Executive Remuneration: A Comparative Overview II

Law Working Paper N° 814/2024
November 2024

Guido Ferrarini
University of Genoa, ECLE, EUSFiL and ECGI

Maria Cristina Ungureanu
Genoa Centre for Law and Finance

ECGI Working Paper Series in Law

Executive Remuneration: A Comparative Overview II

Working Paper N° 814/2024
November 2024

Guido Ferrarini
Maria Cristina Ungureanu

Abstract

In this paper, the first edition of which was published 10 years ago, we analyse prior and current trends in the regulation and practice of executive remuneration. The role of regulation and governance in this area have further increased in the last decade and the standards of pay governance and structure have spread from the financial sector to the non-financial one. Consequently, today's remuneration practices are substantially shaped not only by the need to align the interests of managers and shareholders and to reduce managerial agency costs at listed companies, but also by the hard and soft laws tackling corporate governance and remuneration structures. Moreover, regulation and practice respond to social issues and political pressures, reflecting concerns about "excessive" pay to corporate managers, inequality in the distribution of wealth and the need to align incentives with environmental and social issues. We examine the main law and policy questions concerning incentive pay, including the optimal design of variable remuneration and the importance of long-term pay. Amongst the governance mechanisms, we consider both the role of boards and independent directors, and that of shareholders under say on pay rules, considering the rise of shareholder engagement in listed companies across the Atlantic. We especially analyse regulatory developments in the EU over the last decade comparing the same with developments at member state level and in the UK and the US. We also focus on the regulation of pay structures, showing that long-term incentives are clearly favoured for both financial and non-financial companies by either regulators or institutional investors. However, financial institutions are the main target of post-crisis regulatory reforms, firstly at international level and secondly in the UK, US and the EU, where the FSB principles have been implemented along partially diverging routes.

Keywords: Executive remuneration, corporate governance, shareholder engagement, say on pay, banks, financial crisis, prudential regulation, supervision

JEL Classifications: G20, G21, G28, G30, G32, G34, G38, K22, K31, M12

Guido Ferrarini*
Emeritus Professor of Business Law
University of Genoa
Via Balbi, 22,
16126 Genoa, Italy
e-mail: guido.ferrarini@unige.it

Maria Cristina Ungureanu
Research Afiiliate
Genoa Centre for Law and Finance
Zone 61, Street 804, Building 45 Beverly Hills Tower
Doha, Qatar
e-mail: mariac.ungureanu@gmail.com

*Corresponding Author

EXECUTIVE REMUNERATION: A COMPARATIVE OVERVIEW II *

GUIDO FERRARINI**

MARIA CRISTINA UNGUREANU***

October 2024

* A shorter and edited version of this paper will be published as a chapter in the *Oxford Handbook of Corporate Law and Governance* (J. Gordon and G. Ringe eds.), Oxford University Press, 2nd edition, forthcoming. The 1st edition of it was published as ECGI Law Working Paper N° 268/2014, October 2014.

** Emeritus Professor of Business Law, University of Genoa; Research Member and Fellow, European Corporate Governance Institute; Academic Member, European Banking Institute.

*** Corporate Governance Expert; Research Affiliate, Genoa Centre for Law and Finance.

ABSTRACT:

In this paper, the first edition of which was published 10 years ago, we analyse prior and current trends in the regulation and practice of executive remuneration. The role of regulation and governance in this area have further increased in the last decade and the standards of pay governance and structure have spread from the financial sector to the non-financial one. Consequently, today's remuneration practices are substantially shaped not only by the need to align the interests of managers and shareholders and to reduce managerial agency costs at listed companies, but also by the hard and soft laws tackling corporate governance and remuneration structures. Moreover, regulation and practice respond to social issues and political pressures, reflecting concerns about "excessive" pay to corporate managers, inequality in the distribution of wealth and the need to align incentives with environmental and social issues. We examine the main law and policy questions concerning incentive pay, including the optimal design of variable remuneration and the importance of long-term pay. Amongst the governance mechanisms, we consider both the role of boards and independent directors, and that of shareholders under say on pay rules, considering the rise of shareholder engagement in listed companies across the Atlantic. We especially analyse regulatory developments in the EU over the last decade comparing the same with developments at member state level and in the UK and the US. We also focus on the regulation of pay structures, showing that long-term incentives are clearly favoured for both financial and non-financial companies by either regulators or institutional investors. However, financial institutions are the main target of post-crisis regulatory reforms, firstly at international level and secondly in the UK, US and the EU, where the FSB principles have been implemented along partially diverging routes.

Keywords: Executive remuneration, corporate governance, shareholder engagement, say on pay, banks, financial crisis, prudential regulation, supervision

JEL Classifications: G20, G21, G28, G30, G32, G34, G38, K22, K31, M12

* Guido Ferrarini
Università degli Studi di Genova – Dipartimento di Giurisprudenza
Via Balbi 22
Genoa, 16126, Italy
Phone: +39-010-5531814
e-mail: guido.ferrarini@unige.it

Maria Cristina Ungureanu
Zone 61, Street 804, Building 45 Beverly Hills Tower, apartment 2607 Doha
Qatar
e-mail: mariac.ungureanu@gmail.com

*Corresponding Author

EXECUTIVE REMUNERATION: A COMPARATIVE OVERVIEW II

GUIDO FERRARINI AND MARIA CRISTINA UNGUREANU

Table of Contents

1. INTRODUCTION

Executive pay lies at the heart of current discussion on corporate governance. Mandatory disclosure, monitoring by the media, and institutional investor engagement often suggest that the levels and structures of executive remuneration are divorced from corporate performance and represent a sharp conflict of interest between management and shareholder interests. Moreover, "excessive" compensation at banks and other financial institutions is widely believed to have contributed to the great financial crisis by incentivizing managers to take excessive risks. In the present chapter we consider executive remuneration from a transatlantic perspective, looking at corporate practices, regulation, and investor behaviour in Europe, UK and the US, also from a theoretical viewpoint. In section 2 we introduce the main problems of executive pay from the perspectives of agency costs theory (underlying the shareholder value approach to incentives and the rent extraction theory) and of the institutional theory which explains the evolution of executive pay practices as a consequence of legal, governance and tax reforms. In section 3 we introduce the main agency costs of executive remuneration at financial institutions considering the 2008 financial crisis experience. In section 4 we analyse the main types of managerial incentives and the issues regarding their design, such as proxies for firm performance, stock options and long-term pay. In section 5 we examine the relationship between executive remuneration and ESG, especially considering income inequality resulting from high executive remuneration, ESG-linked compensation, and the impact of sustainability regulation on executive pay. In section 6 we examine pay governance, with special reference to the role of boards and independent directors, shareholders' engagement and disclosure regulation. In section 7,we analyse the regulation of pay governance with special reference to the EU Shareholder Rights Directive (SRD II) and US Regulation. In section 8 we consider the regulation of managerial pay at financial institutions, with regard to the international FSB Principles and to their implementation in the EU, the UK and the US. In section 9 we conclude.

