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Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe

Abstract

This article considers the regulation "on the books" of executive pay across the EU and the evidence "in action" on corporate practice concerning executive pay (based on disclosures by FTSE Eurofirst 300 companies) in relation to the best practice recommendations set out in two key Commission Recommendations from 2004 and 2005. It finds that Member State implementation of the two Recommendations has been patchy and, in particular, that reliance on Corporate Governance Codes has not resulted in the embedding of good practices, particularly with respect to disclosure concerning executive pay, across Europe's largest companies. It argues that if the EU is to succeed in promoting stronger alignment between shareholder and manager interests by means of the executive pay contract, closer attention is needed to remuneration governance and that a mandatory, harmonized disclosure obligation should be introduced. Although the Commission has recently adopted a 2009 Recommendation on executive pay in the corporate sector generally as part of its response to the financial crisis, the article suggests that this attempt to influence the design of executive pay is mis-conceived and that attention would have been better focused on the enforcement of basic disclosure obligations.

Keywords: executive remuneration; corporate governance; financial crisis; EU harmonization

1. Executive Pay, Shareholder/Manager Interest Alignment and Harmonization: is there a Role for the EU?

1.1 Executive Pay and Incentive Alignment

This article considers the EU's role with respect to executive pay in the corporate sector generally.[1] It examines the EU's efforts to achieve executive pay practices in listed companies which support efficient alignment between shareholder and manager interests, the effectiveness of these efforts, whether further reform is required and the shape which reform should take. The evidence which it considers, both "on the books", in terms of Member States laws, and "in action"[2], in terms of the related disclosure practices with respect to pay adopted by Europe's largest companies, is based on a data-set constructed prior to the financial crisis. The article relates this evidence to the EU's first two major initiatives on executive pay, the Commission's 2004 Recommendation on Directors' Remuneration[3] and its 2005 Recommendation on the Role

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Section 3 is partly based on the answers given over 2007-2009 to a questionnaire on the national laws relating to directors' remuneration in the EU. We are grateful to: Hanák András, José Engrácia Antunes, Hanne Birkmose, Francesco Chiappetta, Filippo Chiodini, Pierre-Henri Conac, Blanaid Clarke, Susanne Kalss, Björn Kristiansson, Christoph van der Elst, Aslan Gülsum, Ignacio Farrando, Paul Lee, Marta Majcher, Peter O. Mülbert, Frans G K Overkleeft, Evanghelos Emm. Perakis, Naheeda Rashid, Rolf Skogg, Matti J Sillanpää, Joëlle Simon and Lientje Van den Steen, for either answering or reviewing the answers to the questionnaire. The completed questionnaires are available at: http://www.ecgi.org/remuneration/ecgi_research.htm. The article also considers more recent reforms in this area (it is based on EU Member States' laws and corporate governance codes as at 28 October 2009).

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2 The contrast between law "on the books" and law "in action" is now a well-established feature of law and finance scholarship, particularly with respect to the effectiveness of enforcement. See, eg, H Jackson and M Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* (2007), available via http://ssrn.com/abstractid=1000086.

3 [2004] OJ L385/55.

of Non-Executive Directors,[4] which were both adopted in the wake of the first major financial crisis of the 21st century – the Enron-era financial disclosure scandal.[5] But major financial crises have a habit of changing the executive pay debate.

The financial crisis has now reshaped the context within which executive pay is examined. The reform of executive pay structures within major financial institutions has been a recurring theme of the financial-crisis-related reform movement. The Financial Stability Board,[6] the G20,[7] the Obama Administration,[8] the European Commission[9] and the UK Financial Services Authority[10] have all highlighted executive pay in financial institutions in their responses to the financial crisis. The international reform agenda is focused on, inter alia, the link between

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[4] [2005] OJ L52/51.

[5] The 2004 Recommendation was designed in part to restore investor confidence in EU companies and securities markets post Enron: Commission, *Report on the application by Member States of the EU of the Commission Recommendation on directors' remuneration* (2007) (SEC(2007) 1022) (the Commission 2007 Remuneration Report), 2.

[6] FSB, *Principles for Sound Compensation Practices* (April 2009) and *Principles for Sound Compensation Practices. Implementation Standards* (September 2009). The FSB Principles increasingly seem to be providing the global template for reform of pay structures in financial institutions. See, eg, *infra* n 7 on G20 endorsement and, in the UK, Speech by FSA Chairman Turner, The City Banquet, London, September 22, available via http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0922_at.shtml.

[7] The G20 has called for "strong international compensation standards" and an end to the practices which led to excessive risk-taking, endorsed the FSB principles and called on the FSB to monitor their implementation: Leaders' Statement. The Pittsburg Summit 24-25 September 2009, available via http://www.pittsburghsummit.gov/mediacenter/129639.htm, Preamble, para 17 and A Framework for Strong, Sustainable and Balanced Growth, para 13.

[8] Executive pay restrictions have been placed on financial institutions in receipt of federal TARP funds (including that incentive payments must be limited to a maximum of 1/3 of the executive's total annual salary and take the form of restricted stocks which cannot vest until the TARP obligation ends): R Romano and S Bhagat, *Reforming Executive Compensation: Focusing and Committing to the Long-Term* (2009), available via http://ssrn.com/abstractid=1336978. Further reforms are expected from the Obama Administration's "executive pay czar".

[9] Commission Recommendation Complementing Recommendations 2004/913/EC and 2005/162 (C(2009) 3177) (the 2009 Pay Recommendation) and Commission Recommendation on Remuneration Policies in the Financial Sector (C(2009) 3159) (the 2009 Financial Institution Pay Recommendation). In July 2009 the Commission also proposed pay-related reforms (SEC(2009) 974 and 975) to the Capital Requirements Directive (Directive 2006/48/EC [2006] OJ L177/1 and Directive 2006/49/EC [2006] OJ L177/201).

[10] The FSA has adopted a Code of Practice on remuneration policies: FSA, Consultation Paper No 09/15, *Reforming Remuneration Practices in Financial Services* (2009). Bank pay practices have also been considered by the Walker Review on bank corporate governance in the wake of the crisis (*A Review of Corporate Governance in UK Banks and other Financial Industry Entities* (2009) and further reforms have been proposed by the UK government.

executive pay and optimal risk management in financial institutions[11] and on how pay can be used to align managers' interests with a range of stakeholder interests, including those of governments as shareholders in state-supported banks. The focus of this article, however, is on executive pay more generally and on what can be learned from the evidence which has emerged concerning the best practice template set out in the Commission's 2004 and 2005 reforms, Member States' rules and market practice. The momentum generated by the financial crisis reform agenda, however, and notwithstanding that pay is not regarded as a central cause of the crisis,[12] may, at EU level, lead to more intrusive intervention in executive pay generally. This is a real risk; financial institutions are different given the systemic implications of poorly designed executive pay.[13] Our purpose, therefore, is to consider the weaknesses which we have identified in the treatment of executive pay generally across the Member States and in the EU's initial tranche of executive pay initiatives and to suggest how the current political and institutional enthusiasm for pay reform might be harnessed such that these weaknesses might be effectively addressed.

The article is structured as follows. This first section argues that the shareholder/manager incentive alignment model remains the most effective means of characterizing executive pay, that intervention in this area should be directed towards support of incentive alignment and that harmonized EU intervention to that end can be justified. Section 2 considers the harmonized EU regime and its focus on strong remuneration governance practices which support effective

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[11] The Pittsburg September 2009 G20 meeting, eg, endorsed the 2009 FSB principles concerning compensation, including with respect to: the avoidance of multi-year guaranteed bonuses; the deferral of significant portions of variable pay and the use of claw-backs; stronger alignment between performance and risk management; greater disclosure and transparency concerning pay policies; limiting variable pay to a % of total net revenues when such pay is inconsistent with the maintenance of a sound capital base; and supporting the independence of pay committees: *supra* n 6, A Framework for Strong, Sustainable and Balanced Growth, para 13.

[12] As was acknowledged in the Turner Review. The European Commission, however, appears overtly hostile to bank pay practices, suggesting that "there is a broad consensus that compensation schemes based on short-term returns….contributed to the incentives that led to financial institutions' engagement in overly risky business practices": Commission, *Communication Accompanying the 2009 Recommendations* (COM (2009) 211), 2.

[13] Eg: J Gordon, ''Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-in" (2009) 46 *Harvard Journal on Legislation* 323, 355 and 363; L Bebchuk and H Spamann, *Regulating Bankers' Pay* (2009), available via http://ssrn.com/abstractid=141072, 1-2; and B Cheffins, *Did Corporate Governance 'Fail' During the 2008 Stock Market Meltdown? The Case of the S & P 500* (2009), ECGI Law Working Paper No 124/2009, available via http://ssrn.com/abstractid=1396126, 37. There appears to be some institutional investor awareness of the risks were banking reforms to be transplanted into the corporate sector generally (Response of the National Association of Pension Funds to the Financial Reporting Council Review of the Effectiveness of the Combined Code, June 2009, available via http://www.napf.co.uk), although the 2009 review by the Financial Reporting Council of the Combined Code suggested that some banking reforms might be replicated in the corporate sector: Financial Reporting Council, Review of the Effectiveness of the Combined Code: Call for Evidence, March 2009.

incentive alignment. Section 3 considers whether Member States' regulation of executive pay "on the books" reflects the best practice benchmarks set out in the 2004 and 2005 Recommendations. Section 4 considers the evidence of corporate practice "in action", as evidenced by the disclosure provided by Europe's largest 300 listed firms by market capitalization. Section 5 concludes by considering whether, in light of this evidence, further reform at EU level is required and whether the reforms necessary are reflected in the Commission's crisis-driven 2009 executive pay Recommendation for the corporate sector generally. The article argues for a binding, disclosure-based regime as the most effective means of promoting executive pay contracts which reflect shareholder interests.

While the financial crisis has created an EU political and institutional space within which executive pay issues can be re-considered, the current context is not entirely helpful for effective reform.[14] Executive pay has a history of being targeted by populist attacks following market declines, crises and scandals.[15] Although it is not clear that executive pay governance structures, outside the financial sector, under-performed (or at least more than usual) over the financial crisis,[16] pay reforms designed to address systemic risk in the banking sector and to assuage public anger may pull in executive pay generally in their wake, This would be a troubling development. Ill-judged over-reaction may only obstruct the ability of boards to adopt effective and innovative pay structures and to retain and attract managerial talent at a time of economic stress. Any transplantation of the bank pay reform movement into the corporate sector generally would also suggest that an unhelpful recharacterization of how the executive contract should be conceptualized for the purposes of regulatory intervention was underway.

The premise of this article, reflecting the line of scholarship which has dominated this field since the 1990s,[17] is that efficient, incentive-based executive pay contracts can provide a

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[14] For pleas for restraint generally see L Enriques, "Regulators' Response to the Current Crisis and the Upcoming Reregulation of Financial Markets: One Reluctant Regulator's Views" (2009) 30 *University of Pennsylvania Law Review* 1147 and C di Noia and S Micossi (with J Carmassi and F Pierce), *Keep it Simple. Policy Responses to the Financial Crisis* (Assonime and CEPS, 2009).

[15] S Bhagat, B Bolton, and R Romano, *The Promise and Peril of Corporate Governance Indices* (2007), ECGI Law Working Paper No 89/2007, available via http://ssrn.com/abstractid=1019921, 10-11.

[16] Cheffins, *supra* n 13 above, drawing on evidence from the S&P 500 and suggesting that corporate governance, including executive pay, worked "tolerably well", that there was relatively little controversy concerning executive pay outside certain financial firms and little evidence of share-based incentives to "cook the books", by contrast with the Enron era (at 29-32 and 37).

[17] Following from the seminal work of Jensen and Murphy: M Jensen and K Murphy, "Performance Pay and Top Management Incentives" (1990) 98 *Journal of Political Economy* 22 and id, "CEO Incentives: It's not How Much You Pay But How" (1990) 3 *Journal of Applied Corporate Finance* 36

powerful means for aligning the interests of shareholders and managers and for addressing agency costs within dispersed and blockholding companies. Healthy executive pay structures, and particularly performance-based incentive pay, in the form of bonuses and equity-based payments,[18] can be used to align the interests of shareholders and managers in dispersed ownership companies.[19] They have been associated with a reduction in the agency costs which arise from the separation of ownership and control, with incentivizing managers to pursue the shareholders' agenda[20] and with stronger corporate performance.[21] Even within blockholding companies, where the agency costs which trouble dispersed owners are reduced as blockholders should wield sufficient power to control management and suffer less from collective action problems, but where the primary agency costs relate instead to the oppression of minority shareholders (including minority institutional investors) and the misappropriation of assets,[22] pay structures can align managerial interests with those of the minority.[23]

Certainly, the incentive model can become malign. The very efficiency with which incentive contracts can drive managerial behaviour was shown to destructive effect over the Enron-era, where share-option pay generated powerful managerial incentives to distort disclosure.[24] The incentive model also depends on effective bargaining between the board, as

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[18] For recent institutional investor support of equity-based pay see NAPF, *supra* n 13 above.

[19] For references see G Ferrarini, N Moloney and C Vespro, "Executive Pay: Convergence in Law and Practice Across the EU Corporate Governance Faultline" (2004) *Journal of Corporate Law Studies* 243

[20] M Conyon and D Leech, "Top Pay, Company Performance and Corporate Governance" (1994) 56 *Oxford Bulletin of Economics and Statistics* 229; B Hall and J Liebman, *Are CEOs Really Paid Like Bureaucrats?* National Bureau of Economic Research (NBER) Working Paper Series, Working Paper No 6213 (1997) 1; and R Aggarwal and A Samwick, "Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence" (1999) 54 *Journal of Finance* 1999.

[21] H Mehran, "Executive Compensation Structure, Ownership, and Firm Performance" (1995) 38 *Journal of Financial Economics* 163 and A Morgan and A Poulsen, "Linking Pay to Performance" (2001) 62 *Journal of Financial Economics* 489.

[22] L Enriques and P Volpin, "Corporate Governance Reforms in Continental Europe" (2007) 21 *Journal of Economic Perspectives* 117.

[23] G Ferrarini and N Moloney, "Executive Remuneration in the EU: the Context for Reform" (2005) 21 *Oxford Review of Economic Policy* 304.

