



UK Executive Pay & Governance

New Secondary Legislation on CEO Pay Ratios and Other New Reporting Requirements

June 2018

Introduction

On 11 June the Business, Energy and Industrial Strategy (BEIS) Department published details of the long-awaited [secondary legislation](#) (click for link) which will be introduced to implement part of the Government's reforms to the UK corporate governance regime. The intention to introduce the legislation was announced by the Government in August 2017.

The legislation – **The Companies (Miscellaneous Reporting) Regulations 2018** – includes new disclosure requirements in the following areas:

- CEO pay ratios
- The impact of share price appreciation on remuneration
- The exercise of discretion
- Directors' duties and wider engagement
- Corporate governance reporting requirements for private companies

The remuneration matters – i.e. pay ratios, share price appreciation and discretion – apply to UK-incorporated quoted companies listed on the Main Market of the London Stock Exchange (not AIM). The changes to reporting on directors' duties apply to all large companies (including private companies), and the corporate governance reporting requirements are intended to cover the largest private companies only (see below for size criteria).

Subject to Parliamentary approval, **the legislation will come into effect from 1 January 2019, and will be applicable for reporting years beginning on or after 1 January 2019.** In practice, this will mean that companies will be required to report in line with the regulations in the annual report published in 2020.

CEO pay ratios

- **A quoted company with more than 250 UK employees will be required to publish the ratio of CEO pay to the pay of the UK employee**

base. The number of employees relates to the number of UK employees within the whole group, not just the parent company.

- The pay ratio must be published on a quartile basis, illustrating the ratio relative to employees at the lower quartile, median and upper quartile.
- CEO pay is defined as total CEO remuneration as disclosed in the single figure table. The pay of the employees at each quartile is based on their full-time equivalent pay and benefits, intended to include everything that is also captured for the CEO (i.e. salary, benefits, pension and short and long-term incentive payments). The *figures* for each quartile (not just the ratio) must be disclosed, in terms of total remuneration and also for salary alone.
- The draft regulations include three options for determining the quartile numbers for the employee base, and the company must explain the rationale for its choice:
 1. Calculate the pay and benefits of all its employees to identify the quartile employees as a standalone exercise;
 2. Use the information previously calculated for the purposes of gender pay disclosures; or
 3. Use other up-to-date data to identify the best equivalents for the quartile employees.
- The company must calculate and publish the pay ratio information each year, **until a full 10-year history of ratios is disclosed**, thereafter to be maintained on a rolling basis.
- In addition to the ratio, **a narrative must also be provided** explaining the change in ratio from the previous year's figure, and whether the change was due to movements in the pay of the CEO or UK employees or due to a change in the company's employment model. The company will also be required to explain any trend in the median pay ratio over the period covered by the pay ratio table (i.e. eventually covering 10 years



of data) and also explain whether (and, if so, why) the median ratio is consistent with the pay, reward and progression policies for the company's UK employees taken as a whole.

The impact of share price appreciation on remuneration

- The directors' remuneration report requirements have been extended so that **for incentive awards disclosed in the single figure table, it must be stated what amount was attributable to share price appreciation**. Where discretion was exercised in respect of any award, the company must also explain whether this was as a result of share price appreciation or depreciation.
- The "scenario charts" which must be provided (albeit only technically in a "policy renewal" year) are being expanded so that, for long term incentive schemes, **an indication is included of the maximum remuneration receivable assuming share price appreciation of 50%** during the performance period.

The exercise of discretion

- The statement from the chair of the remuneration committee must include **a summary of any discretion which has been exercised in the award of directors' remuneration**.