2. The Economics of Executive Pay

2.1 Shareholder Value

The principal–agent model has generated two competing views of executive pay focusing on either shareholder value or rent extraction.[1] Under the shareholder value view,[2] executive pay remedies the agency costs deriving from the misalignment of management and shareholder interests in the dispersed ownership company. Shareholders in dispersed ownership systems have only a fractional interest in firm profits, are not fully incentivized to discipline, and have limited opportunities to monitor management.[3] Management's unobserved actions, particularly where personal costly decisions (e.g., laying off employees) and private beneficial activities (e.g., consuming perquisites) are involved, can reduce shareholder wealth, and give rise to agency costs. Whether, and the extent to which, a manager will fully pursue the shareholders' agenda depends on how she is incentivized. Agency theory suggests that the performance-based pay contract, which links pay to shareholder wealth via performance indicators such as share prices or accounting-based targets, is a powerful way of attracting, retaining, and motivating managers to pursue the shareholders' agenda.[4] In the dispersed ownership context, this approach has dominated the

[1] Guido Ferrarini & Niamh Moloney, "Executive Remuneration in the EU: The Context for Reform", 21 Oxford Rev. Econ. Pol'y 304 (2005).
2 See Alex Edmans, Xavier Gabaix & Dirk Jenter, "Executive Compensation: A Survey of Theory and Evidence", in The Handbook of the Economics of Corporate Governance, volume 1 (2017), 385, referring to the view which "argues that compensation contracts are chosen to maximize value for shareholders, taking into account the competitive market for executives and the need to provide adequate incentives".
[3] Michael Jensen & William Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 J. Fin. Econ. 305 (1976).
[4] Michael Jensen & Kevin Murphy, "Performance Pay and Top-Management Incentives", 98 Journal of Political Economy 225 (1990); Michael Jensen, Kevin Murphy & E. Wruck, "Remuneration: Where We've Been, How

pay debate and pay practices since the early 1990s and still enjoys considerable support as making management more sensitive to shareholders' interests.[5]

The relationship between agency problems and the executive pay incentive contract takes on an additional complexity in continental European firms, characterized by concentrated shareholdings and long-term shareholder commitment.[6] Here, incentives and conflicts change, as concentration of control (possibly intensified by cross shareholdings, pyramidal ownership structures, proxy voting by financial institutions connected to the company, multiple voting shares, and voting pacts) recasts the agency problem which executive pay is designed to resolve. The agency costs that trouble the dispersed ownership company are reduced, as block-holding shareholders have both incentives and resources to monitor managers effectively. As a result, there is less need for an incentive contract to control the conflict between management and shareholder interests that is remedied by executive pay. There is also less probability of the agency problem which derives from executive pay arising. However, other concerns may emerge with regards to concentrated shareholdings regarding also executive pay.[7]

We Got to Here, What Are the Problems, and How to Fix Them", ECGI Finance Working Paper No. 44/2004, available at: www.ecgi.org; Martin J. Conyon & Dennis Leech, "Top Pay, Company Performance and Corporate Governance", 56 Oxford Bulletin of Economics and Statistics 229 (1994); Brian J. Hall & Jeffrey Liebman, "Are CEOs Really Paid Like Bureaucrats?", 113 Q.J. Econ. 653 (1998).

[5] Bengt Holmstrom & Steven N. Kaplan, "The State of U.S. Corporate Governance: What's Right and What's Wrong?", 15 J. Appl. Corp. Fin. 8 (2003); Rajesh K. Aggarwal & Andrew A. Samwick, "Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence", 54 J. Fin. 1999 (1999); Conyon & Leech (1994).

[6] Guido Ferrarini & Niamh Moloney, "Executive Remuneration and Corporate Governance in the EU: Convergence, Divergence, and Reform Perspectives", 1 Eur. Company & Fin. L. Rev. 251 (2004). The relevant arguments are developed and shown also empirically by Roberto Barontini, Stefano Bozzi & Guido Ferrarini, "Executive Remuneration Standards and the 'Conformity Gap' at Controlled Corporations", 21 Journal of Management and Governance 573 (2017).

[7] For analysis of agency problems of controlling shareholders with special regard to corporate groups, see Luca Enriques and Sergio Gillotta, Justifications for Minority-Co-Owned Groups and Their Corporate Law Implications (March 20, 2023). European Corporate Governance Institute - Law Working Paper No. 693/2023, Theoretical Enquiries in Law journal (2024), Forthcoming, Available at SSRN: https://ssrn.com/abstract=4397428.

2.2 Rent Extraction

According to the second view focusing on "rent extraction",[8] executive pay can also be regarded as an agency cost in itself in that it provides a powerful and opaque device for self-dealing by conflicted managers.[9] In practice, pay is not set by shareholders; rather, it is set on their behalf by the board of directors, which is expected to align shareholder and managerial incentives.[10] Nonetheless, a conflicted board may use the pay-setting process to influence pay and extract rents for the managers in the form of pay in excess of that would be optimal for shareholders, given weaknesses in the design of pay contracts and in their supporting governance structures.[11] In other words, executive pay raises an additional agency problem: How can the effectiveness of the executive pay contract as a remedy for manager/shareholder agency costs be protected from conflicts between the board, as pay-setter, and the shareholders?[12] The equity-based incentive contract may, as post-Enron scholarship argues, deepen conflicts of interest between shareholders and managers by generating perverse management incentives to manipulate financial disclosure, particularly earnings, and distort share prices, which can lead to catastrophic corporate failures. The consequences of such a cycle of ever higher share prices, and their impact on pay, have been examined as "the agency costs of overvalued equity."[13]

---

[8] See Edmans et al. (2017), 385, with reference to the view which argues that compensation "contracts are set by executives themselves to maximize their own rents".
[9] Lucian Arye Bebchuk, Jesse M. Fried, & David I. Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation", 69 U. Chi. L. Rev. 751 (2002); Jennifer Hill & Charles M. Yablon, "Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict", 25 U.N.S.W. Law Journal 294 (2002); Lucian Bebchuk & Jesse Fried, "Pay without Performance: The Unfulfilled Promise of Executive Compensation" (2004).
[10] Jensen & Murphy (2004).
[11] Bebchuk et al. (2002); Bebchuk & Fried (2004).
[12] Jensen & Murphy (2004); Jeffrey N. Gordon, "Executive Compensation: If There's a Problem, What's the Remedy? The Case for 'Compensation Disclosure and Analysis'", 30 J. Corp. L. 675 (2005); Jensen & Murphy (1990); Michael C. Jensen & Kevin J. Murphy, "CEO Incentives—It's Not How Much You Pay, but How", 3 J. Appl. Corp. Fin. 64 (2010).
[13] Jensen & Murphy (2004).

2.3 Institutional and Mixed Views

Under another view, executive pay is shaped by institutional forces such as regulation, tax, and accounting policies.[14] M. Jensen and K. Murphy analyse the regulations that in their opinion have substantially damaged the efficacy of CEO pay practices, ranging from the first disclosure rules in the 1930s to the 2018 Trump tax rules.[15] Their main finding is that the persistent outrage over CEO pay has prompted the imposition of a wide range of disclosure requirements, tax policies, accounting rules, governance reforms, direct legislation, and other rules constraining executive compensation stretching back nearly a century. Jensen and Murphy discuss the political forces behind these regulatory interventions and assess their continuing unintended consequences.[16] They conclude that the best way the government can "fix" executive compensation is to stop trying to fix it, and by undoing the damage already caused through existing regulations that have, in aggregate, imposed enormous costs on organizations, their shareholders, and social welfare. However, a similar conclusion may be too extreme, especially for countries other than the US. Not all executive pay regulation is counterproductive, e.g. "say on pay" has some merits which have been proven by empirical research.[17] Also, disclosure regulation may have a positive impact on self-discipline by the boards and their accountability.[18]

A mixed view is offered by Edmans et al. who argue that executive compensation is driven by many factors indicated in the different theories examined so far.[19] Firstly, boards and shareholders try to maximize firm value. Secondly, executives try to maximize their own

[14] Edmans et al. (2017), 385.
[15] Kevin C. Murphy & Michael J. Jensen, "The Politics of Pay: The Unintended Consequences of Re gulating Executive Compensation," 3 Journal of Law, Finance, and Accounting (2018), 189.
[16] See also Kevin C. Murphy, "The Politics of Pay: A Legislative History of Executive Compensation", in Jennifer Hill & Randall Thomas (eds.), The Research Handbook on Executive Pay (2012).
[17] Ferri, F., & Göx, R. F. (2019), "Executive Compensation, Corporate Governance, and Say on Pay", Foundations and Trends in Accounting, 13(1), 1-96.
[18] Leuz, C., & Wysocki, P. D. (2015). The economics of disclosure and financial reporting regulation: Evidence and suggestions for future research. European Corporate Governance Institute (ECGI) - Law Working Paper No. 306/2016
[19] Edmans et al. (2017), 505.

rents, perhaps in conjunction with entrenched boards and inattentive shareholders. Thirdly, institutional forces are at play, such as legislation, taxation, accounting policies, and social pressures. In the end, “no one perspective can explain all the evidence, while a narrow attachment to one perspective will distort rather than inform the view of executive pay”.[20] In addition, executive pay interacts with other topics such as board and shareholder structure, income inequality, and political economy, and these interactions also open avenues for further investigation.