[24] Eg: J Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections" (2002) 69 *University of Chicago Law Review* 1233; L Ribstein, "Bubble Laws" (2003) 40 *Houston Law Review* 77; J Coffee "A Theory of Corporate Scandals: Why the US and Europe Differ", P Davies, "Enron and Corporate Governance Reform in the UK and the European Community" and S Deakin and S Konzelmann, "Corporate Governance after Enron: An Age of Enlightenment", all in J Armour and J McCahery (eds), *After Enron: Improving Corporate Law and*

custodian of shareholder interests, and the manager. Where bargaining is distorted, whether through incompetence or conflicts of interest, executive pay, far from aligning shareholder and manager interests, can become an occasion for rent-seeking by managers[25] who, abetted by flawed board monitoring,[26] are deterred only by the threat of public outrage.[27] Persuasive evidence continues to emerge as to weaknesses in the incentive contract. In the US, Bebchuk and Fried have vividly charted major failures in an opaque and complex pay-setting process which hides massive rent-seeking by directors, particularly through equity-based schemes with weak performance links which reward executives for performance based on economy and industry-wide factors and which do not penalize failure.[28] Executive pay has increased steadily as firms have increased in size over the past three decades; average CEO total compensation and average firm size have increased six times between 1980 and 2003.[29] Increases in CEO pay have also been linked to an increase in CEO power.[30] In the UK, the 2009 AGM season saw repeated challenges

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Modernising Securities Regulation in Europe and the US (Oxford, Hart Publications, 2006); and J Hill, "Regulating Executive Remuneration: International Developments in the Post-Scandal Era" (2006) 3 *European Company Law* 64.

[25] R Posner, "Are American CEOs Overpaid and, If So, What if Anything Can be Done About It" (2009) 58 *Duke Law Journal* 1013 and J Hill and C Yablon, "Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict" (2000) 25 *New South Wales Law Review* 294.

[26] Eg: J Core, R Wayne and R Thomas, *Is US CEO Compensation Inefficient Pay Without Performance?* (2004), Vanderbilt Law and Economics Research Paper No 05-05; U of Penn, Inst for Law & Econ Research Paper 05-13, available via http://ssrn.com/abstractid=648648; Enriques and Volpin, *supra* n 22, 117-140; G Ferrarini and P Giudici, "Financial Scandals and the Role of Private Enforcement: The Parmalat Case" in Armour and McCahery, *supra* n 24; Hill, *supra* n 24; and B Holmstrom, "Pay without Performance and the Managerial Power Hypothesis: A Comment" (2005) 30 *Journal of Corporation Law* 703.

[27] As was made compellingly clear in Fried and Bebchuk's re-assessment of executive pay structures: L Bebchuk and J Fried, *Pay without Performance. The Unfulfilled Promise of Executive Pay* (Harvard University Press, 2004) (discussed in the symposium published in the (2005) 30(4) *Journal of Corporation Law*). Similarly, L Bebchuk, J Fried and D Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation" (2002) 69 *University of Chicago Law Review* 751.

[28] *Supra* n 27 and, similarly, Posner, *supra* n 25.

[29] X Gabaix and A Landier, "Why has CEO pay increased so much?" (2008) 123 *Quarterly Journal of Economics* 49.

[30] L Bebchuk and J Fried, "Executive Compensation as an Agency Problem" (2003) 17 *Journal of Economic Perspectives* 71 and Posner, *supra* n 25. Although, for a contrasting perspective, see M Kahan and E Rock, *Embattled CEOs,* ECGI Law Working Paper No 116/2009 (available via http:ssrn.com/abstractid= 1281516), finding evidence of a gradual decline of CEO power in several areas, including with respect to executive remuneration.

to the mandatory Directors' Remuneration Report from shareholders and a "spreading shareholder revolt" on remuneration, primed by co-ordinated institutional investor activism.[31] Recent trends in UK executive pay have been ever upwards, although there is some evidence that the performance sensitivity has increased.[32] A recent survey of executive pay practices across members of the FTSE 100 in 2008 has pointed to increasing levels of pay despite significant losses in value across the FTSE 100.[33] Continental Europe has also seen failures in performance-based contracts, most infamously perhaps in the form of the compensation payments to Mannesmann executives.[34] While the overall quantum of pay remains considerably higher in US firms than in European firms, the level of incentive-based pay is much lower in European firms[35], suggesting inefficiencies in pay structures.

But it is this article's contention that the executive pay problem, and leaving aside the particular systemic and stakeholder issues raised by financial institutions, must still be regarded in terms of incentive alignment. Additional pan-EU reforms, which experience with the 2004 and 2005 Recommendations suggests are necessary, should be directed to the process through which the pay contract is negotiated and to how optimum incentive contracts (and shareholder monitoring of these contracts) can be supported. This leads to the politically unpalatable reality that high or "excessive" levels of executive pay are not an occasion for intervention - as long as pay is efficiently linked to performance and to shareholder/manager incentive alignment.[36] This view has its detractors. Prior to the crisis, an alternative critique of executive pay had already

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[31] K Burgess and J Croft, "Provident bonuses shot down by shareholders", *Financial Times* 7 January 2009, 21. Shareholders either voted against remuneration policies, or showed large dissenting minorities, in a number of high-profile UK companies including Provident Financial, TRG and BP, with some predicting that "no" votes will become more common: K. Burgess, "Shareholders to adopt tougher stance", *Financial Times*, 7 May 2009, 23.

[32] Gordon, *supra* n 13.

[33] The Guardian Executive Pay Survey (2009) examined pay practices across the FTSE 100 in 2008 (in respect of executive and non-executive directors). Headline findings included that basic salaries rose on average by 10% but that bonus payments were lower, that there was evidence of performance targets being reset and that cash payments of up to 40% of basic pay were being made in lieu of generous pension contributions: available via http://www.guardian.co.uk/business/2009/sep/14/executive-pay-keeps-rising

[34] Discussed in C Milhaupt and K Pistor, *Law and Capitalism, What Corporate Crises Reveal About Legal Systems and Economic Development around the World* (University of Chicago Press, 2008).

[35] R Thomas, *International Executive Pay: Current Practices and Future Trends*, Vanderbilt Law and Economics Research Paper No 08-26 (2008), available via http://papers.ssrn.com/abstractid=1265122.

[36] Generally, Bebchuk and Fried, *supra* n 27. Similarly, "even the most severe critics of executive compensation have advocated structural changes to give shareholders greater control in director elections, as opposed to elimination of incentive pay altogether": Bhagat et al, *supra* n 15, 11.

engaged with the social implications of high levels of executive pay[37] and with a fairness agenda.[38] High levels of executive pay have been criticized for failing to reflect wider stakeholder interests and, in particular, for failing to engage with the social justice implications of stratospheric pay awards.[39] The financial crisis, however, has seen the wider debate on executive pay become entangled with the notions of fairness, equality, and "excessive" pay, which, along with systemic risk concerns, are now strongly associated with the "bankers' pay" debate.[40] Certainly, public opprobrium concerning high levels of executive pay in financial institutions has been intense and the scale of the pay-outs to managers in failed financial institutions, now supported by the tax-payer, would shock the most disinterested observer.[41]

However appealing the fairness agenda, it is a troublesome one. Shareholder interest alignment remains a clear and transparent basis for reform which responds to the agency costs experienced by shareholders.[42] Executive pay is not a device for reflecting societal expectations or, as might be the case currently, a desire for retribution. It is (or should be) simply a corporate governance mechanism for driving strong corporate performance in the interests of shareholders and for reducing agency costs. Although the debate is ongoing, strong investor protection is associated with stronger returns for investors and is reflected in investors' preferences.[43] While the evidence remains unclear,[44] some studies suggest a positive relationship between corporate

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[37] J Gordon, "Executive Compensation: If there's a Problem, What's the Remedy? The Case for Compensation Disclosure and Analysis" (2005) 30 *Journal of Corporation Law* (2005) 675.

[38] Gordon, *supra* n 13, 328

[39] *Ibid* and M Loewenstein "Reflections of Executive Compensation and a Modest Proposal for (Further) Reform" (1996) 50 *Southern Methodist University Law Review* 201.

[40] Eg: Cheffins, *supra* n 13, Bebchuk and Spamann, *supra* n 13 and Gordon, *supra* n 13.

[41] The Walker Review noted that the UK taxpayer had provided UK banks with nearly £1.3 trillion in support (equivalent to almost 90% of UK GDP) and that "political, taxpayer and social tolerance of practices, including unsafe remuneration policies, which led to this calamitous state, is understandably low": *supra* n 10, 91.

[42] On the importance of transparency and simplicity in this area see Romano and Bhagat, *supra* n 8.

[43] J McCahery, Z Sautner, and L Starks, *Behind the Scenes. The Corporate Governance Preferences of Institutional Investors,* European Corporate Governance Institute Working Paper No 239/2009, available via http://ssrn/com/abstractid=1331390.

[44] Eg: N Fernandes, *Board Compensation and Firm Performance: The Role of 'Independent' Board Members*, ECGI Finance Working Paper No 104/2005 (2005), available via http://ssrn.com/abstractid=830244 and L Brown and M Caylor, "Corporate Governance and Firm Operating Performance" (2009) 32 *Review of Quantitative Financial Accounting* 129.

governance practices and growth,[45] although firm value also depends on country-level shareholder protection laws.[46] The costs of implementing effective corporate governance mechanisms seem to be lower than the monitoring benefits which result in higher cash flows accruing to shareholders and in lower costs of capital for firms.[47] And even if "fairness" could somehow be captured and could displace the primary interests of shareholders, the difficulties in implementing a fairness agenda through regulatory fiat are such as to make the exercise almost pointless. It is very difficult to design an effective incentive contract given the different objectives, even only with respect to interest alignment, it must serve.[48] Achieving effective pay design, particularly with respect to equity-based pay, increasingly in the ascendant as a preferred form of pay post-crisis, is notoriously complex, not least given the risk of rewarding managers for market-wide gains and of complex pay structures being used to hide rent-seeking.[49] Fairness-driven measures would be all the more troublesome,[50] reflecting the difficulties in reflecting

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45 Eg: M Ammann, D Oesch and M Schmid, *Corporate Governance and Firm Value: International Evidence* (2009), available via http://www.phitrust.com; R Aggarwal and R Williamson, *Did New Regulations Target the Relevant Corporate Governance Attributes*?, available via http://ssrn.com/abstractid=891411; V Bruno and S Claessens, *Corporate Governance and Regulation: Can There be Too Much of a Good Thing?,* ECGI Finance Working Paper No 142/2007, available via http://ssrn.com/abstractid=956329; and V Chhaochharia and L Laeven, *Corporate Governance, Norms and Practices,* ECGI Finance Working Paper No 165/2007 (2007), available via http://ssrn.com/abstractid=965733.

46 Bruno and Claessens, *supra* n 45.

47 Ammann *et al, supra* n 45.

48 Gordon, *supra* n 13 above, 329-335, noting how incentive contracts must provide a reward for prior successful service, provide incentives for future service, retain and attract talent and align managerial and shareholder interests, even though these objectives may at times conflict.

49 Eg: A Rappaport, "New Thinking on How to Link Executive Pay with Performance" (1999) March/April *Harvard Business Review* 91; M Brenner, R Sundaram and D Yermack, "Altering the terms of executive stock options" (2000) 57 *Journal of Financial Economics* 108; D Chance, R Kumar and R Todd, "The 'repricing' of executive stock options" (2000) 57 *Journal of Financial Economics* 129; A Morgan and A Poulsen, "Linking Pay to Performance - Compensation Proposals in the S&P 500" (2001) 62 *Journal of Financial Economics* 489; and K Chauvin and C Shenoy, "Stock Price Decreases Prior to Executive Stock Option Grants" (2001) 7 *Journal of Corporate Finance* 53.

50 Particular difficulties arise where limits are imposed on pay. Following restrictions on the income tax deductibility of cash compensation to $1 million, US firms altered their mix of compensation to reduce cash salaries and to increase incentive compensation, particularly stock options: T Perry and M Zenner, "Pay for Performance? Government Regulation and the Structure of Compensation Contracts" (2001) 62 *Journal of Financial Economics* 453. Similarly, after the 2002 Sarbanes-Oxley Act required claw-backs of incentive-based compensation in certain circumstances, US firms increased fixed compensation and decreased incentive compensation: D Cohen *et al, The Sarbanes-Oxley Act of 2002: Implications for Compensation Structure and Managerial Risk-Taking* (2007) available at http://papers.ssrn.com/abstractid=1027448 and Bhagat and Romano, supra n 8, 11-12.

wider stakeholder concerns in pay design.[51] They would require some form of balancing act between corporate and societal interests as well as some form of monitoring mechanism, beyond the board, to address fairness, whether through regulatory proxies in the form of pay limits and design requirements. The difficulties are immense.

1.2 Executive Pay and Harmonization

Although shareholder manager interest alignment is typically associated with Anglo-American corporate governance, effective interest alignment, which the Commission has highlighted as its main objective in intervening in this area[52], is a concern across the EU and despite the dispersed ownership/blockholding divide. EU corporate ownership, despite some recent movement towards market-finance-based structures,[53] remains strongly characterized by bank-finance-based structures. It is accordingly characterized by a distinction between dispersed ownership (or at least dispersed institutional ownership) in some Member States (notably the UK, Ireland and the Netherlands) and blockholding ownership by controlling shareholders (albeit to differing degrees) in others.[54] Earlier research which we conducted prior to the adoption of the Recommendations confirmed the link between incentive pay structures and their regulation and different corporate ownership regimes. We found relatively unsophisticated regulation of executive pay in blockholding regimes and a much closer focus on the effectiveness of the pay-setting process in dispersed ownership regimes.[55] But the effectiveness of the executive pay contract remains relevant across both ownership systems.[56] Minority shareholders, including minority institutional investors, require protection from the agency costs of blockholding governance and, in particular,

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[51] See, eg, the different views of Professors Bebchuk and Spamann and of Professors Romano and Bhagat on the appropriateness of restricted stock as incentive payments in banks in receipt of tax-payer funds: *supra* nn 13 and 8.

[52] On the Commission's interest alignment objectives see Ferrarini et al, *supra* n 19.