Directors' duties and wider engagement

- Section 172 of the Companies Act 2006 includes a requirement for directors to promote the success of the company for the benefit of shareholders, while having regard to employee and other interests. **The new regulations will require the strategic report to describe how the directors have had regard to such matters.**¹
- A company with more than 250 UK employees across the group as a whole must also include in the directors' report a **statement summarising how the directors have engaged with employees**, and how the directors have had regard to employees' interests in respect of the principal decisions taken by the company during the year.
- The directors' report must also contain a **statement summarising how the directors have had regard to the need to foster the company's business relationships with suppliers, customers and others**, and the effect of that regard on the key decisions taken during the year.¹

Corporate governance reporting requirements for private companies

- Private companies which have (i) more than 2,000 employees *or* (ii) turnover of more than £200m *and* assets of more than £2bn will be required to include in their directors' report a statement on corporate governance. **This must state which, if any, corporate governance code has been applied by the company**, how the company has applied the code and any reasons for departing from the code's provisions. If no code has been applied, the company must explain why.

¹ Applies only to large companies as defined in the Companies Act, i.e. companies meeting at least two of the following three criteria: (i) turnover of more than £36m, (ii) balance sheet total of more than £18m, (iii) more than 250 employees.



Our View

- The secondary legislation was expected and contains no fundamental surprises. The implementation date of 1 January 2019 gives companies time to prepare ahead of formal reporting in 2020, and also aligns with the effective date of the new UK Corporate Governance Code. The final version of the revised Code is due to be published by the Financial Reporting Council next month.
- Companies should not, however, rest on their laurels. The Investment Association has been encouraging companies to voluntarily disclose CEO pay ratios for a couple of years now, and further pressure for early disclosure in 2019 may be exerted by some investors. Starting to think about the disclosure requirements sooner rather than later is recommended.
- We expect the pay ratio disclosures to attract considerable attention from the media, politicians and other parties as well as from investors. The public focus on the ratios will be intense when mandatory reporting starts in 2020. Companies where the CEO is perceived as being paid excessively will come under the spotlight, and we expect detailed comparisons to be drawn across sectors and the market as a whole.
- The regulations will add at least half a page to the length of remuneration reports. Instead of reporting just a single CEO:employee pay ratio, companies will have to include quartile-by-quartile ratios, UK employee salary and total pay for each quartile, extensive supporting narrative and the build up over time of 10 years' of information.
- Among other things, decisions will need to be taken on which of the options to use for generating the employee pay data. The option of using the gender pay reporting data has been included in an attempt to lessen the procedural burden on companies.
- Some large UK-listed companies have fewer than 250 UK employees and so the pay ratio legislation does not formally apply to them. We anticipate, however, that there will be an expectation from investors for voluntary disclosure from these companies. Companies with fewer than 250 UK employees but a large international workforce will need to decide if some

form of pay ratio disclosure taking into account the wider employee base would be helpful (recognising the potential challenges in arriving at a meaningful figure).

- The aspects of the regulations dealing with the reporting of share price appreciation are an attempt to clarify how far outcomes – or potential outcomes – are a product of share price movements, and directly address concerns with some LTIPs raised over the last few years (with Persimmon at front of mind). Whether investors will take a fundamentally different view of long-term incentives when they have this information remains to be seen.
- The reporting of the impact of discretion picks up another key theme in the recent debate about executive pay. It sits alongside the expected provision in the new UK Corporate Governance Code that remuneration committees should have the discretion to override the formulaic outcomes of incentive schemes (although investors will doubtless have greater sympathy for reductions rather than increases).
- The requirement for companies to disclose how directors have taken into account the interests of employees and other relevant stakeholders is a significant reporting change, and should be considered alongside the expected new Code provision requiring boards to gather the views of the workforce. For many companies, it will take time to develop new processes and consider the best way of reporting, making it even more important to start thinking about these changes now.
- Large private companies which will need to report against a corporate governance code will have a number of codes to choose from: the UK Corporate Governance Code, the QCA's revised Corporate Governance Code (released earlier this year) or the principles currently being developed by a Coalition Group specifically targeted at private companies. These principles are due to be released for consultation shortly*.

***Update (13 June):** The [principles](#) (click for link) have now been published and are open for consultation until 7 September.

Want to know more?

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