Moreover, Edmans, Gosling, and Jenter conduct a survey on the objectives, constraints, and determinants of CEO pay finding that directors face significant constraints other than participation and incentive compatibility.[21] These constraints lead to lower pay levels and more one-size-fits-all structures. Shareholders are the main source of such constraints, while intrinsic motivation and reputation are stronger motivators than incentive pay. In fact, pay matters to CEOs not to finance consumption, but because of CEOs’ perceptions of fairness. The need to fairly recognize the CEO’s contribution explains why flow pay responds to performance and why peer firm pay matters beyond retention.[22]

3. Financial Stability Issues

3.1 Three types of agency costs

[20] Ibidem.
[21] Alex Edmans, Tom Gosling & Dirk Jenter, “CEO compensation: Evidence from the field”, Journal of Financial Economics, Volume 150, Issue 3 (2023)
[22] Ibidem. See also Pierre Chaigneau, Alex Edmans & Daniel Gottlieb, “A Theory of Fair CEO Pay”, November 25, 2022, available at: https://ssrn.com/abstract=4294589, who argue that standard moral hazard models assume that the agent cares about pay only for the consumption it enables: “Such theories have contributed substantially to our understanding of CEO pay. (…) However, a crucial difference with other agents is that CEOs are typically wealthy, and nearly all their consumption needs are already met. (…) Their pay is not driven purely by the desire to provide consumption incentives, but significantly influenced by concerns for fairness”. The paper studies optimal pay when the CEO is motivated by both traditional consumption utility and fairness concerns.

Three types of agency problems affect executive compensation at financial institutions.[23] The first type of problems relate to the relationship between managers and shareholders and are similar to the ones usually found in non-financial firms. The second regard the relationship between managers and debt holders and are increased by the fact that banks and other financial institutions (like some investment firms) are highly leveraged. Incentives should take leverage into account, as suggested by the proposals to link pay to credit default swaps or to pay in debt instruments.[24] The third type of agency costs concern the managers vis-à-vis the financial system. Financial institutions, particularly the large ones, generate systemic risks which are enhanced by aggressive remuneration structures.[25]

A widespread post-crisis view holds that the failure of banks in 2007-2008 both in Europe and the US may have been at least partially caused by flawed remuneration structures, including short-term incentives that may have led bank managers to take risks which in the long run appeared to be excessive. [26] This view has been analysed by economists both on theoretically and empirical grounds with mixed results.

3.2 Empirical studies

Empirical research has shown that banks that failed in the crisis somehow complied with best practices as to corporate governance and executive remuneration.[27] A paper by Rüdiger Fahlenbrach and René Stulz analyses a sample of 98 large banks across the world and finds

[23] John Thanassoulis and Misa Tanaka, Bankers' pay and excessive risk, Bank of England Staff Working Paper No. 558, October 2015

[24] Alex Edmans & Qi Liu, "Inside Debt", 15 Review of Finance 75 (2011) advocate the use of debt in pay, while Patrick Bolton, Hamid Mehran & Joel Shapiro, "Executive Compensation and Risk Taking", 19 Review of Finance 2139 (2015) suggest using credit default swaps may be more reliable.

[25] See John Thanassoulis & Misa Tanaka, "Optimal pay regulation for too-big-to-fail banks", 33 J. Finan. Intermediation 83 (2018), suggesting that linking remuneration to interest rates can incentivize the executive to make socially optimal risk choices.

[26] Andrea Beltratti & René Stulz, "The Credit Crisis around the Globe: Why Did Some Banks Perform Better?", 105 J. Fin. Econ. 1 (2012); Renée Adams, "Governance and the Financial Crisis", ECGI Finance Working Paper No. 248 (2009), available at www.ssrn.com; Rüdiger Fahlenbrach & René M. Stulz, "Bank CEO Incentives and the Credit Crisis", 99 J. Fin. Econ. 11 (2011).

Beltrati & Stulz (2012)

“no evidence that banks with a better alignment of CEOs’ interests with those of their shareholders had higher returns during the crisis.”[28] The authors rather identify “some evidence that banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return o<n equity.” According to their study, CEOs had substantial wealth invested in their banks, with the median CEO portfolio including stocks and options in the relevant bank worth more than eight times the value of the CEO’s total compensation in 2006. Similar equity holdings should have led CEOs to focus on the long term, avoiding too much risk and excessive leverage for their banks. Instead, the study shows that a bank’s stock return performance in 2007–2008 was negatively related to the dollar value of its CEO’s holdings of shares in 2006, and that a bank’s return on equity in 2008 was negatively related to its CEO’s holdings in shares in 2006.

However, another stream of literature highlights possible agency costs in banks caused by inadequate remuneration structures. A paper by Lucian Bebchuk, Alma Cohen, and Holger Spamann on executive compensation at Bear Stearns and Lehman Brothers focuses on the link between substantial short-term incentives and excessive risk taking.[29] The authors argue that the large losses on shares that the top financiers suffered when their firms melted down do not offer a full picture of their payoffs, which should include what the same executives cashed out in the 2000–2008 period and what they owned initially. In the observed timeframe, the relevant executives received large amounts of cash bonus compensation and “regularly took large amounts of money off the table by unloading shares and options.” Indeed, performance-based compensation paid to top executives at Bear Stearns and Lehman Brothers substantially exceeded the value of their holdings at the beginning of the period. Bebchuk et al. argue that this provides a basis for concern about the incentives of the two

[28] Fahlenbrach & Stulz (2011)
[29] Lucian Bebchuk, Alma Cohen, & Holger Spamann, “The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008”, 27 Yale J. Reg. 257 (2010).

banks' executives. Rather than producing a "tight alignment" of their interests with long-term shareholder value, the design of performance-based compensation provided executives of the relevant firms with substantial opportunities "to take large amounts of compensation based on short-term gains off the table and retain it even after the drastic reversal of the two companies' fortunes."

3.3 Short-term incentives in the crisis

In order to get the full picture, the remuneration of other bank employees (such as traders) should also have been taken into account, particularly that of high earners who contribute to risk taking by the firm.[30] Even though precise empirical data are lacking, it is well known that many of these employees were paid short-term incentives before the crisis in amounts much greater than that of their fixed salaries. As explained by Diamond and Rajan (2009):

> Given the competition for talent, traders have to be paid generously based on performance. But many of the compensation schemes paid for short-term risk-adjusted performance. This gave traders an incentive to take risks that were not recognized by the system, so they could generate income that appeared to stem from their superior abilities, even though it was in fact only a market-risk premium.[31]

No doubt, assuming that CEOs and other top managers were awarded the right incentive schemes—i.e., not only short-term, but also long-term incentives—the fact that other employees had mainly short-term incentives should not be a source of great concern, provided that sound risk management systems were in place and an effective oversight was exercised on risk takers by their superiors. However, as widely acknowledged in the

[30] Ing-Haw Cheng, Harrison Hong, & Jose A. Scheinkman, "Yesterday's Heroes: Compensation and Creative Risk-Taking", ECGI Finance Working Paper No. 285 (2010), available at www.ssrn.com.
[31] Douglas W. Diamond & Raghuram G. Rajan, "The Credit Crisis: Conjectures about Causes and Remedies", 99 Am. Econ. Rev. 606 (2009).