[53] N Moloney, *EC Securities Regulation* (Oxford University Press, 2 ed, 2008), 62-67.

[54] In France, Germany, Italy and the UK, the incidence of dispersed ownership across the 20 largest listed companies is in the order of, respectively, 60%, 50%, 20%, and 100%: Enriques and Volpin, *supra* n 22, 118-119.

[55] G Ferrarini and N Moloney, "Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives", in G Ferrarini, K Hopt, J Winter and E Wymeersch (eds), *Reforming Company and Takeover Law in Europe* (Oxford University Press, 2004) 267 and Ferrarini *at al, supra* n 19.

[56] The twin-track model is, of course, more nuanced in practice, with the influence of, and nature of blockholders differing across the Member States.

the risk of misappropriation.[57] The different techniques for supporting the incentive contract (discussed in section 2 below), but particularly disclosure, can highlight conflict of interest risks and allow minority investors to monitor management more effectively. Many of Europe's largest companies are, at least in part, in dispersed public ownership. Incentive contracts, and their risks if poorly designed, are becoming more widespread.[58] The encouragement of performance-based pay is a recurring theme of Corporate Governance Codes across the EU (section 3 below) as corporate governance reforms are being employed by Member States across the EU to deepen their capital markets.[59]

But does it follow that harmonization is appropriate? "One-size-fits-all" regulatory models may be ineffective as the determinants of good corporate governance vary across companies[60] and effective pay "in action" must be tailored to specific companies. The related risks of harmonization in the corporate governance sphere and in company law have been well documented.[61] These risks are no less serious in the pay context given the weaker reliance on high-powered incentive contracts in blockholding companies where controlling shareholders monitor management, and where the general meeting and shareholder voice are of limited importance in the pay-setting process;[62] great caution is called for where costly Anglo-American reforms are transplanted to a different governance context.[63] But it is our contention that while caution is required, the benefits of EU harmonization are greater than the costs. The costs of diverging regimes are not immaterial, particularly for pan-EU corporate groups. Diverging regimes limit the extent to which institutional investors can act as effective monitors of pay practices. There are scale efficiencies from the EU consolidating best practices in this area. EU

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57 Enriques and Volpin, *supra* n 22, 125, noting the inefficiency of private contracting and of social norms as mechanisms for protecting minority shareholders.

58 Thomas, *supra* n 35.

59 Eg Enriques and Volpin, *supra* n 22 and G Ferrarini, "Corporate Governance Changes in the 20th Century: A View from Italy" in K Hopt, E Wymeersch, H Kanda and H Baum (eds), *Corporate Governance in Context. Corporations, States, and Markets in Europe, Japan and the US* (OUP, 2005) 31.

60 Bhagat *et al*, *supra* n 15

61 Eg: L Enriques and M Gatti, "The Uneasy Case for Top-Down Corporate Law Harmonization in the European Union" (2006) 27 *University of Pennsylvania Journal of International Economic Law* 939 and G Hertig, "Ongoing Board Reforms: One Size Fits All and Regulatory Capture" (2005) 21 *Oxford Review of Economic Policy* 269.

62 Shareholders are, however, often given power to set supervisory board pay (section 3 below).

63 Enriques and Volpin, *supra* n 22, and Ferrarini *et al, supra* n 19.

level law-making may also act as a convenient proxy for Member States reluctant to address local vested interests and may also dilute local political tensions and demands for retribution; careful harmonization may have the benefit of defusing potentially inefficient and populist short-term solutions at Member State level. As discussed in sections 2 and 5, where harmonization addresses disclosure, it is relatively risk-free.

Costs arise, however, where the EU regime is inefficient. Section 2 examines how regulation can support an effective incentive contract through "remuneration governance" mechanisms and considers the techniques which the EU has adopted to support effective remuneration governance. Our evidence suggests that the current regime has, however, proved ineffective in supporting the roll-out of the key elements of effective remuneration governance. We sought to examine whether the regulation of executive director[64] pay, and the related pay governance practices adopted by listed companies, reflected the best practice recommendations of the 2004 and 2005 reforms and to assess the effectiveness of the Commission's harmonization model. We found, based on an assessment of legal regimes in 17 Member States, and on an examination of the governance and disclosure practices of the EU's largest public companies , that significant differences persist across Member States' regulatory regimes and in pay governance practices. While divergence is problematic in principle in that it raises costs and weakens shareholder monitoring, the real difficulties concern the extent to which the key mechanisms for supporting an effective incentive contract (section 2 below) have not been adopted. Best practice, particularly with respect to disclosure, is not securely embedded across Europe's largest companies. And it is also not clear that the current reform movement will address these weaknesses.

2. The Elements of the EU Executive Pay Model

It is not easy to ensure that the incentive contracts which emerge from the pay-setting process are, at best, effective in aligning incentives, and, at worst, not malign in that they do not generate perverse managerial incentives. The complexities of the choices involved – for example, should performance be linked to earnings or to the share price and should equity awards be deferred and if so, for how long[65] - certainly cautions against blunt regulatory intervention which attempts to

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[64] When using the term "director", we follow the Commission's definition of the director as "any member of the administrative, managerial or supervisory bodies of a listed company': 2004 Recommendation, para 2.1. The article also makes brief reference to the treatment of non-executive directors.

[65] Gordon, *supra* n 13, 333-334.

deliver incentive alignment through design requirements. Action in support of efficient private ordering is likely to be more effective. While the financial crisis has seen widespread acknowledgement that systemically significant financial institutions require closer regulatory intervention, the essential appropriateness of the adversarial, arms' length bargaining model in the corporate sector generally has not been subject to radical re-evaluation.[66] Careful attention is required, however, to the governance process through which incentive contracts emerge and to the conflicts of interest and other risks which can distort the pay bargaining process and lead to pay contracts which do not deliver efficient incentive alignment.[67]

"Pay governance" refers to the different but interlinked governance mechanisms which can support the adoption of effective incentive contracts, in particular board monitoring (particularly by independent directors), disclosure and shareholder voice.[68] These mechanisms are interlinked and ultimately assume that the board is the fulcrum of corporate governance. Corporate Governance Codes typically affirm that one of the board's central responsibilities is to align the pay of key managers and directors with the long-term interests of the company and its shareholders.[69] But comprehensive disclosure supports stronger board monitoring by strengthening the board's ability to withstand managerial/director pressure and, through reputational and publicity dynamics, stimulating shareholder and public reaction which can lend further legitimacy to a board's position and enhance the public perception of the social value of remuneration. "Say on pay" mechanisms, which can bolster the independence of the board, are similarly of limited value unless they are coupled to effective disclosure.

Corporate governance policy in the US and Europe is currently based on the assumption that good board governance can be buttressed by independent directors.[70] A conflicted board may

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[66] See, eg, Cheffins, *supra* n 13, cautioning against any major reforms to remuneration governance and Romano and Bhagat, *supra* n 8, highlighting the essential effectiveness of performance-based incentive contracts.

[67] See further Ferrarini and Moloney, *supra* n 55.

[68] This article does not seek to examine the wider fiduciary/conflicts of interests law which also governs executive pay with respect to the duties the board of directors owes to the company and shareholders (although brief reference is made to recent German reforms to the duties and liabilities of directors). It tracks the 2004 and 2005 Recommendations, focusing accordingly on pay governance.

[69] Eg, OECD, *Principles of Corporate Governance* (2004), Principle VI.D.4 This theme also emerges across the corporate governance codes of the EU Member States (available via the ECGI website, http://www.ecgi.org/codes/all_codes.php.).

[70] Eg, J Gordon, "The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices" (2007) 59 *Stanford Law Review* 1465, P Davies, "Enron and

use the pay-setting process to influence pay to the detriment of the shareholders by, for example, adopting weak performance targets, awarding share option packages which reward wider market gains and resetting performance targets where they are not met.[71] Boards may become conflicted in a number of well-documented ways: a dominant CEO, for example, can prejudice the independence of the pay process as well as the appointment of robust and independent-minded non-executive directors.[72] The independent director, however, can close the information and monitoring gap to which shareholders are exposed. In blockholding companies, controlling shareholders have the power to monitor and influence management. Nonetheless non-executive directors, independent from controlling shareholders, can support the interests of minority shareholders and, in particular, monitor conflicts of interest and the risk of misappropriation of assets.

Disclosure also supports effective pay governance by assisting shareholders in assessing the relationship of pay to performance, signalling good practice to the market and buttressing board independence. In the wake of the financial crisis, it is also clear that firms should demonstrate that their pay policies are sound, thereby facilitating constructive engagement with stakeholders and, in particular, diluting potentially unhelpful "outrage" effects. Enhancing disclosure does not mean that ever more complex details on pay packages are provided; rather disclosure must be published in a clear and exhaustive manner and allow for easy assessment of the performance link and, ideally, easy industry comparison. But it is a generally non-interventionist and flexible instrument[73] which accommodates firm autonomy. The information costs to institutional shareholders and proxy services can be reduced by effective and standardized disclosure which can sharpen shareholder engagement and focus board attention more closely on performance criteria and on termination payments. It certainly provides a safer outlet for governmental energies than more interventionist governance or design requirements. It can also manage the particular agency costs of executive pay across both dispersed and blockholding systems without intervening in governance choices and structures.[74]

Corporate Law Reforms in the UK and the European Community" in Hopt *et al, supra* n 59, 163, and Ferrarini *et al, supra* n 19.

[71] See further Ferrarini and Moloney, *supra* n 55, 301-303.

[72] L Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 *Harvard Law Review* 833.

[73] Eg, Bhagat *et al*, *supra* n 15, calling for "a straightforward governance disclosure regime, which is fully cognizant of the costs and benefits of disclosure. Such a regime acknowledges that there is no one benchmark or set of best practices that is appropriate for all, or even most, firms" (at 68). Similarly, Posner has called for greater disclosure in response to failures in executive pay-setting: *supra* n 25 above, 1045.

The pay governance matrix also includes shareholder voice. The "say on pay" mechanism, supported by effective disclosure,[75] has emerged over the financial crisis as something of a reform "du jour" for firms in receipt of government support.[76] More generally, strong shareholder voice, based on accurate disclosure, may buttress the independence of remuneration committees and their ability to stand up to a strong board. A "say on pay" may also impose some industry-wide discipline on pay as institutional investors, following proxy service providers' recommendations, are likely to react most strongly to "outlier" pay awards which do not conform to best practice.[77] Radical and market-wide shareholder revolts may also provide the systemic shock required to reset current norms on pay[78] and so drive more efficient market-led, rather than regulatory reforms. The UK evidence, based on the longest EU experience with a direct "say on pay" requirement, suggests that there has been a general increase in the sensitivity of the pay/performance relationship since the introduction of the "say on pay" in 2002. In particular, "golden parachutes" have become less valuable and less common as the terms of director service contracts have been reduced generally to one year.[79] Pay packages also appear to have become more sensitive to performance, with shareholders raising concerns where performance conditions were changed or the conditions of long term incentive plans reset.[80] The possibility of a negative vote on pay policy certainly has the potential to exert considerable ex

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[74] Ferrarini and Moloney, *supra* n 55.

[75] Davies has described the "say on pay" and disclosure as, respectively, the strong and weak supports for shareholder voice: *supra* n 70, 173.

[76] The US stimulus reforms, eg, require institutions in receipt of government funds to put executive remuneration to a shareholder vote.

[77] Gordon, *supra* n 13, K Sheehan, *Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the UK and Preliminary Results from Australia* (2007), available via http://www.ssrn.abstractid=974965 (noting the importance of the ABI and NAPF guidelines in the UK) and B Cheffins and R Thomas, *Should Shareholders have a Say on Executive Pay? Learning from the US Experience* (2001), available via http://www.ssrn.abstractid=268992.

[78] Gordon, *supra* n 13, 329. Davies similarly points to the shareholder vote as a means of controlling large, outlier pay awards: *supra* n 70, 176.

[79] Gordon, *supra* n 13, 341-347 (commenting on research by F Ferri and D Maber, *Say on Pay Vote and CEO Compensation: Evidence from the UK* (2009) (previously titled *Solving the Executive Compensation Problem Through Shareholder Votes? Evidence from the UK*, Working Paper, Columbia Business School, 2007).

[80] Sheehan, *supra* n 77 and Davies, *supra* n 70 (citing a 2004 Deloitte survey).

ante influence on boards, as suggested by the upsurge in shareholder action across Europe over the financial crisis.[81]

None of these mechanisms provide a magic bullet or are risk-free and they must all work together efficiently if the pay governance matrix is to be robust. Consistent weaknesses are, for example, observed in UK incentive contracts, despite the UK remaining, as discussed in sections 3 and 4, the most demanding Member State with respect to pay disclosure. Disclosure policy and regulation must be nuanced, clear and effective if it is to avoid a ratcheting upwards of pay awards, the generation of undue "outrage" or, conversely, the cloaking of rent-seeking arrangements with a veneer of legitimacy. The "say on pay" may lead to an unhealthy homogeneity in pay practices and the suppressing of innovative pay structures.[82] The evidence of shareholder influence on the quantum of pay is also unclear,[83] with some evidence that shareholders only bring influence to bear on systemic pay difficulties.[84] While the UK evidence suggests some positive effects, it is variable. The 2002 "say on pay" appears to have led to widespread approval of remuneration policies in practice (only eight rejections between 2002 and summer 2009) and to continual increases in pay. Overall, while consultation between shareholders and boards has improved, and some modest refinements have been made,[85] there have not been notable changes to UK pay practices. Certainly, without clear and effective disclosure, co-ordinated institutional investor action could be a loose cannon and the herding tendency often displayed by institutional investors could become destructive. Ultimately, intervention based on supporting effective pay governance in may be a "least worst" strategy for managing pay risks, given the costs and complexities of design-based intervention.

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[81] K Burgess and R Milne, "Floored boards", *Financial Times*, June 2 2009, 15, noting "a new determination among shareholders across Europe to be seen to hold boards to account, clamp down on excesses and stave off the political backlash that many see brewing against corporate greed". Heineken, DSM, Volvo and Carrefour were all required to change their remuneration policies following shareholder agitation in recent months.

[82] Gordon, *supra* n 13.

