rates of increase of executive pay, or indeed the link between executive pay and performance.

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

The TUC believes that requiring companies to issue a public statement where there the proportion of votes cast in favour is 75% or below would encourage companies to take shareholder views on remuneration seriously and should help to discourage poor practice on executive pay. This proposal will help shareholders to hold companies to account in situations where remuneration reports have failed to secure support from a significant proportion of shareholders.

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

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shareholder vote be more appropriate?

The TUC believes that directors' notice periods should be in line with those offered to other staff at the company, and that payments to departing directors should be limited to their salary for their notice period. Company directors have a much greater influence on decisions that affect the future of their company than do their workforce; yet directors have greater protection when things go wrong, despite also being more able to save, given their much larger remuneration packages. There is no justification for this and directors and their workforce should have the same notice periods on the same terms.

The TUC therefore proposes that the binding vote should apply to exit payments above salary relating to the notice period that applies to other staff at the company. It is very important that basic payments (on which a vote is not required) are restricted to salary only. Directors' salaries are sufficiently high for this to be a perfectly acceptable redundancy payment and, as argued above, there is no reason for directors on their much higher salaries to receive more protection from their own decisions than other employees on much lower salaries.

It is very important that the Government does not follow the Australian model and allow companies to approve exit payments in advance; it is essential that each case is judged in context, which is impossible in advance of knowing why an executive is leaving the company.

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

Amending directors' service contracts to bring them in line with the requirement to seek shareholder approval for exit payments will be necessary for the policy on exit payments to be effective.

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

As argued above, the TUC believes that directors should have the same notice periods as their workforce. It is very rare for the notice periods of ordinary employees to be above three months. One month's notice period is common, and some workers are entitled to just one week's notice period. The TUC believes that section 188 of the Companies Act should be amended to require shareholder approval for notice periods of over three months.