aftermath of the crisis, this was not always the case at large banks, where risk management systems were often deficient, and CEOs and top managers frequently did not have proper controls over the financial operations. Moreover, the problems were exacerbated by the huge amounts promised by banks to their employees. As colourfully described by Professor Alan Blinder, traders and other employees were often offered:

> the following sort of go-for-broke incentives when they place financial bets: Heads, you become richer than Croesus; tails, you get no bonus, receive instead about four times the national average salary, and may (or may not) have to look for another job . . . Faced with such skewed incentives, they place lots of big bets. If heads come up, they acquire dynastic wealth. If tails come up, OPM [other people money] absorbs almost all losses.[32]

4. INCENTIVE DESIGN

4.1 Types of incentives

While stock option compensation has been widespread in many countries, in the last two decades restricted stock grants have replaced stock options as the most popular form of equity compensation.[33] For many stock grants, vesting depends on firm performance.[34] In the case of time-vesting stock, the executive receives a fixed number of shares at the end of the vesting period, which is often three years, if the executive is still with the firm and one or more performance conditions have been fulfilled.[35]

Financial economists predict that executives' wealth should be sensitive to the stock price, but generally they do not specify whether this sensitivity should be provided by stock or options.[36] No doubt, options provide a "higher delta" (i.e., a higher wealth-performance

---

[32] Alan S. Blinder, After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead (2013).
[33] Edmans et al. (2017), 401.
[34] Ibidem, 416
[35] Ibidem.
[36] Ibidem, 454.

sensitivity) than shares. However, "options pay off in 'high' states of the world in which risk-averse executives' marginal utility is low, which causes the ex-ante incentives created per unit of delta to be smaller for options than for stock".[37] Moreover, since option values are more volatile, options are worth less to the executive than stock.[38]

4.2 Design Problems. Proxies for Firm Performance

Performance pay may suffer from several inherent design defects which damage the performance link at the heart of the incentive contract's effectiveness as an interest-alignment device, and which provoke conflicts between management and shareholders or, potentially, between management/controlling shareholders and minority shareholders. These defects heighten the need for an effective governance and disclosure matrix for pay setting if the alignment process is to work. We highlight three main design challenges: proxies for firm performance, stock options, and long-term pay.[39]

Share price is ordinarily the best available proxy for shareholder wealth and reflects overall corporate performance more effectively than business-line linked, target-specific bonuses. But the danger arises when generating incentives to inflate earnings and manage disclosure to generate short-term share-price increases. Equity-based compensation also risks over-compensation of executives who preside over a period of market growth and under-compensation of those caught in a period of overall poor market performance. It is, however, difficult to construct a better alternative for shareholder wealth, given that it does reflect the market's perception of the company's current and future cash flows, and so its perceptions of management performance and investment opportunities.[40] The risk of management inflating

[37] Ibidem.
[38] Ibidem.
[39] Ferrarini & Moloney (2005); Guido Ferrarini, Niamh Moloney, & Maria-Cristina Ungureanu, "Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe", 10 J. Corp. L. Stud. 73 (2010).
[40] Kevin J. Murphy, "Corporate Performance and Managerial Remuneration: An Empirical Analysis", 7 J. Acct. & Econ. 11 (1985); Jensen & Murphy (1990).

the share price, however, demands that the governance matrix, which monitors management and supports pay setting, whether it be independent directors, institutional investors, or controlling shareholders, is robust and establishes risk-adjustment mechanisms in the remuneration policy.

4.3 Stock Options' Design

Stock options pose a second major design problem. They can create potentially powerful incentives by linking pay to shareholder returns expressed via the share price. They can incentivize executives to take efficient but personally stressful decisions and promote greater efforts to increase the global value of the company and the share price.[41] They have an attractively asymmetrical pay structure in that they reward success but do not appear to penalize failure: executives are not likely to equate the failure to make a gain with an actual loss. Options can also act as a powerful inducement to attract talent and can incentivize executives to stay. At the same time, stock options also display a number of inherent inefficiencies and possible risks,[42] such as the following:

1 *Relative performance*. Fixed price options, where vesting is independent of performance, can deliver very large gains for executives whenever the market is rising, even if the company is under-performing its competitors.[43] This problem can be avoided by linking the option's exercise price to a market or

[41] Jeffrey N. Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", 69 U. Chi. L. Rev. 1233 (2002).
[42] Bebchuk et al. (2002). For similar problems in restricted stock, see David Walker, "The Way We Pay Now: Understanding and Evaluating Performance-Based Executive Pay", 1 Journal of Law, Finance, and Accounting 395 (2016), 449.
[43] Alfred Rappaport, "New Thinking on How to Link Executive Pay with Performance", *77* Harv. Bus. Rev. 91 (1999); Menachem Brenner, Rangarajan K. Sundaram, & David Yermack, "Altering the Terms of Executive Stock Options", 57 J. Fin. Econ. 103 (2000); Don M. Chance, Raman Kumar, & Rebecca B. Todd, "The 'Repricing' of Executive Stock Options", 57 J. Fin. Econ. 65 (2000); Angela B. Morgan & Annette B. Poulsen, "Linking Pay to Performance—Compensation Proposals in the S&P 500", 62 J. Fin. Econ. 489 (2001); Keith W. Chauvin & Catherine Shenoy, "Stock Price Decreases Prior to Executive Stock Option Grants", 7 J. Corp. Fin. 53 (2001).

peer-group index such that executives are rewarded only when they outperform the competition, or linking exercise to the achievement of performance conditions.

2 *Repricing*. The capacity for share options to be re-priced when the share price falls on poor corporate performance (rather than on sector-wide movements) further weakens the incentive justification and damages the alignment mechanism.[44] This was a common practice in the US prior to changes in accounting regulations.[45]

3 *Impact on dividend policy*. If stock options appropriately align shareholder and management incentives, management should be incentivized to allocate cash flow to shareholders in the form of dividends. Stock options can distort this alignment as the value of options drops with dividend payment, incentivizing management to reduce dividends.[46]

4 *Dilution*. Stock options carry the risk of dilution and, therefore, of a reduction in earnings per share and entrenchment of management voting power.[47] Dilution also raises difficulties in blockholding companies, where controllers may see their dominant position weakened.

Option grants can, however, be structured to avoid incentive alignment weaknesses. The stock option problem then becomes one of how to ensure good supporting governance in,

---

[44] Brenner et al. (2000); Chance et al. (2000).

[45] Mary Ellen Carter & Luann J. Lynch, "An Examination of Executive Stock Option Repricing", 61 J. Fin. Econ. 207 (2001).

[46] Richard A. Lambert, William N. Lanen, & David F. Larcker, "Executive Stock Options Plans and Corporate Dividend Policy", 24 J. Fin. Quant. Anal. 409 (1989); Scott J. Weisbenner, "Corporate Share Repurchases in the 1990: What Role Do Stock Options Play?", FEDS Working Paper No. 2000-29 (2000), available at www.ssrn.com; Markus C. Arnold & Robert M. Gillenkirch, "Stock Options as Incentive Contracts and Dividend Policy", University of Frankfurt Finance & Accounting Working Paper Series (2002), available at www.ssrn.com.

[47] Morgan & Poulsen (2001); Chauvin & Shenoy (2001).

and disclosure of, pay setting, rather than a difficulty with the option as a tool of executive pay per se. Design problems are in the hands of the board, as pay setter, and its allied monitoring structures. If the board strategy is aligned with shareholder interests, structure problems can be mitigated. Although the connection between bad governance and suboptimal pay structures is not entirely clear,[48] the link between optimal shareholder interest alignment and good governance drives regulatory responses to remuneration.