[83] Certainly international experience varies. There is US evidence that shareholder activism can lead to a reduction in the amount of pay (F Ferri and T Sandino, *The Impact of Shareholder Activism on Financial Reporting and Compensation: the Case of Employee Stock Option Expensing* (2009), available via http://www.ssrn.abstractid=1461713). The UK experience (outlined below), however, suggests limited shareholder influence on the size of pay awards.

[84] Gordon, *supra* n 13 and Sheehan, *supra* n 77.

[85] Cheffins, *supra* n 13.

Disclosure, shareholder voice and the independent director all appear in the EU's strategy for executive pay. The EU's initial approach to executive pay, set out in the 2004 and 2005 Recommendations, was based on pay governance and not on pay design. A number of directives adopted under the Financial Services Action Plan also form part of the EU's pay matrix by improving disclosure, both generally and with respect to pay, and by addressing insider dealing risks.[86] In particular, from September 2008, listed companies have been required to include a corporate governance statement in their annual reports, covering whether the company follows a particular Corporate Governance Codes and whether it complies or not with it.[87] The 2004 Recommendation, however, was the EU's first attempt to address best practice with respect to pay governance.[88] It uses disclosure and shareholder voice mechanisms to support efficient pay and recommends: disclosure of company pay policy, either in a distinct remuneration report or in the annual report;[89] detailed disclosure concerning individual directors' pay;[90] a shareholders'

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[86] The Transparency Directive (Directive 2004/109/EC [2004] OJ L390/38) requires annual disclosure concerning remuneration policies, total remuneration paid, any contingent or deferred compensation and benefits in kind granted to each member of the administrative, management or supervisory bodies. The Accounts Modernisation Directive (Directive 2003/51/EC [2003] OJ L178/16) encourages consistency across Member States in the level of narrative reporting presented in the annual report. The Market Abuse Directive (Directive 2003/6/EC ([2003] OJ L96/16) requires senior executives to notify their share transactions and prohibits insider dealing. The Prospectus Directive (Directive 2003/71/EC [2003] OJ L345/64) governs disclosure concerning certain share offerings, including employee share plans.

[87] Directive 2006/46/EC [2006] OJ L224/1.

[88] "Remuneration systems should…be subjected to appropriate governance controls, based on adequate information rights": recital 2.

[89] Policy disclosure should focus on company policy for the following financial year and subsequent years (where appropriate) and overview the manner in which policy has been implemented in previous years. It should include: an explanation of the relative importance of the variable and non-variable components of directors' remuneration; sufficient information on the performance criteria on which shares or variable compensation is based; sufficient information on the linkage between remuneration and performance; the main parameters and rationale for any annual bonus scheme and non-cash benefits; a description of the main characteristics of supplementary pension or early retirement schemes; a summary of company policy on directors' contracts, including the terms and duration of contracts, and provisions for termination payments; and a discussion of the decision-making process used for determining the remuneration policy: 2004 Recommendation, para 3.

[90] Individual disclosure is recommended concerning: total amount of salary paid; remuneration paid in the form of profit-sharing and/or bonus payments and the reason for its grant; compensation in connection with contract termination; the total estimated value of other non-cash benefits considered as remuneration; the number of share options offered or granted; the number of shares exercised, the exercise price or the value of the interest in the scheme; number of shares unexercised, their exercise price, the exercise date, and the main conditions for the exercise of rights; pensions; and loans, advance payments and guarantees, including the amount outstanding and the interest rate: para 5.

vote on company pay policy, which can be either binding or advisory;[91] and prior approval of share-based schemes.[92] The Recommendation does not engage with pay design, although support for performance-based pay is implicit across the Recommendation. The role of the board in pay-setting is addressed by the parallel 2005 Recommendation on the role of non-executive directors which highlights remuneration as an area in which the "potential for conflict of interest is particularly high" (recital 9) and recommends that: boards should have an "appropriate balance" of executive and non-executive directors such that no individual or group of individuals can dominate decision-making and a "sufficient" number of 'independent' non-executive directors (paras 3.1 and 4); board committees should be created for issues particularly vulnerable to conflict of interest (including remuneration) (para 5); and the remuneration committee (its functions are delineated in some detail) should be composed exclusively of non-executive or supervisory directors, a majority of whom should be independent (Annex I, para 3). The Recommendation also provides guidelines on the notion of "independence".[93]

To achieve its objectives, the Commission employed a non-binding Recommendation,[94] avoiding a "one-size-fits-all" solution at firm and Member State levels.[95] Member States were free to adopt the Recommendations (implementation was not mandatory) either through legislation or, as has been the dominant method, through soft law, typically based on the local Corporate Governance Code and, for many Member States although not all, on the related "comply or explain" principle.[96] Poor compliance need not necessarily follow from soft law

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[91] The remuneration policy should be an explicit item on the annual general meeting agenda and should be submitted to the general meeting for a mandatory or advisory vote. Member States may provide that the vote will only be held where shareholders representing at least 25% of the total number of votes held by shareholders present so request: para 4.

[92] Para 5.

[93] Although independence is "fundamentally an issue for the…board" (para 13.2), a director should be considered to be independent only if s/he is free of any business, family or other relationship with the company, its controlling shareholder or the management of either that creates a conflict of interest such as to impair the director's judgement (para 13.1). The Recommendation also sets out a series of criteria for assessing the independence of directors (para 13.2 and Annex II).

[94] Member States were to "take all appropriate measures to ensure that listed companies having their registered office in their territory have regard to this Recommendation": 2004 Recommendation, para 1.1. A similar approach was adopted under the 2005 Recommendation.

[95] The Recommendation was asserted to "respect fully the diversity of corporate governance systems within the Community" (recital 2), which it achieved by avoiding prescription and relying heavily on disclosure.

implementation; companies that voluntarily adopt more rigorous corporate governance structures can be rewarded by a positive effect on firm value.[97] The effectiveness of the "comply or explain" mechanism and of investor monitoring "in action" in embedding good remuneration governance across the EU is, however, doubtful, given low levels of conformity in practice with the Recommendations (section 4 below).

3 Reviewing the Remuneration Regime

3.1 Corporate Governance Reforms

This section considers whether remuneration law and best practice guidance (mainly in the form of Corporate Governance Codes[98]) across the Member States reflects the best practice recommendations set out in the 2004 and 2005 Recommendations. A large part of the analysis is based on the answers to a questionnaire sent to specialists in 17 EU Member States.[99] The findings underline the persistent differences in the quality of Member State rules governing board governance, disclosure, shareholder voice and certain elements of pay design. Reforms have, however, been ongoing, with a swathe of reforms to Corporate Governance Codes over 2006-2009.

A number of changes were, for example, made to the UK Combined Code on Corporate Governance in 2006;[100] it is currently under review. A new and more detailed Corporate Governance Code was published in Italy in March 2006 which, for example, specifies the duties of the remuneration committee. The new Spanish 2006 Unified Corporate Governance Code provides that a remuneration report should be submitted to the AGM for an advisory vote and that

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96 Commission, *Report on the application by the Member States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board* (2007) (COM SEC(2007) 1021) (Commission 2007 NED Report), 5.

97 *Supra* n 45.

98 But not always. The French best practice regime, eg, is based on a series of industry Recommendations.

99 Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, The Netherlands, Poland, Portugal, Spain, Sweden and the UK. Questionnaires were distributed over 2007-2008. They are available at the ECGI's website: http://www.ecgi.org/remuneration/ecgi_research.htm.

100 The Code has also been complemented by institutional investor guidance: Association of British Insurers (ABI), *Executive Remuneration – ABI Guidelines on Policies and Practices*, 3 December 2007 and ABI/NAPF (National Association of Pension Funds), *Joint Statement on Executive Contracts and Severance*, 18 February 2008.

the report should include individualized disclosure of directors' pay. Amendments to the German Corporate Governance Code in 2008 strengthen the responsibility of the supervisory board for management board pay; earlier, a law on the transparency of executive pay came into force in 2006 and requires companies to provide individualized disclosure on directors' pay. More radical German reforms, discussed further below, were adopted in 2009 in the form of a new Act on the Appropriateness of Management Board Compensation (the 2009 German Act).[101] Related revisions were also made to the German Corporate Governance Code in 2009. France's industry-based MEDEF/AFEP issued two pay recommendations in 2008 which are designed to enhance disclosure; the recommendations also provide guidelines on the pay/performance link.[102] The Dutch Corporate Governance Code, as amended in 2008, aims to align remuneration closely with company strategy and encourages a remuneration policy that creates long-term value. The new 2009 Belgian Corporate Governance Code focuses closely on executive pay and calls for complete transparency. Several other European Corporate Governance Codes were also amended in the period following the 2004-2005 Recommendations; the revisions generally focus on increased transparency, provide new guidelines on pay design and call for greater shareholder power over the pay process.[103]

Whether or not the reform movement is directly linked to the two Recommendations is, of course, unclear. Member States over that period generally engaged in reforms to their corporate governance regimes in an effort to deepen capital market liquidity and support industry competitiveness;[104] later reforms in 2008/2009 reflected the financial crisis. But it is not unreasonable to suggest that the Recommendations had some influence and that the reputational

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101 The VorstAG. The Act came into force on 5 August 2009. It specifies criteria for determining the appropriate level of directors' remuneration by amending sec. 87 of the German Stock Corporation Act (Aktiengesetz, AktG). It applies to all stock corporations.

102 AFEP/MEDEF, *Remuneration of Executive Corporate Officers of French Sociétés Anonymes: Legal and Tax Rules*, June 2008; *Recommendations Concerning the Compensation of Executive Directors of Companies whose Shares are Admitted on a Regulated Market*, October 2008.

103 Including: Austria - *Code of Corporate Governance,* revised in 2007; Luxembourg - *The Ten Principles of Corporate Governance of the Luxembourg Stock Exchange* (2006); Denmark - Committee on Corporate Governance, *Recommendations for Corporate Governance* (2005), revised in 2008; Finland - *Finnish Corporate Governance Code (*2008); Hungary - *Corporate Governance Recommendations* (2008); Poland - *Code of Best Practice for WSE Listed Companies* (2007); Portugal - *CMVM Regulation n.1/2007, CMVM Code on Corporate Governance* (2007); Sweden - *Code of Corporate Governance*, revised in 2008. All codes (original and amended versions) are available via http://www.ecgi.org/codes/all_codes.php.

104 Enriques and Volpi, *supra* n 22, 127-138.

sanction which the Commission can exercise through its monitoring of implementation[105] had some effect.

3.2 Board Governance and the Remuneration Committee

The remuneration committee recommendation has been addressed through local Corporate Governance Codes. Most Member States' Codes require, generally on a "comply or explain" basis, that a remuneration committee be established. But significant differences have arisen with respect to the composition and the independence of the committee, given the different approaches taken to "independence" across local Codes, particularly with respect to independence from controlling shareholders.[106] Reflecting the 2005 Recommendation, boards are also typically charged with determining what constitutes "independence", according to their own judgment, increasing the potential for divergence. Also reflecting the 2005 Recommendation,[107] Codes generally accommodate "joined committees" (which usually combine the nomination and remuneration committee functions), although the ability of committee members to focus effectively on these different tasks is questionable. On the other hand, the nomination and remuneration processes are interlinked and efficiencies may follow.

The most significant difficulties arise with respect to the number of "independent" directors on the committee. The UK Combined Code on Corporate Governance – also applicable in Ireland via its listing regime – and the Dutch Tabaksblat Code recommend the creation of a separate remuneration committee, composed entirely of non-executive, independent directors. Additionally, in the Netherlands no more than one member of the remuneration committee may be a member of the management board of another Dutch listed company. The Austrian Code of Corporate Governance and the Luxembourg Code both recommend a "sufficient" number of independent members. In most other countries, Codes typically recommend the creation of a remuneration committee composed of all non-executive, but in the majority independent directors. The Polish Code, however, simply provides for a remuneration committee to be established within the supervisory board; it does not address its composition. Although some

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[105] Commission 2007 Remuneration Report, *supra* n 5 and 2007 NED Report, *supra* n 96.

[106] Commission 2007 NED Report, *supra* n 96, 3. Germany, in particular, does not link independence to an absence of close links with controlling shareholders. While many Codes specify independence criteria in detail, others (including the German Code) adopt a very general approach or do not address independence: at 7.

[107] Para 7 acknowledges that nomination, remuneration and audit committee functions can be combined, although the company should explain why.

improvements have occurred since then, the Commission's 2007 assessment was that the main weaknesses in the implementation of the 2005 Recommendation were with respect to the independence of committee members;[108] it found it "alarming" that neither law nor a Corporate Governance Code in a "considerable number" of Member States required that independent directors sit on remuneration committees and warned that the "costs for the company and risk of abuse may remain high".[109]

The chairmanship of this committee also exposes differences between the Member States. Codes in the UK, Ireland and the Netherlands stipulate that the board chairperson may not chair the remuneration committee (although the UK Combined Code permits the chairperson to sit on the committee as long the chairperson met the Code's independence requirements on initial appointment). While other Codes allow for the common chairmanship of the board and the remuneration committee, they often recommend that only a non-executive director (including the board chairperson) should chair the committee. Under the Austrian regime, however, the chairperson of the remuneration committee should always be the chairperson of the supervisory board.[110]

Member States Codes also generally adopt guidelines regarding the role and functions of the remuneration committee. Typically, the remuneration committee in most Member States: makes proposals on general remuneration policy for executive (or managing) directors; makes proposals on individual remuneration packages; monitors compliance by the company with its remuneration disclosure obligations; debates the company's general policy on the granting of share-based incentive schemes and makes related proposals to the board; reviews the remuneration information provided in the annual report; consults with the chairman/CEO on remuneration issues; and appoints, and consults with, external advisors.

The German regime varies significantly from that of other Member States. The German Corporate Governance Code indicates that it is good practice for many companies to have special committees for specific tasks, but it does not give clear guidance concerning the role of committees in pay-setting, the composition of such committees or the nature of "independence". Recent reforms, however, have placed more direct responsibility on the supervisory board with respect to remuneration. The German supervisory board's scope for discretion in setting

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[108] Only 11 Member States had implemented the Recommendation with respect to the presence and number of independent directors: Commission 2007 NED Report, *supra* n 96, 8.

[109] Commission 2007 NED Report, *supra* n 96, 4 and 8.