4.4 Long-Term Pay

One of the concerns in the discussion regarding executive pay design has been that it is insufficiently focused on the long term, leading to reckless, short-term decision-making by executives and possibly even to financial bubbles.[49] However, combating short-termism has appeared to be high on the post financial crisis agenda, as shown by the Kay Review in the UK, suggesting that "companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business."[50] In addition, corporate governance scholars suggest that executives should be encouraged to focus on the long term by holding a large fraction of their equity after it vests. Bhagat and Romano recommend that incentive compensation should consist only of restricted stock and restricted stock options—restricted in the sense that the executive cannot sell the shares or exercise the options for two to four years after his or her last day in office. They contend that such an incentive compensation package will focus

[48] Brenner et al. (2000); Marianne Bertrand & Sendhil Mullainathan, "Agents with and without Principals", 90 Am. Econ. Rev. 203 (2000); Carter & Lynch, 2001.
[49] David I. Walker, "The Challenge of Improving the Long-Term Focus of Executive Pay" 51 Boston College Law Review 435 (2010); Bebchuk & Fried (2004).
[50] The Kay Review of UK Equity Markets and Long-Term Decision Making (July 2012), available at www.gov.uk; European Commission, Communication on long term financing of the European economy, available at http://www.ec.europa.eu (March 2014)

management's attention on the long-run and discourage investment in high-risk, value-destroying projects.[51] Bebchuk and Fried also focus on equity-based compensation as a way for tying incentives to long-term results.[52] They particularly analyse the optimal design of limitations on unwinding, arguing that an executive receiving an equity-based grant should not be free to unwind the received equity incentives for a specified period of time after vesting, after which she should be permitted to unwind the equity only gradually. Moreover, they advocate that firms adopt arrangements designed to ensure that executives cannot easily evade both the prescriptions that require executives to hold equity for the long term and those that prevent gaming.

Investor initiatives and political developments continue to exert pressure over executive compensation, especially on the design and structure of long-term incentives.[53] The public debate and regulatory initiatives have resulted in heightened scrutiny of executive pay by the shareholders and shareholder advisory groups, particularly focusing on the relationship between executive pay and firm performance. A related theme for investors is that a greater portion of incentive pay should relate to long-term performance, as it is widely believed that anything less than three-year performance periods would carry the risk of significant compensation being paid for performance that is not truly sustainable.[54]

The combination of these forces has accelerated the adoption of performance-linked long-term incentive programs. Two decades ago, plain-vanilla stock options filled-up the

---

[51] Sanjai Bhagat & Roberta Romano, "Reforming Executive Compensation: Focusing and Committing to the Long-Term", 26 Yale J. Reg. 359 (2009).
[52] Lucian A. Bebchuk & Jesse M. Fried, "Paying for Long-Term Performance", 158 U. Pa. L. Rev. 1915 (2010).
[53] Barontini et al. (2017); Massimo Belcredi & Guido Ferrarini, Corporate Boards, Incentive Pay and Shareholder Activism in Europe: Main Issues and Policy Perspectives, in Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms 1 (Massimo Belcredi and Guido Ferrarini eds., 2013); Steven N. Kaplan, "CEO Pay and Corporate Governance in the U.S.: Perceptions, Facts, and Challenges", 25 J. Appl. Corp. Fin. 8; Murphy (2013).
[54] Association of British Insurers (ABI), Principles for Executive Remuneration (2013), available at https://www.ivis.co.uk/guidelines; Yonca Ertimur, Fabrizio Ferri, & David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay", 51 J. Accounting Research 951 (2013).

compensation packages of executives, while terms such as restricted stock, full-value awards, or performance shares were almost unheard of.[55] Research has shown that a majority of individuals view stock options as a "gift."[56] As a result, they significantly discount the value of stock options and view them as something that is a "nice to have" rather than an essential element of their compensation plan. More recently, plain-vanilla options have been on the decline, while restricted stock and performance shares are a regular part of the long-term incentive lexicon, especially in public companies.[57] In a pay-for-performance world, equity compensation is increasingly becoming a reward for achievement of success. The problem with paying for upside potential is not only reflected in cash bonuses but also in short-term gains through stock options.[58] Initial values mean far less than what is finally delivered (or not) to the employee. Performance criteria add another layer of complexity to a compensation program, but performance may also add the secret ingredient of direct alignment that allows for a compelling discussion between the company and its stakeholders on current and potential value.

The key condition to any reward is making sure that the linkage between achievement and pay-out is reasonable and comprehensible. Investors pay more attention to changes in the proportion of shares issued and shares conveyed to employees; they scrutinize time-based stock plans (i.e., restricted stock, time-vested stock) and performance share plans with a lower than three-year performance period.[59] They value stock ownership and retention

---

[55] Hamid Mehran & Joseph Tracy, "The Effect of Employee Stock Options on the Evolution of Compensation in the 1990s", 7 Economic Policy Review 17 (2001).
[56] Peter Cappelli & Martin Conyon, "Stock Option Exercise and Gift Exchange Relationships: Evidence for a Large U.S. Company", NBER Working Paper No. 16814 (2011), available at http://www.nber.org/papers/w16814.
[57] David I. Walker, "Evolving Executive Equity Compensation and the Limits of Optimal Contracting", 64 Vand. L. Rev. 611 (2011). See also para. 3.1 above.
[58] Patrick Bolton, José Scheinkman, & Wei Xiong, "Executive Compensation and Short-Termist Behaviour in Speculative Markets", 73 Rev. Econ. Stud. 577 (2006).
[59] David Yermack, "Shareholder Voting and Corporate Governance", 2 Annual Review of Financial Economics 103 (2010); Misra, Srijit, & Brian Yang. "Say on Pay and Executive Compensation Design." Journal of Financial Economics 130.2 (2018): 440-464.

requirements, which are considered to reinforce executives' "shareholder mindset." Similar concerns have led to legal changes and governance codes reviews in major markets over the last years, either requiring or recommending deferral of annual incentives and/or longer vesting periods for long-term incentives for senior executives in all listed companies (not just financial services). As we have moved into the era of "say on pay", performance hurdles are also being added to these awards.[60]

As a result, companies are working to balance their compensation philosophy and executive pay programs have come under closer scrutiny. Equity compensation has become more volatile and complex during the past two decades, requiring more planning, expertise, and pragmatism.[61] The growing focus on aligning pay with long-term performance has driven many companies to grant performance-vested long-term incentives,[62] apply not lower than three-year performance measurement periods, align plans with two or more performance measures, make executive directors maintain a substantial ownership interest for the duration of their employment, and establish stock ownership plans for directors. Several companies have moved away from full vesting and toward pro-rata vesting of equity, toward more disciplined target setting and greater consideration of strategic, non-financial performance measures in annual and long-term incentives.[63]

---

[60] Barontini et al. (2017).
[61] Walker (2010); Jeffrey N. Gordon, "Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay", Columbia Law and Economics Working Paper No. 373 (2010); available at: www.ssrn.com; Yermack, D. (2023), "Executive compensation: A review of recent literature" Journal of Financial Economics, 148(2), 247-280.
[62] Gomes, A. S., & Wachter, A. (2023). Executive compensation and shareholder value. Annual Review of Financial Economics, 15, 335-365; Clearbridge, The ClearBridge 100 Report (2013), available at http://www.clearbridgecomp.com.
[63] Equilar, Equity Trends Report (2013) available at www.equilar.com; GMI Ratings, 2013 CEO Pay Survey (2013) available at www3.gmiratings.com; BlackRock, Time to Rethink Executive Incentive Programs (2012), available at www2.blackrock.com; Yermack (2023).