[110] *Austrian Code of Corporate Governance* (2007), point 43.

remuneration was substantially curtailed in 2005 following the ruling by the German Federal Court of Justice in the Mannesmann case which addressed the legality of the "golden parachute" awards granted in the context of the takeover of Mannesmann by Vodafone in 2000.[111] More dramatic reform came in summer 2009 with the 2009 German Act. It increases the responsibility of the supervisory board for remuneration, requiring that the full board decide on individual management board pay (including salary and incentive-based pay).[112] In a new departure for European law and practice on remuneration, it also engages closely with enforcement and renders supervisory board members personally liable for damages to the company where remuneration does not reflect legal requirements. In particular, members can be held personally liable for the difference between the remuneration awarded and the remuneration which would be regarded as "appropriate" under the new regime. While it remains to be seen whether this regime will be enforced in practice, this approach represents a significant hardening of the German regime, "on the books" at least, and a move away from "comply or explain"-based market discipline.[113] Although the Dutch Tabaksblat Code does not go so far as the 2009 German Act, it shares with it a concern to increase the responsibility of the supervisory board for remuneration and to delineate how the board should determine remuneration.[114]

3.3 Disclosure: Separate Remuneration Report and General Remuneration Policy

Implementation of the 2004 Recommendation's core disclosure requirements is also variable. There are some bright spots; by comparison with implementation of the remuneration committee recommendations, there is greater reliance on binding rules, particularly with respect to disclosure of individual directors' pay. But implementation of the foundation remuneration policy disclosure recommendation has been poor and the form in which disclosures are provided is unsatisfactory.

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[111] The German court stated that, as a general rule, payments of that kind may only be made if the employment contract between the company and the executive director so provided *ex ante*. Otherwise, such a gratuitous payment may be made only if the company will benefit from it and if the benefits to the company are "simultaneous" and "adequate". A payment that does not fulfill these requirements qualifies as a waste of the company's assets and the members of the supervisory board can be held liable for the criminal offence of a fraudulent breach of trust: Answers to Questionnaire by P O Mülbert.

[112] The remuneration committee retains an advisory/preparatory role.

[113] The Act also addresses conflicts of interest on the supervisory board, imposing a two-year "cooling off" period before a management board member can be appointed to the supervisory board (unless the member is nominated by shareholders representing 25% of total voting rights). Previously, however, management board members could not be appointed to the supervisory board.

[114] *Dutch Corporate Governance Code* (2008), para II.2.

Presentation and format requirements differ. Most troublingly, the majority of Member States do not require companies to produce a separate remuneration report. The UK stands apart in requiring that a detailed and separate Directors' Remuneration Report is produced.[115] Most local rules (or Codes where relevant) provide that remuneration disclosure, including remuneration policy disclosure, can be presented anywhere in the annual report, including in the corporate governance report (now required as a matter of EU law for listed companies in their annual reports),[116] in the management report and/or in the notes to the financial statements. Greater transparency could be supported by a requirement for standardized tabular reporting. But only UK law and the French best practice recommendations address the format of pay disclosure, although greater standardization would enhance the clarity of remuneration disclosure.[117]

Implementation of the recommendations concerning remuneration policy disclosure is generally poor; the Commission reported that "regrettably" the policy recommendations had not met with a high level of acceptance.[118] Only a few Member States require that these disclosures be provided,[119] although Corporate Governance Codes tend to recommend policy disclosure, albeit often without specifying the detailed elements identified in the 2004 Recommendation.[120] The UK regime continues to stand out for its detailed mandatory disclosure requirements concerning remuneration policy.

3.4 Disclosure: Individual Directors' Pay

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[115] Companies Act 2006 ss 420-421 and Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008/410, Sch 8.

[116] Under Spanish and Portuguese law, eg, listed companies are required to publish a report on corporate governance which can be presented either as a chapter of the annual report or in the form of an appendix to the report, and one of the chapters of this report must include details of the remuneration framework.

[117] While the UK regime does not provide a best practice format, the French recommendations do.

[118] Commission 2007 Remuneration Report, *supra* n 6, 3. The Commission reported that only 60% of Member States implemented the disclosure policy recommendation. Of those Member States, 50% implemented the recommendation only in part (at 5).

[119] Eg France, Ireland, Italy and Sweden.

[120] Policy disclosure is recommended by Codes in, eg, Austria, Belgium, Denmark, Germany, Luxembourg, France, Hungary and the Netherlands. The Belgian Corporate Governance Code, eg, recommends disclosure on the remuneration-setting process, on remuneration policy and on the criteria against which incentive-based pay is evaluated, while the Dutch Tabaksblat Code recommends that disclosure be provided on how remuneration is adopted, on future remuneration policy, on how the policy contributes to long-term objectives and on performance criteria. By contrast, the relevant Finnish recommendation only addresses remuneration governance.

Clear, individualized disclosure of directors' pay, which identifies the fixed and variable elements, is central to effective remuneration disclosure and a core element of the 2004 Recommendation. Significant improvements have occurred in this regard since our earlier research in this area,[121] although shareholder assessment of this disclosure is hampered by the poor implementation of the parallel disclosures on the underlying policy which drives individual remuneration. In 2007, the Commission found that a "large majority" of Member States had introduced high disclosure standards concerning the remuneration of individual executives.[122] In many Member States this individualized disclosure is required by law on a mandatory basis (or through mandatory stock exchange listing requirements), although a few countries still require only aggregate disclosure by law, reflecting the minimum requirement of the EU's harmonized regime for annual reports.[123] In one notable example, Germany now requires individualized disclosure for management and supervisory boards by law (and under the German Corporate Governance Code) but non-compliance is permitted if the general meeting (a 75% majority) so resolves (until 2011).

Weaker regimes are often, however, supplemented by more demanding Corporate Governance Codes. In Austria, disclosure requirements apply only to the combined remuneration of the management board and of the supervisory board. The Austrian Corporate Governance Code, however, recommends individualized disclosure. In Belgium, aggregate disclosure is required by law, but the Belgian Corporate Governance Code recommends individualized disclosure for non-executive directors and the CEO; where an executive manager is also a member of the board, information on the amount of remuneration he receives in this capacity should also be disclosed. The Danish regime is similar; the legal requirement for aggregate disclosure is supplemented by the Code's recommendation of individualized disclosure. This is also the case in Spain.

Where individualized disclosure is required or recommended, variations in the particular disclosures required are common, with the UK regime still requiring the most detailed disclosures. Individualized disclosure of the remuneration received by directors during preceding years, for example, is recommended in only a few national Codes.[124] Most regimes require

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[121] It has been observed that "until recently, compensation received by European companies' directors was a well-guarded secret": Enriques and Volpin, *supra* n 22, 135.

[122] Commission 2007 Remuneration Report, *supra* n 5, 3.

[123] Austria, Belgium, Denmark, Finland, Greece, Luxembourg and Spain.

disclosure of the fixed and variable elements of remuneration, but are typically more focused on the specific details of individual grants under share-based remuneration schemes, as discussed in the following section.

3.5 Disclosure: Share-based Incentive Schemes and Performance Conditions

Disclosure requirements for share-based incentive schemes (as stipulated by the 2004 Recommendation and typically required by law but also in local Corporate Governance Codes[125]) generally relate to: the number of options and shares granted to individual directors; the terms of such schemes, in particular the exercise price and how the price is determined; the respective estimated values of the instruments at the time they are issued; the periods during which the options can be granted and exercised and the related lock-up period; and the number of exercised options during the period under review. Disclosure concerning vesting periods, lock-up periods and the valuation methods applied (in order to determine whether performance criteria have been fulfilled) is required in only some Member States.[126]

Disclosure concerning the performance criteria for incentive pay generally is typically governed by Corporate Governance Codes rather than by law.[127] The French and Dutch Codes, for example, stipulate that the disclosure on performance criteria should contain an indication as to whether the criteria have been met.[128] The Spanish guidelines similarly recommend that firms disclose information on the relationship between the remuneration obtained by executive directors and the company's profits, or other measure of corporate performance, for the year in review.[129] Disclosure requirements on performance criteria tend to apply to variable pay

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124 Eg, France.

125 Eg, the Austrian regime applies by law but the Austrian Corporate Governance Code also applies.

126 Eg in France and the Netherlands.

127 Although Danish law requires that the necessary information be provided to evaluate incentive programmes and Portuguese law requires that the remuneration report describe how remuneration is aligned with the interests of shareholders and how performance is evaluated.

128 *Dutch Code of Corporate Governance* (2008), para II.2.13.

129 *Spanish Unified Code on Corporate Governance* (2006), 57.c. It also requires that the remuneration policy statement be accompanied by an estimate of the total remuneration paid following the meeting of performance benchmarks and calls for information on the relationship between remuneration and corporate profits (or other performance measures). Similarly, the Belgian Corporate Governance Code recommends disclosure concerning how performance targets for incentive pay are evaluated, while the Dutch Tabaksblat Code recommends that a description be provided of the performance criteria for variable remuneration and the method applied to determine whether they have been fulfilled, on an ex-ante and an ex-post basis.

generally, rather than to particular forms of incentive pay. UK disclosure requirements for share incentive schemes and performance conditions, however, are particularly stringent. In addition to disclosure on the relevant performance conditions, listed companies must also give an explanation of why such performance conditions were chosen, a summary of the methods used to assess performance and an explanation as to why such methods were chosen. If a director's entitlement to share options or long-term incentive awards is not subject to performance conditions, an explanation as to why this is the case must also be provided.[130] The Remuneration Report must also contain a performance graph which illustrates the total shareholder return (TSR) for each class of the company's listed securities over a period of five years and compares that return with the TSR for a broad equity market index (even if the company does not use TSR as a measure of performance for its share schemes).

3.6 "Say on Pay"

Despite the emphasis on board governance in the two Recommendations, the remuneration committee and the board are not always central to remuneration-setting across the EU. In Member States with a two-tier board regime shareholders are often responsible for determining the remuneration of supervisory board members, although the general meeting may be empowered to delegate the allocation of individual remuneration to board members. The remuneration of the members of the executive or management board, however, is typically fixed by the supervisory board, following proposals from the remuneration committee (where one exists).

The role of the general meeting in remuneration-setting for executive directors is generally limited across the EU. In order to increase board accountability, the 2004 Recommendation called for a general meeting vote on remuneration policy and for shareholder approval of share-based remuneration schemes.[131] The 2009 Recommendation (section 5 below) reinforces the importance of shareholder engagement in the remuneration process, recommending that shareholders and, in particular, institutional shareholders, should be "encouraged" to attend general meetings where appropriate and to make "considered use" of their votes. But the Recommendation remains merely exhortatory and does not substantively strengthen the "say on pay".

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[130] The detailed disclosure requirements for the Directors' Remuneration Report are set out in the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008/410 and discussed in Ferrarini *et al*, *supra* n 19.

[131] Nn 91 and 92 above.

Only a few Member States have implemented the 2004 recommendation for a vote on remuneration policy, leading the Commission to report in 2007 that "only a disappointingly low number of Member States" considered it necessary to recommend a shareholder vote.[132] We found that in most Member States a vote on the remuneration report generally or on company remuneration policy is not a separate item on the general meeting agenda; and approval of remuneration policy through the annual report (France and Ireland) only implicitly constitutes approval of the remuneration policy. This reluctance to engage with a direct "say on pay" may reflect the influence of controlling shareholders in the respective jurisdiction or in particular firms, as well the more limited role of the general meeting in blockholding governance. As in our earlier research, the UK remains the notable exception. The 2006 Companies Act (reflecting earlier reforms in 2002) requires listed companies to prepare a Directors' Remuneration Report and to put the report to a shareholder vote.[133] The vote is advisory and requires a 50% majority of those voting.

Recently, however, other Member States have introduced a vote on company remuneration policy. In the Netherlands and Sweden, the remuneration policy must, by law, be submitted for approval to the general meeting ex-ante. The Spanish Corporate Governance Code similarly requires that boards should submit a consultative report on the directors' remuneration policy to the vote of the general meeting of shareholders as a separate item on the agenda. The 2009 German Act also introduces an advisory shareholder vote on remuneration policy, which has been strongly supported by shareholder groups.[134] The vote is without prejudice, however, to the rights, competences and liabilities of the supervisory board.

Other regimes do not specifically require shareholder approval of the remuneration policy, while, quixotically, providing that the general meeting has a function in this respect. For example, the Danish and Portuguese Codes simply state that a declaration on the policy for remunerating members of a company's corporate bodies should be submitted to the attention of shareholders at the AGM. But they do not provide further explanation or suggest that approval be obtained. In Italy, approval of the remuneration policy is required only of banks.[135]

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[132] Commission 2007 Remuneration Report, *supra* n 5, 3. Only "about a third" of Member States recommend that a vote take place (at 4), but this vote can take the form of a vote on the annual report generally.

[133] Companies Act 2006, ss 420-421 and s 439.

[134] B Benoit and R Milne, "Move for German Investors to Vote on Pay" *Financial Times* 25 May 2009, 7.

The position concerning the approval of share-based incentive schemes is very different – as was also the case in our earlier research. Most Member States have either recommended or, more usually, imposed by law a requirement for shareholder approval of share-based incentive schemes, although divergences also exist here. Some Member States limit approval requirements to certain types of share-based remuneration only. In Luxembourg and Sweden, only share-based remuneration involving new share issues, share options and any other new share acquisition rights must be approved by the general meeting, while in Portugal the approval requirement is restricted to capital increases.[136] It is also typically required that the policy for the relevant schemes be clearly explained to the general meeting when shareholders are asked to authorise the award of share options or shares.

3.7 Design

The 2004 Recommendation does not expressly intervene in the design of remuneration although it implicitly supports incentive pay. Guidance on the design of remuneration packages is now, however, generally a feature of Corporate Governance Codes across the Member States, notably with respect to contract terms (which impact on termination payments and, accordingly on "rewards for failure") and incentive pay. Most of these recommendations do not differentiate between executive and non-executive directors' contracts.

(i) Terms of Contracts and Termination Payments

The setting of contract term limits is important for ensuring that pay is linked to performance and for limiting "rewards for failure." But only some Member States have adopted limits for executive directors' service contracts and limits on termination payments are rare.