5. Environmental and Social Sustainability

5.1 Executive remuneration and income inequality

The criticism over excessive executive pay concerns all types of firms and, across sectors, portrays a social perspective. Indeed, populist and political resentment against income disparity is widespread particularly in the present context of economic uncertainty, leading to a lack of confidence in the integrity and fairness of large corporations.[64] Moreover, income disparity within firms is seen as an aspect of the wealth inequality which is still plaguing capitalism despite substantial levels of growth in the world economies after the second world war.[65]

The US was the first country to partially address the social implications of high executive pay in legislation requiring public companies to disclose the ratio of the median employee annual total compensation to the CEO annual total compensation.[66] In August 2015, the SEC adopted new rules on the disclosure of such ratio as mandated under Section 953(b) of the Dodd–Frank Act.[67] This approach has been the subject of intense debate and

[64] See Matteo Gatti & Chrystin Ondersma, "Can a Broader Corporate Purpose Redress Inequality? The Stakeholder Approach Chimera", 46 J. Corp. L. 1 (2020), at 44, arguing that an oft-cited cause of inequality is the rise in managerial compensation. They specifically refer to Anthony Atkinson, Inequality, 107-108 (2016) and Thomas Piketty, Capital in the XXI Century, 397-405 (2014) who "impute raising income inequality across the world, and especially in the U.S., to excessive compensation for supermanagers and the collapse of pay norms that were once taming excessive salaries".

[65] See Joseph Stiglitz, The Price of Inequality: How Today's Divided Society Endangers Our Future (2012), who blames "rent-seeking" for causing inequality, with the wealthy using their power to shape monopolies, incur favourable treatment by the government, and pay low taxes. In his view, the end-result is not only morally wrong but also hurts the productivity in the economy.

[66] Section 953(b) of Dodd–Frank Act directs the SEC to amend its executive compensation disclosure rules to require public companies to disclose (1) the median of the annual total compensation of all employees, other than the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of the median employee annual total compensation to the CEO annual total compensation. The Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203 (2010).

[67] The SEC adopted a final rule (available at https://www.sec.gov/rules/final/2015/33-9877.pdf) that requires a public company to disclose the ratio of the compensation of its CEO to the median compensation of its employees beginning on Jan. 1, 2017. The rule provides companies with flexibility in calculating this pay ratio and helps inform shareholders when voting on "say on pay." It provides shareholders with information they can use to evaluate a CEO's compensation and requires disclosure of the pay ratio in registration statements, proxy and information statements, and annual reports that call for executive compensation disclosure. A company is permitted to select its methodology for identifying its median employee and that employee's compensation, including through statistical sampling of its employee population or other reasonable methods.

has garnered significant media attention.[68] Its supporters, including pension funds and other socially-minded investors, argue that the ratio represents material information for investors and that looking at the overall compensation framework of a single company can help rein in excessive executive pay.[69] In contrast, several business organizations, major law firms, and other market constituencies argue that the pay ratio would provide little or no insight for investors, who are rather interested in the correlation between CEO pay and the company's financial performance, also in comparison with pay practices at other public companies.[70] The reported ratio was very high, even for CEOs whose compensation is relatively modest.[71]

The UK adopted similar legislation on pay ratios in 2018.[72] In its Corporate Governance Reform green paper,[73] the UK government noted the "widespread perception that executive pay has become increasingly disconnected from both the pay of ordinary working

[68] AFL-CIO, Dodd–Frank, section 953(b): Why CEO-to-Worker Pay Ratios Matter for Investors (2013), available at www.aflcio.org.
[69] For example, the Council of Institutional Investors recommends that compensation committees consider the "goals for distribution of awards throughout the company" and "the relationship of executive pay to the pay of other employees" as factors in developing their executive pay philosophy. Council of Institutional Investors, Corporate Governance Policies (2010), available at http://www.cii.org/CouncilCorporateGovernancePolicies/.
[70] For an analysis of the debate including critics, Gary Shorter, "The 'Pay Ratio Provision' in the Dodd–Frank Act: Legislation to Repeal It in the 113th Congress" (October 2013), available at https://www.fas.org/sgp/crs/misc/R43262.pdf.
[71] See Deloitte, Pay Ratio Disclosures (2018), available at https://www2.deloitte.com/us/en/pages/human-capital/articles/ceo-pay-ratio-disclosure-updates.html, finding that in the first year of application of the SEC Rule the median pay ratio was 163:1, with a median employee total annual compensation of USD 68,708. The following are some interesting takeaways from pay ratio disclosures reported on the page of Deloitte website just cited: "The CEO pay ratio and the median employee's compensation cannot be compared across companies, even within similar industries, as each company has its own unique organization structure and/or geographic footprint that leads to the identification of very different median employees and corresponding pay levels. There is large variation in pay ratios across industries, within an industry, and across revenue sizes. There is, however, one clear trend: Typically, the larger the organization, the higher the CEO pay ratio. This is directly related to the level of CEO compensation, which generally increases to reflect the size and complexity of the organization, whereas the median employee's pay is largely unaffected by company size". According to an article by Reuters of July 14, 2021, available at https://www.reuters.com/business/us-ceo-to-worker-pay-ratio-rose-2991-last-year-union-2021-07-14/, "the average S&P 500.SPX chief executive made $15.5 million last year, 299 times the pay of the median worker and a higher ratio than in 2019, the top American labor union said on Wednesday, as the COVID-19 pandemic drove layoffs while executive compensation grew. The ratio was 264-to-1 in 2019".
[72] See The Companies (Miscellaneous Reporting) Regulations 2018, available at https://www.legislation.gov.uk/ukdsi/2018/9780111170298/contents.
[73] See Department for Business, Energy & Industrial Strategy (BEIS), Corporate Governance Reform. Green Paper, November 2016, available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf.

people and the underlying long-term performance of companies" and that it contributed to public distrust and shareholder dissatisfaction.[74] It suggested introducing CEO pay ratios and supporting explanations to increase transparency and help shareholders hold boards to account about executive pay, as was subsequently done by The Companies (Miscellaneous Reporting) Regulations 2018.[75] Regulation 17 requires companies within scope to disclose pay ratio information in the annual director's remuneration report and to account for the results and for any changes over time. BEIS published guidance in the form of FAQs in June 2018, which sets out the reporting requirements.[76]

Whilst the US and the UK have attempted to deter excessive pay ratios in large companies by holding boards accountable both to shareholders and society through mandated disclosure, some European countries have targeted similar goals through different measures.[77] For example, France uses taxation as a means to rebalance pay differences between corporate executives (and high earners in general) and other employees, through a 75 percent "super tax" payable by employers on compensation over €1m.[78] In Germany,

---

[74] Ibidem, 29.
[75] The Regulations concerning executive pay apply to quoted companies with more than 250 UK employees which are counted at group level for companies in a group structure. UK employees are defined as those employed under a contract of service, except people employed to work wholly or mainly outside the UK. According to guidance from the Department for Business, Energy & Industrial Strategy (BEIS), it is unlikely that contractors or agency workers would be included because they are employed under a contract with a different organization: see The Chartered Institute of Payroll Professionals, CEO pay ratios: The new reporting requirements, 25 September 2018, available at https://www.cipp.org.uk/resources/news/ceo-pay-ratios-the-new-reporting-requirements.html.
[76] See Department for Business, Energy & Industrial Strategy (BEIS), Corporate Governance, The Companies (Miscellaneous Reporting) Regulations 2018, Q&A, available at: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/755002/The_Companies__Miscellaneous_Reporting__Regulations_2018_QA_-_Publication_Version_2__1_.pdf. The figures must be set out in a table within the annual director's remuneration report. The figures to report are the CEO's total pay as a ratio to the 50th percentile (median) employees' remuneration, the 25th percentile employees' remuneration, and the 75th percentile employee's remuneration. Beneath the table of figures, companies must provide supporting information and explanation including: the methodology chosen for calculating the ratios; the reason for any changes in the ratios from the previous year; for the median ratio (50th percentile), whether the company believes that it is consistent with the company's general employee pay, reward and progression policies and, if so, why.
[77] Tower Watson, Executive Remuneration—Europe. Corporate Governance Developments (2014), available at: www.towerwatson.com.
[78] French General Tax Code, Article 750, Public Finances General Directorate, Tax Policy Directorate, Minister of Economy, Finance and Industry, available at: https://www.impots.gouv.fr.

changes to the 2019 Corporate Governance Code were effected requiring supervisory boards (1) to set maximum payout levels on the total and individual pay of executive board members and (2) to consider the relationship between executive board members' remuneration and that of staff generally.[79] In Switzerland, following a public referendum against excessive salaries in March 2013 (the "fat cat initiative"), the voters' majority called for constitutional rules to control executive pay and improve the corporate governance of listed companies.[80] As the referendum's outcome was not directly enforceable, the Federal Council adopted an ordinance,[81] which intended to improve the corporate governance of Swiss listed companies and empower shareholders to express a binding vote on executive compensation. The ordinance is particularly striking as it includes penal provisions for breaches of its rules and for executives being granted or accepting excessive compensation.