The UK Combined Code provides that notice or contract periods should be set at one year or less; in practice, longer periods are unusual. By contrast, under Austrian and German corporate law members of the management board must be appointed by the supervisory board for a period not exceeding five years. In Italy board directors cannot be appointed for a period exceeding three years; the appointment may be renewed, however, where so permitted in the articles of association and directors may be removed at any time by the general meeting (as they can be under UK company law), with no loss of entitlement to damages in case of unfair

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[135] Bank of Italy, *Supervisory Provisions Concerning Banks' Organization and Corporate Governance*, March 2008.

[136] Commission 2007 Remuneration Report, *supra* n 5.

dismissal.[137] French law requires that board directors' service contracts must not exceed six years.[138] French best practice recommendations, however, suggest that a director's term of office should not exceed four years.[139] Directors of Spanish listed companies are subject to a maximum term limit of six years, but they can be re-elected without any term limits.[140] The Spanish Unified Code, however, recommends that independent directors should not serve for a continuous period of more than twelve years.[141] In Denmark and Portugal, members of the board of directors are elected by the general meeting for the period stipulated in the company's articles of association and for a period no longer than four years. In Poland, members of the management board, by law, may serve for a maximum period of five years. Most other Member States do not stipulate any specific requirements concerning directors' service contracts.

In the UK, disclosure concerning termination payments policy, notice periods and the duration of directors' service contracts must be made in the Directors' Remuneration Report, together with disclosure concerning payments made to directors for breach of service contracts in the relevant financial year. Remuneration committees are exhorted by the Combined Code to "carefully consider" the impact of early termination in terms of compensation pay-outs and to avoid rewarding poor performance; they are also recommended to "take a robust line" on reducing compensation to reflect the departing director's duty to mitigate losses.

Elsewhere, efforts have also been made to limit rewards for failure in the form of termination payments. The Dutch Code now recommends that termination payments should not exceed one year's fixed salary; if this is, however, considered unreasonable for a management board member who is dismissed during his first term of office, termination pay should not exceed twice the director's annual salary. In Germany, the Corporate Governance Code recommends that payments to management board members on premature termination of contracts without serious cause must not exceed the value of two years' compensation (the severance payment cap) and, in the event of a change in control, payments must not exceed 150% of the severance payment cap. Under the new Belgian Corporate Governance Code, termination payments should not exceed one year's basic and variable remuneration. The board may consider a higher award, but only

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[137] Italian Civil Code, art 2383

[138] French *Code de Commerce*, art L225-18.

[139] *Vienot II Report* (1999).

[140] Spanish Companies Act, art 126.2.

[141] *Spanish Unified Code on Corporate Governance* (2006), point 40.

further to a recommendation by the remuneration committee and any award should be limited to a maximum of eighteen months remuneration. Contracts should also specify that termination payments should neither take account of variable remuneration nor exceed twelve months' basic remuneration if the departing CEO or executive manager did not meet the contractual performance criteria. French law is considerably interventionist. It requires complete transparency and makes termination payments conditional on performance requirements.[142] Furthermore, French law does not allow rewards to be made to failing executive directors. A termination payment cap of two years of compensation, including fixed and variable components, also applies. Some Member States, however, such as Austria, do not have any specific rules regarding termination payments. Similarly, disclosure of termination payments is not always required. The German position, however, has recently hardened, with the new 2009 Act requiring that benefits paid to directors on regular or early termination of contracts be disclosed on an individualized basis.

(ii) Incentive Pay

Encouragement of performance-based remuneration is implicit in the 2004 Recommendation and is a recurring theme of local Corporate Governance Codes; there are also, however, some rather more quelling references across the Codes which appear to be designed to blunt "excessive" variable pay awards and so point to a concern in some Member States, at least, to depart from the shareholder/manager alignment model which underpins the Commission's 2004 and 2005 Recommendations.

The Spanish Corporate Governance Code supports incentive alignment but highlights the risks. It underlines the potentially distorting effects of share-based pay and warns that executives should be rewarded for share value increases which are significant relative to the cost of capital for shareholders or an industry peer group but should not be rewarded for gains from general market movements. A similar approach is followed by the Dutch Tabaksblat Code which provides for the variable components of remuneration to be adjusted in exceptional circumstances and for claw-backs where awards were made on the basis of incorrect financial information. The Dutch Code also recommends that remuneration policy reflect the company's strategy and support long-term value creation. Similarly, the Austrian Code recommends that stock options should support sustainable value creation, while the Italian Code recommends that remuneration be aligned with the creation of medium to long-term shareholder value. A number of Codes,

[142] The "TEPA" Act (Act of 21 August 2007 for labour, employment and purchasing power).

however, make general reference to the need for remuneration to be variously “reasonable” (Denmark) and proportionate to the economic situation of the company (Germany and Austria). The German position towards variable pay has recently become considerably more interventionist, and more focused on wider stakeholder concerns, through the 2009 Act (which reflects similar reforms made to the German Corporate Governance Code in 2009). The Act imposes an obligation on the supervisory board to take into account the company’s condition and director performance when setting remuneration and to assess incentive pay over a multi-year period. It also requires that remuneration must not, absent good reasons, exceed “usual” remuneration levels, with reference to German industry sector and market standards and remuneration levels within the company. The Act also requires that the supervisory board adopt a remuneration policy which supports long-term sustainable development and that the long-term effects of incentives be considered. Supervisory boards are also empowered (although not required) to reduce awards in time of hardship.

Otherwise, the encouragement of performance-based variable pay is a recurring theme, increasingly reflected in practice, with stock option awards in Germany, Italy, the Netherlands and the UK, in particular, typically linked to benchmarked performance criteria.[143] Although the 2004 Recommendation is not prescriptive in this regard, corporate governance guidelines often recommend a “proper balance” between base pay and variable pay[144] or that remuneration be linked to performance by means of relatively low base salary and higher proportions of variable pay.[145]

The UK Combined Code addresses the design of incentive pay in some detail. It recommends, for example, that, in normal circumstances, shares granted or other forms of deferred remuneration should not vest, and options should not be exercisable, in less than three years. Directors should also be encouraged to hold their shares for a further period after vesting or exercise, subject to the need to finance any costs of acquisition and associated tax liabilities. Grants under executive share option schemes and other long-term incentive schemes should also be phased rather than awarded in one large block. The total rewards potentially available under incentive schemes should not be “excessive”. The Combined Code further recommends that performance criteria for incentive scheme payments should be “challenging” and that consideration should be given to the use of performance criteria which measure the company’s

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143 Thomas, *supra* n 35.

144 See, eg, the AFEP/MEDEF Recommendations (October 2008).

145 Eg, the UK, Italian and Belgian Codes.

performance relative to comparator companies with respect to some key variables, including Total Shareholder Return (TSR). Share-based schemes have also been addressed by leading institutional investor organizations. The ABI Guidelines, for example, state that remuneration committees should have regard to dilution effects,[146] while the NAPF Guidelines state that directors should ideally only participate in one share-based incentive scheme at a time.[147]

Elsewhere, vesting periods or deferrals are also used to enhance incentive alignment. In Germany the Corporate Governance Code recommends that, where extraordinary, unforeseen developments occur, the supervisory board be empowered to limit long-term incentives; the 2009 Act has formalized the supervisory board's power in this regard. The 2009 Act also imposes a four year vesting period on share option grants. In France, with respect to share option schemes, boards of directors or management boards are recommended to prohibit the immediate resale of all or part of any shares granted for a particular period (the custody period), which period may not exceed three years from the date of exercise of the option. Similarly, in the Netherlands options should not be exercised within the first three years after the date of granting, and shares granted without financial consideration must be retained for a period of at least five years, or until at least the end of the employment, if this period is shorter.

4. Remuneration Governance "In Action" and the Effectiveness of Corporate Governance Codes

4.1. Main Trends

This evidence suggests that the achievement of effective remuneration governance pan-EU largely depends on the resilience of the "comply or explain" mechanism (where it applies) and on the effectiveness of shareholder monitoring, given that Corporate Governance Codes are the main mechanisms for embedding good governance with respect to executive pay across the EU. Our results on the nature of remuneration governance "in action", however, discussed in this section, suggest significant weaknesses in Corporate Governance Codes as robust instruments for delivering effective pan-EU remuneration governance. They also suggest somewhat limited

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[146] ABI Guidelines, *supra* n 100, para 2.3.

[147] The NAPF published their Corporate Governance Policy and Voting Guidelines in November 2007 (available via www.napf.co.uk). The Guidelines are supportive of the Combined Code and the ABI Guidelines and also contain Global Remuneration Principles. An update was published in February 2009.

engagement by institutional shareholders with remuneration governance, given the extent to which companies' practices deviate from the good practice standards recommended by the Codes.

In order to test remuneration governance "in action", we examined the disclosures provided by Europe's largest 300 listed firms by market capitalization.[148] We examined 295 firms (the remaining 5 did not provide the necessary material), based in 16 countries, 14 of which are EU Member States;[149] this analysis focuses on the EU data. The analysis was conducted on the annual financial statements or corporate governance reports (where separate from the annual report) for the financial year ending December 2007 or March 2008. The data accordingly reflects firms' remuneration governance just before the crisis occurred and how firms' responded to Member States' pre-crisis regulation of remuneration.

Our analysis covered conformity with[150] 23 specific criteria,[151] classified into 8 broader categories. The 8 categories were designed to capture firm behaviour relating to remuneration setting and relating to disclosure. They also reflect the detail of the 2004 and 2005 Recommendations and so are not biased towards particular Member State approaches. They cover: the remuneration committee; the remuneration statement; disclosure concerning preparatory and decision-making processes on remuneration; disclosure concerning firm remuneration policy; disclosure on terms of contracts; individualized remuneration disclosure; disclosure of emoluments; and disclosure concerning share-based incentive schemes.

Across these eight categories, we found the following levels of firm conformity, based on a global assessment of the different specific criteria within each category: remuneration

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[148] FTSE Eurofirst 300 as at November 2008.

[149] The EU components are: UK (64 companies); France (55); Italy (20); Germany (34); the Netherlands (14); Belgium (11); Spain (21); Sweden (14); Ireland (5); Austria (7); Denmark (5); Portugal (5); Greece (7); and Finland (5). The non-EU components are Switzerland (20) and Norway (8).

[150] The study was based on a Degree of Conformity assessment under which a value of '1' was assigned to each criteria with which a company complied and a '0' assigned otherwise. All criteria were given the same weight. For full details of the empirical data see Ferrarini *et al, supra* n 1.

[151] Existence of remuneration committee; composition of committee; existence of remuneration policy statement; disclosure on overview of policy; forward-looking nature of disclosure; disclosure on contract terms; disclosure on notice periods; disclosure on termination payments; disclosure on mandate and composition of the remuneration committee; disclosure on external consultants; disclosure on the role of the AGM; disclosure on the relative importance of fixed and variable pay; disclosure on the main parameters and rationale of annual bonuses; disclosure on the performance criteria for share-based remuneration; disclosure on the linkage between remuneration and performance; individualized disclosure on executive director pay; individualized disclosure on non-executive director apy; individualized disclosure on salaries and fees; individualized disclosure on bonuses and other benefits; individualized disclosure concerning the preceding year; disclosure on stock options granted; disclosure on stock options exercised; and disclosure on stock options unexercised.

committee (71.1%); remuneration statement (70.4%); disclosure concerning preparatory and decision-making processes (59.4%); specific disclosures concerning remuneration policy (51.3%); disclosure on terms of contracts (45.9%); individualized disclosure generally (executive and non-executive directors) (73.6%); individualized disclosure on emoluments (59.3%); and disclosure on share incentive schemes (46.7%). Overall, we found the highest levels of conformity (with conformity levels in excess of 80%) with respect to just four of the 23 specific criteria: existence of a remuneration policy statement (92.8%); disclosure of policy information (91.8%); existence of a remuneration committee (82.7%); and individualized disclosure of non-executive director remuneration (80.3%). The lowest level of compliance occurred with respect to: disclosure of notice periods (36.6%); disclosure concerning remuneration consultants (32.8%); disclosure on the linkage between remuneration and performance (29.9%); and forward-looking disclosure on the policy statement (26.4%).

Firms tend to apply only the basic requirements of national best practice Codes or rules (where some discretion exists in how rules are applied). Where requirements apply on a "comply or explain" basis, compliance tends to be partial. While firms, as might be expected, generally conform to legally-binding rules, they do not usually go beyond what is required by these rules. The extent to which firms comply with the 2004 and 2005 Recommendations therefore depends on how a Member State has approached implementation; law seems to matter. Overall, firms pay most attention to basic disclosure requirements; recommendations concerning detailed information relating to, for example, terms of contracts and concerning qualitative information regarding the performance link are not widely followed. There appears, accordingly, to have been limited market pressure for more sophisticated and comprehensive disclosures.

The results also reflect the persistent differences in the structure of corporate ownership across Europe. Overall, the remuneration committee has proved most amenable to transplantation across the governance divide, with over 70% of firms complying with the committee-related criteria. But, and notwithstanding its "softer" nature, conformity with the individualized disclosure criteria and with the remuneration policy disclosure criteria is lower, with approximately 60% of firms complying with the criteria. For example, firms in the UK, Ireland, and the Netherlands – traditionally countries with dispersed ownership firms but also jurisdictions where disclosure is subject to mandatory rules – produce the highest levels of compliance with the criteria concerning individualized disclosure (between 90% and 100%). But firms from Belgium (just over 30%), Spain (20%), Sweden (20%), Austria (just over 20%) and Greece (5%) (all traditionally block-holding systems and which, for the most part, do not require

individualized disclosure by law[152]) achieve much lower levels of individualized disclosure according to the criteria. Law matters in this area: despite the dominance of blockholding, German firms perform better in the individual disclosure area (60%), but individualized disclosure is required by law in Germany unless the general meeting decides to the contrary. Similarly, compliance levels of just over or below 40% relating to remuneration policy disclosure (which is generally governed by Corporate Governance Codes) appear in Italy, Germany, Belgium, Spain, Austria, Denmark and Greece. Policy disclosure levels are considerable higher in the UK (at over 95%, reflecting the mandatory disclosure regime), the Netherlands (just over 80%), and Ireland (50%) (the lower levels of compliance in Ireland with this more qualitative category may be related to the small sample of five).[153] Notably, compliance is also significantly higher in Sweden with respect to remuneration policy disclosure (just over 60%) than with respect to individualized disclosure (20%). Best practice therefore continues to diverge significantly across the Member States, according to whether disclosure requirements apply by law and reflecting the dispersed/block-holding ownership profile. The results are considered in more detail in the following sections.