5.2 ESG-linked remuneration

A current trend in executive remuneration is to link part of its variable components to the company's ESG performance. Approximately half of CEOs report that their compensation is now tied to sustainability goals, up from only 15percent one year before, according to a global CEO survey released by IBM.[82] For the study, the IBM Institute for Business Value interviewed 3,000 CEOs across more than 30 countries and 24 industries, with a focus on areas including: perspectives on leadership and business, the executives' changing roles and responsibilities, key challenges and opportunities, and their use of technology, data and metrics.

---

[79] German Corporate Governance Code, 2019, section G, principle 23 and relevant recommendations, available at https://dcgk.de/files/dcgk/usercontent/en/download/code/191216_German_Corporate_Governance_Code.pdf.
[80] Text of initiative (in German) Eidgenössische Volksinitiative "gegen die Abzockerei," available at http://www.admin.ch/ch/d/pore/vi/vis348t.html. Brief in English available at http://www.lexology.com/library/detail.aspx?g=d97687f6-db1d-430e-b157-3c3432b5ed1a.
[81] Ordinance against Excessive Compensation with respect to Listed Stock Corporations (OaEC, 2014). See information on http://www.lexology.com/library/.
[82] See https://www.esgtoday.com/50-of-ceos-have-pay-tied-to-esg-goals-up-from-15-one-year-ago-ibm-survey/.

In the UK, ESG targets have been on the rise in bonuses and long-term incentives (LTIs) of FTSE 100 companies.[83] The most common category of metrics used for bonuses are the S (social) factors, such as diversity, employee engagement, health, and safety. The most common category of metrics in LTIs are the E (environmental) factors, such as decarbonization and energy transition.

In the EU, the ESG pay practices of FTSE 300 companies mainly involve short-term incentives, while decarbonisation is generally considered in LTIs.[84] In particular, 91 companies (61.90 percent of the sample) tie short-term incentives to ESG performance; 37 (25.2 percent) tie both long-term and short-term incentives to ESG performance; the remaining 12 percent connect only long-term incentives to ESG performance. The alleged long-term orientation of stakeholder capitalism would suggest a prevalence of long-term incentives tied to ESG. However, some ESG-related targets may not necessarily require a long-term horizon to be implemented, such as equal gender representation in boards of directors and management, while shifting the business model to zero emissions may require a multi-year business plan for implementation. Short-term incentives are therefore the main ESG incentives in EU corporate practice, including annual bonuses, annual variable pay, cash compensation, and shares/performance shares awards. As to long-term ESG remuneration, most remuneration reports refer to long-term incentive plans, and a minority of them to long-term variable pay. The incidence of ESG metrics and targets on the overall executive

[83] See PWC & London Business School, Paying Well for Doing Good (2021), available at: https://www.pwc.co.uk/services/human-resource-services/insights/environmental-social-governance-exec-pay-report.html, arguing that almost half of FTSE 100 companies now incorporate an ESG measure into their Executive Incentive Plans (45%).

[84] See Marco dell'Erba & Guido Ferrarini, "ESG and Executive Remuneration", in EBOR, 2024 (published online 11 July 2024). We analyse the companies listed in the FTSE EuroFirst300 Index, based on their Remuneration reports for the year 2020, and find that183 companies (61.6% of the total) take ESG into account for purposes of defining executive compensation. A group of 35 companies will take ESG metrics into account starting from 2021-2022, but the remaining 148 companies already take ESG metrics into account for defining executive compensation in 2020. The metrics in question target specific stakeholders, in particular employees, customers, suppliers, the community at large, and the environment. Other ESG metrics refer to more general instances, which cannot be easily included in a specific stakeholder class.

remuneration package should also be considered. In our sample, ESG targets determine more than 20 percent of remuneration in almost one third of companies (30.4 percent) and 15-20 percent in one fifth of them (21.6 percent). Therefore, most companies in the data set show an ESG impact on at least 15 percent of total compensation, confirming a trend towards increasing economic relevance of ESG-related compensation.[85]

In the US, S&P 500 companies have increasingly tied executive compensation to some form of ESG performance, with their share growing from 66 percent in 2020 to 73 percent in 2021.[86] However, just a minority of the corporate executives polled by The Conference Board believe that including ESG performance goals in executive pay is very important in achieving their ESG goals. Incorporating ESG measures into compensation is rather part of companies' broader efforts to achieve their objectives.[87] The top two reasons for not tying executive compensation to ESG is the challenge of defining specific goals, followed by scepticism about their effectiveness.[88]

An article by Lucien Bebchuk and Roberto Tallarita provides a conceptual and empirical analysis of the current US trend and exposes its fundamental flaws and limitations.[89] They identify two structural problems with the use of ESG compensation metrics. First, ESG metrics commonly attempt to tie CEO pay to limited dimensions of the

---

[85] As to the remaining companies, 17% of the total do not provide any percentage for the ESG impact on remuneration, 3% show an ESG impact on 0-5% of remuneration, 12.9% on 5-10%, and 6.4% on 10-15% of the total remuneration amount. Data also show that the same companies introduced either malus (19% of the total) or clawback provisions (1.4%) or both (22.3%) in ESG-based compensation. The presence of similar clauses in ESG compensation confirms the strategic relevance of ESG targets in the business strategy of listed companies.
[86] See The Conference Board and ESGAUGE**,** Linking Executive Compensation to ESG Performance**,** October 28, 2022, 3, available at https://www.conference-board.org/topics/esg-risks-and-opportunities/linking-executive-compensation-to-ESG-performance, noting the most significant increase in companies' use of diversity, equity & inclusion (DEI) goals, rising from 35 percent in 2020 to 51 percent in 2021, and of carbon footprint and emission reduction goals growing from 10 percent in 2020 to 19 percent in 2021.
[87] Ibidem, 10. Leading reasons to incorporate ESG measures into executive compensation are to signal that ESG is a priority, to respond to investor expectations, and to achieve ESG commitments the firm has made. However, there are other less costly and disruptive ways of signaling ESG is a priority, such as building ESG factors into professional development, succession, and promotion practices. Companies can also convey or achieve their commitment to ESG by enhancing disclosure on ESG performance.
[88] Ibidem, 12.
[89] Lucian A. Bebchuk & Roberto Tallarita, "The Perils and Questionable Promise of ESG-Based Compensation", Journal of Corporation Law, Volume 48, pp. 37-75 (2022).

welfare of a limited subset of stakeholders. The use of these metrics could well ultimately hurt, not serve, aggregate stakeholder welfare. Second, the push for ESG metrics overlooks and exacerbates the agency problem of executive pay. To ensure that they are designed to provide effective incentives rather than serve the interests of executives, pay arrangements need to be subject to effective scrutiny by outside observers.

Bebchuk and Tallarita's empirical analysis shows that in almost all cases in which S&P 100 companies use ESG metrics, it is difficult for outside observers to assess whether these metrics provide valuable incentives or merely line CEO's pockets with performance-insensitive pay. Practices for using ESG metrics, they conclude, likely serve the interests of executives, not of stakeholders. This conclusion however seems to be too extreme as other reasons might explain ESG compensation, such as the willingness of the board to underline some corporate sustainability targets and promote them through specific incentives to the managers which are also publicized to investors.

5.3 Sustainability Regulation in the EU

There have been several key updates to EU corporate governance since 2017, which also impact on the executive remuneration behaviour. These updates encompass new rules for listed companies with an increased focus on sustainability and the consideration of ESG factors in the pay incentives.