4.2 The Remuneration Committee

Almost 83% of the firms reviewed have established either separate or joined remuneration committees. But only 60% of all firms have remuneration committees composed of non-executive, in the majority independent, directors. Reflecting the pan-EU governance divide, variations occur mostly between jurisdictions, whilst conformity with the remuneration committee criteria on a country basis is generally quite homogenous. Remuneration committees (either separate or joined) are found in all firms from the UK, the Netherlands, Ireland and Portugal. Germany, Denmark and Austria have the lowest numbers of firms with remuneration committees. Firms from Belgium, Spain, Sweden, Greece and Norway have the lowest compliance with the requirements regarding the committee's composition.

Nearly all the UK firms reviewed had set up dedicated remuneration committees. Several Dutch firms also have separate remuneration committees, although some have established joined nomination and remuneration committees. UK and Dutch firms also comply with the composition

[152] Swedish firms provide individualized disclosure for board members and for the CEO, as required by national law. In general, however, individualized disclosure is not provided with respect to share-incentive schemes, which led to a low overall score.

[153] We also weighted the data with respect to the Degree of Conformity within countries in order to reflect the different weightings of national representation in the Index: see further Ferrarini *et al*, *supra* n 1.

requirements. In France, most firms have joint nomination and remuneration committees, whilst the majority of Italian firms have dedicated remuneration committees. Greek and Norwegian firms have set up remuneration committees but they typically do not fulfil the independence criteria. German firms do not have separate remuneration committees; in most cases, other committees (most often the human resources committee) have been delegated responsibility for senior management remuneration and information regarding the independence of their members is not typically given.

4.3 General Remuneration Policy Disclosure

Despite the detail recommended in the 2004 Recommendation, the precise coverage of remuneration policy disclosure is not well defined in local requirements or recommendations, creating divergences in the levels of disclosure provided. We assessed remuneration policy disclosure with respect to: the existence of a basic remuneration statement (which would typically include individualised disclosure as well as more general policy disclosures); disclosure concerning contract terms for executive directors; disclosure on the preparatory and decision-making processes; and the information contained in the remuneration statement concerning incentive alignment and performance conditions.

Remuneration statement

More than 90% of the firms reviewed provide a remuneration statement of some form, although the disclosure provided varies very considerably. At the lower end of the spectrum, firms typically provide a boilerplate statement, with insufficient bespoke coverage. At the upper level, firms disclosure their remuneration policy clearly in the statement, including details of any recent changes or future changes. Poorer disclosure is generally associated with firms from Continental Europe. Very few national regimes have implemented the recommendation concerning forward-looking disclosure with respect to remuneration policy in the following year and subsequent years; even fewer firms have applied it. Only UK and Dutch firms achieve a higher than 50% conformity with this criterion and most other firms do not conform at all in this respect.

Terms of contracts

Overall, and despite its importance to effective governance and shareholder voice and given the extent of the “rewards for failure” which the financial crisis has exposed, this category produced very low levels of compliance, at approximately 45% of firms. In addition, in several cases where only partial information is disclosed, this information is only provided in sections of the annual

report that are not linked to the remuneration statement and is unclear. Nearly all UK firms and most Dutch and Swedish firms, however, consolidate all information relating to the terms of contracts in the remuneration statement. In other cases, the terms of directors' contract are often understood by companies as being related to general corporate governance issues and are disclosed along with board practices generally. Disclosure of firm policy on termination payments is provided by 61% of all firms and it is often disclosed separately from the duration of contracts. More than 70% firms from Sweden, the UK, the Netherlands and Portugal provide some disclosure on policy on termination payments, while less than 30% of firms from Italy, Austria and Norway provide this disclosure.

Preparatory and decision-making processes

We assessed disclosures concerning the mandate and composition of the remuneration committee, disclosure concerning external remuneration consultants and disclosure concerning the role of the general meeting of shareholders in the pay process. This category is best complied with by UK firms and, although with significantly lower levels of conformity, by Dutch, Swedish, Irish and Portuguese firms.

With the exception of UK firms, most European firms provide the remuneration statement and the information related to the remuneration committee separately, with the latter often found in the general corporate governance report or section. We considered two scenarios: in the first we did not penalize firms that disclosed the information elsewhere in the annual report; in the second we only recorded disclosures made in the remuneration statement. 75% of firms disclosed the information under the first scenario, with most countries achieving overall scores higher than 80%. Under the second scenario, only 30% of all firms (mainly UK firms) complied.

The names of external remuneration consultants are disclosed by only 33% of firms, mostly UK firms. The role of the general meeting of shareholders in the remuneration process is disclosed by almost 70% of the firms. But less information is provided by German, Austrian, Norwegian and Finnish firms, where the role of shareholders in the remuneration process has been weaker.

Alignment of remuneration with performance

Disclosure plays a major role in assisting shareholders in assessing the "relative importance" of the variable and non-variable components of directors' remuneration and so the extent to which pay is incentive-based. But the "relative importance" concept, which frequently appears in Corporate Governance Codes, is rather vague. Companies often express "relative importance" as

a comparison of the relative values of fixed remuneration (salary) and variable remuneration (such as bonuses, options and long-term incentive scheme awards). Approximately 55% of firms in our sample provide an explanation as to the balance between the different elements of remuneration, although the level of disclosure varies.

Most UK firms provide details on the breakdown between fixed remuneration and annual incentives (bonuses) and between fixed remuneration and other long-term incentives, often also disclosing the minimum as well as the maximum levels for these incentives payments. Several UK firms also present these proportionate disclosures in aggregate form as part of the firm's total estimated annual pay bill. Most other European firms that disclose the relative importance of fixed and incentive pay usually only refer to the relationship between basic pay and annual bonuses. This more limited approach may be linked to the limited disclosure on the value of share-incentive schemes (discussed below). Given that the 2004 Recommendation does not specifically require disclosure of the balance between fixed and the different elements of the variable remuneration, our assessment credited firms with compliance where they disclosed only the relative importance of fixed remuneration and annual incentives (or bonuses). UK, Dutch, Swedish, Austrian and Portuguese companies rate highest, while Spanish, Belgian, Italian, Irish and Danish firms have low conformity with this criteria.

We found generally lower levels of disclosure concerning the linkage between remuneration and performance. Disclosure of the performance targets for bonus schemes is provided by 64% of companies. Performance targets for share-based incentive schemes are provided by only 56% of companies. These disclosures are not always complemented by information on the achievement of targets, such that we assessed that only 30% of firms provided sufficient information on the link between remuneration and performance. The highest levels of disclosure are provided by UK, Dutch and to some extent German firms, while Belgium, Spanish, Italian and Swiss firms are the lowest performers. The low levels of disclosure may be explained by firms considering performance targets to constitute commercially sensitive information.

4.4 Individualized Disclosure

Adequate transparency depends on individualized disclosure of executive and non-executive director remuneration, including a breakdown of salary/fees and short-term and long-term incentives. Monitoring can only be accurate if all the components of remuneration are disclosed individually, relative to the year in review and the preceding years. Our assessment indicates that 58% of all firms conform to all the criteria in this area.

We assessed the level of disclosure of emoluments (the total amount of salary or board fees paid to the director under the year in review) and of remuneration paid in the form of annual bonuses and any additional benefits. Overall, 74% of firms provide individualized disclosure of emoluments and bonuses to executive and non-executive directors. The remuneration of non-executive directors is disclosed by a greater number of firms. Firms tend to follow domestic regulation in this regard. For example, most Swedish and Finnish firms disclose the individual remuneration of non-executive directors but do not individually disclose the individual remuneration of executive directors, reflecting local rules.

Disclosure of individualized remuneration over preceding years can sharpen shareholder monitoring. Nearly all UK and Irish firms and about 71% of Dutch firms disclose individual remuneration for the previous year. Almost half of French and Italian firms also provide this information; many French firms also provide information on executive remuneration over the previous two or even three years. Typically reflecting local rules, several firms provide this disclosure only for executive directors and are therefore penalized by our assessment. In line with the 2004 Recommendation and several national Codes, we consider that the comparison of non-executive remuneration year-on-year is important in evaluating board performance, as frequently the non-executive directors receive variable pay based on meeting attendance and, in several cases, based on performance.[154]

We also evaluated the conformity of individual disclosure concerning share schemes awards, including share options granted, exercised, unexercised, exercise price, and exercise date. Details on share-incentive schemes are fully disclosed on an individual basis by 46% of firms. The majority of UK, Irish and Dutch firms and approximately 40% of firms from Italy and France provide disclosure against all the criteria. Companies in other Member States, however, generally provide low levels of disclosure.

Overall, individualized disclosure is provided only in part by European firms and coverage tends to reflect the minimum local requirements. In particular, where disclosure is governed by "comply or explain" it is generally of poorer quality, although firms typically provide explanations for their approach (notably firms from Spain, Belgium, Austria and Portugal).

5. More Harmonization?

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[154] Several German firms pay variable bonus remuneration based on performance to members of the supervisory board. Spanish non-executive directors receive a certain percentage (eg 1% or 2%) of the company's net profits.

5.1 Key Weaknesses and the Reform Proposals

Given our assumption that strong remuneration governance can promote executive pay contacts which achieve effective incentive alignment, and that a pan-EU approach brings efficiencies, the evidence is troubling. Good practice is very far from being securely embedded across the EU. In the absence of binding rules, firms appear reluctant to provide full disclosure concerning remuneration, particularly on the pay/performance link and on termination payments. It is not possible to compare with any degree of ease how Europe's largest companies address executive pay and, in particular, their approach to performance conditions. While the remuneration committee is generally well-established, composition problems remain and the "say on pay" mechanism remains embryonic.

Why have the divergences arisen? Our research does not drill into whether particular patterns of non-compliance in practice reflect industry-specific drivers. It does seem clear that "law matters", as stronger practices follow binding rules. Member States have, however, generally shown limited enthusiasm for legislating on pay governance (although initially the UK and now Germany have adopted stringent legal requirements), preferring Corporate Governance Codes, but Codes appear to have limited traction in this area. Where practices are discretionary and set out in Codes, there appears to be a relationship between levels of compliance and the dominant ownership regime, with blockholding systems generally slower to provide disclosure, in particular, perhaps reflecting the influence of dominant shareholders. We also suggest that institutional investors have not been active in demanding better practices, which may reflect the difficulties they face in assessing industry-wide practices given generally poor disclosure.

Do the divergences matter? We contend that they do, given the importance of the incentive alignment contract, the role of remuneration governance in this regard and the need for common best practices across the EU. The risks of board-level conflicts of interest and of minority shareholder oppression, often quiescent institutional investors, the growth in incentive pay, the persistence of poor disclosure practices and the apparent reluctance of Member States to intervene in this area suggest that a binding regime may carry benefits. Certainly at present, the playing field between firms in the FTSE Eurofirst 300 is not level concerning remuneration regulation. The risks associated with harmonized rules may be less troublesome than the costs of a lack of convergence, particularly given what appears to be entrenched resistance to the adoption of good practices. The unresolved tensions between the Commission's concern to support flexibility in corporate governance structures and the need to support some consistency in best

practices, particularly with respect to disclosure, have certainly limited the effectiveness of the Commission's reforms.

So how should reforms proceed? Any reforms must be limited, targeted and not distort boards' ability to design effective and innovative pay packages and the complexities of pay design. As the ongoing international discussion on bankers' pay makes clear, the impact of regulatory intervention on international competitiveness falls to be considered; the Enron-era SOX reforms provide a rich seam of evidence on the potential adverse impact of corporate governance reform on competitiveness.[155]

Disclosure appears to hold the most promise for reform and to carry the least costs. At present, coverage ranges from boilerplate statements to detailed, firm-specific discussions of performance sensitivity. Remuneration policy disclosure, particularly on performance targets and on termination payments policy, is very limited, diluting the effectiveness of individualized disclosure. Formats are not standardized. Disclosures, particularly with respect to pay-setting and directors' contracts, can be scattered across the annual report and "a clear and comprehensive overview of the company's remuneration", as called for the 2004 Recommendation, has not been achieved by the majority of firms. UK firms are required to produce a Remuneration Report and so deliver a high degree of consolidation with 94% of firms conforming to this criterion. Almost 80% of German firms produce a consolidated remuneration statement, but all other FTSE Eurofirst 300 firms tend to scatter the remuneration information throughout their annual reports, leading to opaque and incomplete disclosure. Whether through inertia or because of the influence of blockholders, shareholders do not appear to have pressed for better disclosure practices.

Given that disclosure can promote stronger shareholder monitoring and act as a deterrent to rent-seeking at board level, it seems therefore that there is a market failure which legislative intervention by the EU could address. Although disclosure is perhaps most strongly associated with supporting shareholder monitoring in dispersed ownership companies, it remains an important tool in blockholding companies, for at least two reasons. First, disclosure helps to reduce the agency costs of controlling shareholders, particularly when they are also the managers of the companies concerned. But secondly, when outside professional managers are employed, controlling shareholders can effectively monitor their pay for the benefit of shareholders in general; disclosure will also provide evidence of this monitoring for the benefit of other companies. Boards in other companies, including those with diffuse ownership, will also be able

[155] Eg K Litvak, "Sarbanes-Oxley and the Cross-Listing Premium" (2007) 105 *Michigan Law Review* 1857.

to benchmark their decisions on pay, taking into account what controlling shareholders in other companies may have done in terms of effective monitoring. Positive externalities with respect to pay governance may therefore follow.

We suggest that a binding requirement for a separate remuneration report, providing a clear, "one-stop" evaluation of the different element of remuneration and explaining the underpinning remuneration policy, be introduced. Standardization of the format in which disclosure is provided would also support better monitoring and positive externalities, given that comparability across companies is currently very difficult to achieve. The standardization of key definitions would eliminate confusion and enhance current transparency levels.[156] Although it has traditionally not engaged with the complexities of disclosure policy "in action", the Commission appears to be committed to exploring greater standardization.[157] It is also increasingly grappling with the processability of disclosure in the retail markets[158] while, at least in their current incarnation, the Committee of European Securities Regulators (which has engaged with corporate governance matters[159]) and the Committee of Banking Supervisors could provide expertise.

Attention is also needed to the substance of disclosure. There appears to be considerable confusion at Member State- and firm-level as to what the remuneration policy disclosures should cover. Greater clarity is needed in particular on termination pay disclosures. The Commission has strengthened its disclosure requirements in its 2009 Recommendation, particularly with respect to the design of remuneration (discussed in section 5.2 below). But this measure repeats the weaknesses of the 2004 Recommendation by not imposing a binding obligation or supporting consistency; the Commission has found it more attractive to recommend more disclosure than to grapple with how to make basic disclosures consistent "in action". Regulatory harmonization should not, of course, be an end in itself. But the current opaque picture of remuneration across the FTSE Eurofirst 300 could be significantly clarified were minimum binding rules to apply concerning the content (and format) of remuneration policy disclosure. Disclosure reforms, whether substantive or format-related are not, however, easy to achieve[160] and the Commission's

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[156] Eg with respect to: remuneration policy; relative importance; severance payments; year's salary; relevant details; sufficient information; and independence.

[157] 2009 Pay Recommendation, *supra* n 9.

[158] Particularly with respect to the UCITS mutual fund and the Key Investor Information document. See further N Moloney, *How to Protect Investors. Lessons from the EC and the UK* (Cambridge University Press, forthcoming 2010).

[159] Eg, through its Takeover Bids Network.

recent design-focused reforms, discussed below, may only prove a distraction to the task of achieving full and clear disclosure.

Is further attention required to the remuneration committee? In many respects an independent remuneration committee might be regarded as the frontline of effective remuneration governance, particularly given the vagaries of shareholder voice, notably in blockholding regimes. There is evidence to suggest that board independence and the existence and independence of board committees is significantly and positively associated with performance.[161] On the other hand, there is international evidence to suggest that board independence is not related to long term firm performance,[162] that boards have not been effective in controlling blockholders[163] and that independent directors have not been effective in managing executive pay risks.[164] Recent failures in the banking industry have certainly shown that the presence of independent directors is not proof against doubtful remuneration practices[165] or a guarantee that awards will be appropriately linked to performance.[166] While the effectiveness of the remuneration committee and the independent director remains unclear, it is, however, clear that the EU's approach and corporate practice is troublesome. In particular, divergences in the independence requirements are troubling, especially with respect to links to controlling shareholders and the risk of abuse of minority shareholders. Competence in the complex area of remuneration is also not a qualification for remuneration committee membership under the 2004 Recommendation. While disclosure reforms should remain the reform priority, Commission attention could be usefully directed to a legally binding obligation concerning the competence of

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[160] Eg, the SEC's recent disclosure reforms (relating to the "Compensation Discussion and Analysis") have been criticized for not taking into account the accumulated ownership position of CEOs and thus the real strength of the incentives provided: Gordon, *supra* n 13, 331.

[161] Bruno and Claessens, *supra* n 45.

[162] B Bhagat and B Black "The Non-Correlation Between Board Independence and Long Term Firm Performance" (2002) 27 *Journal of Corporation Law* 231

[163] D Denis and J McConnell, "International Corporate Governance" (2003) 38 *Journal of Financial and Quantitative Analysis* 1.

[164] Gordon, *supra* n 13, 1503-1504.

[165] Cheffins, *supra* n 13

[166] Royal Dutch Shell suffered a heavy defeat at the hands of its institutional investors when its Directors' Remuneration Report was rejected (by a 59% majority) at its summer 2009 AGM following institutional investor concern at the decision of the remuneration committee to make performance awards although the performance criteria had not been met: K Burgess and M Steen, "Investors rebel over executive pay at Shell" *Financial Times* May 20 2009, 1.

the remuneration committee and the weight of independent directors, independent from controlling shareholders, in the remuneration process.

The "say on pay" mechanism presents the most difficulties in terms of further harmonization given the complexities of local company law and of different governance regimes. Shareholders' rights to monitor remuneration policy or to participate in its design continue to differ across Europe, reflecting different ownership structures and the diverging role of the general meeting. In Germany, for example, where current employees may serve as members of the supervisory board, employee unions typically do not support a shareholder "say on pay" as this would reduce their power in the supervisory board. And although shareholder voice is more usually associated with dispersed ownership, collective influence "behind the scenes" in these companies can diminish the importance of the actual vote.[167] It is also not clear that shareholder voice is an effective means of managing executive pay risks, as discussed in section 2 above. It is also difficult to envisage a harmonized, mandatory "say on pay", even in an advisory form, having an easy legislative passage in the EU. Enhanced mandatory disclosure is likely to remain the most effective harmonized mechanism for supporting shareholder engagement. A pay vote may ultimately become more widespread under pressure from international investors and reflecting public hostility to high levels of pay; these reforming forces could also be strengthened by enhanced disclosure. The current division of labour between the EU and the Member States may therefore be efficient; the necessary but less glamorous (and less controversial) reforms to disclosure, which may promote stronger pay governance generally, may be better achieved by the EU.

5.2 The 2009 Reforms: Do they Address the Real Problems?

Executive pay in non-financial firms appears to have been pulled into the Commission's wider financial crisis reform agenda with the adoption of a 2009 Recommendation on Directors' Remuneration, to be implemented by the Member States by the end of 2009.[168] Reflecting the dangers of momentum and fashion in policy-making, the 2009 Recommendation does not address the core enforcement and consistency difficulties we have found with the earlier Recommendations, notwithstanding the evidence already available to the Commission from its 2007 assessment. Instead, the Commission has moved closer to the problematic, but politically

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[167] B Cheffins and R Thomas, "Should Shareholders Have a Greater Say Over Executive Pay? Learning from the US Experience" (2001) 1 *Journal of Corporate Law Studies* 277.

[168] *Supra* n 9.

appealing, design sphere and, most worryingly, appears to be moving away from the incentive alignment model as the basis for intervention. Noting, albeit without presenting empirical evidence, that remuneration structures have become increasingly complex, too focused on the short-term, and leading, in some cases, to "excessive" remuneration not justified by performance,[169] the Commission has adopted a series of voluntary principles concerning the structure of remuneration. The 2009 Recommendation focuses in particular on the pay/performance link, long-term sustainability and, notably, on restricting "excessive" variable pay.

Not all of the Recommendation is problematic, although the charge of ineffectiveness can be raised. The Recommendation addresses remuneration policy disclosure, suggesting that the remuneration policy be clear and easily understandable, that an explanation be provided concerning how performance criteria relate to firms' long term interests and with respect to whether those criteria were fulfilled, and that "sufficient information" be provided concerning termination payments, vesting and other restrictions, and concerning the peer groups on which the remuneration policy is based.[170] At the very least, the Commission has identified the major weaknesses in current disclosure practice. But whether or not benign effects will follow is more doubtful given the failure to address enforcement and consistency and the persistence reliance on a non-binding measure to support good disclosure practices.

The recommendations concerning the remuneration committee are also relatively uncontroversial.[171] They should not interfere unduly with internal governance choices and may buttress the independence of the committee; the suggestion that one member have knowledge and experience concerning remuneration,[172] in particular, is sensible. But, based on experience with the earlier regime, compliance is likely to remain weak.

Difficulties emerge with the design recommendations, where the Commission appears to be moving away from supporting effective incentive alignment and into the muddier waters

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[169] In the accompanying Communication, the Commission noted that "wider concerns have also been voiced about recent substantial increases in executive pay and the constantly growing importance of variable pay…across all sectors of the economy": *supra* n 12, 1.

[170] Para 5.

[171] The committee should periodically review the remuneration policy for directors, exercise independent judgment and integrity, address conflicts of interests concerning consultants by ensuring that any consultant does not at the same time advise the human resources department or the executive directors and report to the shareholders on its functions: paras 8 and 9.

[172] Para 7.1.

associated with the fairness agenda. The recommendations that variable remuneration should be subjected to predetermined and measurable performance criteria, that performance criteria promote long-term sustainability and include relevant non-financial criteria, that variable pay be withheld when performance criteria are not met[173] and that arrangements be made to claw-back variable pay awarded on the basis of data which proves to be misstated,[174] are hard to argue with, although they represent a considerable tightening of the Commission's approach. But they do not intervene to any material extent in firm decision-making on pay. The more express recommendation that termination payments should not exceed a fixed amount and, in general, not be higher than two years of non-variable pay,[175] while more directive, relates to rewards for failure and thus does not second-guess firms in how they promote performance.

But the Recommendation goes further. The reforms in train for remuneration within financial institutions are likely to be directed to the support of better risk management.[176] But there is also a strong current public concern that, to be optimal, pay generally should also be "fair" and there is widespread public hostility to high levels of remuneration. The executive remuneration question has, in some quarters, evolved from a concern as to how to achieve optimal pay structures that reward performance into a concern as to whether pay structures are "just". While there has been concern in some reform efforts not to impose limits on pay,[177] the Recommendation appears imbued with a concern to reduce pay levels, notwithstanding the risks as intervention moves away from remuneration governance and the strain this approach places on the incentive alignment model. The suggestion that undefined "limits" should be placed on

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[173] Paras 3.1 and 3.2.

[174] Para 3.4

[175] Para 3.5.

[176] A number of harmonizing measures have been adopted by the EU. Reforms to the Capital Requirements Directive (proposed in summer 2009) will impose a binding obligation on CRD-scope credit institutions and investment firms to have remuneration policies that are consistent with and promote sound effective risk management. The Commission has also adopted a specific 2009 Recommendation on remuneration in financial institutions (including investment firms, insurance companies, and banks)· consistent with the protection of clients and investors (*supra* n 9). The Committee of European Banking Supervisors has adopted similar principles on remuneration policy (CEBS, *High Level Principles for Remuneration Policies* (2009)).

[177] The Turner Review was careful to distinguish between the debate on levels of remuneration, which it did not regard as its concern, and the debate on appropriate incentive alignment with respect to stability, which was its concern. FSA Chairman Turner took a similar approach in September 2009 (*supra* n 6). The Walker Review similarly noted that it was not concerned with whether remuneration should be capped, but with the structure of remuneration, deferment, the performance link and disclosure.

variable pay[178] is particularly troubling given the benefits of incentive alignment.[179] This recommendation is vague, appears to be designed to reflect prevailing public and political opinion and is an undue incursion into corporate autonomy. It also seems to reflect the current concern that variable pay be restricted in banks, particularly where a bank's capital base remains unstable; but this systemic consideration does not apply to the corporate sector generally. This recommendation may prejudice the remuneration contract as a means for aligning shareholder and managerial interests, particularly if a more active institutional investor community regards this recommendation as best practice; it is all the more troubling as the Recommendation has been adopted in the absence of clear and detailed evidence as to how these limits might address specific failures.[180] The Recommendation similarly suggests that remuneration committees should ensure that executive director remuneration is "proportionate" to that of other executive directors and other staff members. As noted in section 3 above, while efforts have been made by some Member States to address proportionality concerns, this is not widespread and there is little evidence that intervention in support of "reasonable" pay works.[181] While these recommendations are more likely to be observed in the breach than otherwise, they represent an unwelcome distraction given the complexities of intervention in this area, the risk of damage to the pay/performance link and the more basic failures which persist with respect to remuneration disclosure and governance.

The Recommendation's suggestions with respect to the deferral of pay are similarly intrusive, if rather less troubling. The Recommendation suggests that the "major part" of variable pay should be deferred for a "minimum period" of time.[182] It also suggests restrictions on share-based pay. Uncontroversially, it recommends that the vesting of shares and the exercise of share options should be subject to predetermined and measurable performance criteria, and so aims to reinforce the performance link.[183] But it also recommends that shares should not vest for at least

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[178] Para 3.1

[179] The 2009 German Act, eg, raises the possibility of limits on variable pay, but only in the form of empowering the supervisory board to limit payments in exceptional circumstances.

[180] Posner has warned of the social costs which can follow from limit-based controls: *supra* n 25, 1045.

[181] Thomas, *supra* n 35, drawing on the experience in Australia, where a 1992 reasonableness requirement was followed by an increase in pay: at 50.

[182] Para 3.3.

[183] Para 4.2.

three years after their award and that share options or similar rights should not be exercisable for three years.[184] The Commission has also suggested that a certain number of shares be retained by directors until the end of their mandate.[185] Restricted shares, particularly those held until a director leaves, could certainly be a very useful mechanism for aligning director interests more effectively with long-term performance[186] and are already a feature of some local Codes (section 3 above). But this restriction appears somewhat arbitrary; three years is not a particularly long horizon in terms of long-term performance. There has been no attempt to explain why this period was chosen or to consider the long-term consequences of these restrictions. As voluntary recommendations they may turn out to be of limited import, but the danger arises that they come to represent corporate best practice.[187]

Ultimately, the 2009 Recommendation represents something of a muddle between shareholder and wider stakeholder interests. It also fails to get to the heart of the enforcement and consistency difficulties raised by the 2004 and 2005 Recommendations. It is, of course, difficult for firms to adopt outlier measures on pay which are designed to sharpen director focus on long-term interests, such as vesting restrictions and deferral periods, given the competitive executive market. The Recommendation may help in this regard. But it not clear that there is a market failure in the corporate sector which warrants the Commission second-guessing boards and shareholders on the design of remuneration. There appears, however, to be a market failure with respect to disclosure. The braver route would therefore have been to legislate for binding, core disclosure standards.

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[184] Para 4.1. This reflects the UK Combined Code (sect 3 above).

[185] Para 4.3.

[186] And are supported by Romano and Bhagat (*supra* n 8) on a mandatory basis for all companies in receipt of TARP funds (albeit with a much longer horizon of until the director leaves the company) and on a hortatory basis for all public companies. Similarly, payment in restricted shares has been suggested as means of supporting auditor independence: S Hannes, *The Case for Gatekeeper Incentive Pay* (2009), available at http://ssrn.com/abstract=1263563.

[187] The Romano/Bhagat proposal suggests that implementation (including the specific selling restriction) be left to corporate directors and investors and be tailored to the needs of specific firms and employees: *supra* n 8, 4.