The EU Directive on Corporate Sustainability Reporting ("CSRD"), which was adopted by the European Parliament in June 2021, aims to establish a framework for sustainability reporting by companies operating in the EU.[90] The directive requires large companies to report on their ESG performance, including on issues such as climate change,

[90] Directive (EU) 2022/2464 amending Regulation (EU) No 537/2014, Directive 2004/109/EC, Directive 2006/43/EC and Directive 2013/34/EU, as regards corporate sustainability reporting

human rights, and diversity, also making it mandatory for companies to have an audit of the sustainability information that they report.

The CSRD pays attention to the social aspect of remuneration, encouraging companies to adopt policies and practices that ensure fair and equal treatment of all employees, regardless of gender or other characteristics. Specifically, Article 19 of the Directive states that "large undertakings shall provide information on their policies, risks and outcomes related to, among others, gender equality, equal pay for equal work and work-life balance." By requiring companies to report on their gender pay gap and equal pay policies, the directive aims to contribute to the broader goal of achieving gender equality and promoting diversity in the workplace. The reporting requirements are intended to enable investors and other stakeholders to assess the sustainability performance of companies and make informed decisions based on ESG criteria.

The EU Sustainability Due Diligence Directive aims to establish a framework for sustainable corporate governance and due diligence, by making companies responsible for identifying, preventing, and addressing sustainability risks throughout their entire supply chains.[91] The Directive has the potential to be one of the EU's most far-reaching pieces of environmental, social and governance regulations. While most other ESG rules impose disclosure requirements on companies, the Sustainability Due Diligence Directive would force them to act on the information they are disclosing. A key focus is to make sure that companies have transition plans for climate change mitigation. The wide-ranging regulation also require companies to identify and address human rights and environmental abuses in their value chains.

[91] Directive (EU) 2024/1760 of the European Parliament and of the Council of 13 June 2024 on corporate sustainability due diligence and amending Directive (EU) 2019/1937 and Regulation (EU) 2023/2859

5.4 ESG and "Say on Pay"

As outlined above, the practice of linking incentive pay for senior executives to performance on ESG factors has surged in the past years. In 2021, Institutional Shareholder Services (ISS), world's largest proxy voting advisor, announced that it was proposing to assess ESG metrics in executive pay in a similar manner to financial metrics.[92] This means that ISS evaluates how well the ESG metrics are aligned with the company's strategy and stakeholders' interests, how challenging and transparent the performance targets are, and how reasonable and consistent the pay outcomes are. ISS also stated that it would consider the quality and relevance of the ESG metrics, as well as the disclosure and engagement on them, when making its voting recommendations on remuneration policies and reports. ISS' 2023 policy update considers that the company's board or compensation committee is generally in the best position to determine the performance metrics, whether they are financial or ESG specific, while affirming that improved disclosure about the committee's rationale and considerations of pay metrics (including those for ESG topics) may benefit shareholders.[93] The policy also includes social considerations, by expecting directors' annual salary increases to be lower proportionally than general increases across the broader workforce is considered to be good market practice.

Several investors and entities representing institutional investors have also updated their own proxy voting policies in the last three years, particularly to reflect their views on ESG issues, such as climate change, diversity, and human rights. BlackRock, the world's largest asset manager, announced in 2020 that it would make sustainability a core goal for its investments and use its voting power to pressure companies to address climate risks. In its proxy voting guidelines, BlackRock stated that it expected companies to align their executive

[92] Institutional Shareholder Services, "Proposed ISS benchmark policy changes for 2022", available at: https://www.issgovernance.com/file/policy/proposed-benchmark-policy-changes-2022.pdf
93 Institutional Shareholder Services, "ISS Announces 2023 Benchmark Policy Updates", available at: https://insights.issgovernance.com/posts/iss-announces-2023-benchmark-policy-updates/

pay with long-term performance and value creation, and to incorporate relevant ESG metrics into their incentive plans.[94] State Street Global Advisors, another major asset manager, updated its proxy voting guidelines in 2021 to include more ESG factors, such as board diversity, racial equity, and climate disclosure.[95] CalPERS, the largest public pension fund in the U.S., adopted a new proxy voting policy in 2021 that supports shareholder proposals on ESG issues and opposes dual-class share structures.[96] Both State Street Global Advisors and CalPERS would vote against the compensation committee chair or the entire committee if the link between executive pay and performance is not sufficiently robust or if it lacks transparency.

Several other institutional investors such as Legal & General, Amundi and others also argue that ESG should be considered as part of the overall performance evaluation process for executives.[97] The UK Investment Association, a trade body representing UK investment managers, publishes annually its Principles of Remuneration, which set out the expectations of its members on executive remuneration. Among the main updates are the Association's expectation that companies align executive pay with long-term value creation and incorporate relevant ESG metrics into their incentive plans.[98] The Investment Association also expects companies to disclose clear and measurable performance criteria for both financial and non-financial objectives and to explain how they are linked to the company's long-term value drivers and material ESG factors. Some investors have gone further. Cevian Capital announced in 2021 their intention to vote against any company remuneration policy that does

94 Blackrock Proxy Voting Guidelines available at: https://www.blackrock.com/corporate/insights/investment-stewardship
95 State Street Global Advisors Proxy Voting and Engagement Guidelines available at: https://www.ssga.com/us/en/institutional/ic/about-us/what-we-do/asset-stewardship
96 CalPERS Proxy Voting Guidelines available at: https://www.calpers.ca.gov/page/investments/corporate-governance/proxy-voting
97 LGIM's UK Principles on executive pay, October 2022, available at: https://www.lgim.com/; Amundi Voting Policy available at: www.amundi.com
98 The Investment Association Principles of Remuneration, available at: https://www.theia.org/

not include ESG targets in executive pay.[99] They think that the “say on pay” process can be used to create accountability between companies and their investors on the short to medium-term ESG goals that will lead towards longer term aspirations.

These developments signal the importance that investors attach to the progress on ESG issues, increasingly on a par with financial performance. ESG is fast becoming a standard component of executive pay, but it is still a relatively new practice and we have not seen the full consequences, nor whether companies have successfully addressed the many challenges involved. Target setting in particular is complex for ESG issues – and there is no clarity whether the calibration done to date, particularly for long-term goals, is fit for purpose. The corporate ESG movement is simultaneously altering the behaviour of both companies and investors. With investors working to integrate sustainability issues into their investment decisions as well as their stewardship duties and proxy voting policies, companies are seeking to respond by defining their purpose and integrating ESG and sustainability issues into their financial reporting, shareholder communications, investor relations, board engagement and voting campaigns.

6. Governance Mechanisms

6.1. Boards

The effectiveness of the incentive contract largely depends on the management of agency problems between the board and shareholders and on adequate monitoring by, inter alia, independent directors and, ultimately, shareholders.

99 Cevian Capital Requires ESG Targets in Management Compensation Plans, 2021,, available at: https://www.ceviancapital.com/wp-content/uploads/2021/03/03.03.2021-Cevian-Capital-Requires-ESG-Targets-in-Management-Compensation-Plans.pdf

A board may become passive or captured by management, and hence poorly incentivized to bargain for optimal incentive pay in shareholder interests. The addition of independent directors to the board (or board remuneration committee) may provide a solution and is a dominant theme of regulatory responses to remuneration, albeit adjusted, in blockholding systems, to reflect the influence of controlling shareholders.[100] Independent, well-resourced, informed, and competent directors should be able to withstand any overbearing influence of senior management and be more likely to judge performance in the shareholders' interests and with respect to the company's performance.[101]

There are, however, certain impediments to optimizing the presence of independent directors. Independent directors in given circumstances may be reluctant to disturb the status quo or may be incentivized to set pay in a manner beneficial to them where they are serving executive directors. They may lack expertise on pay or have insufficient time to become expert. Disclosure flows to independent directors on corporate performance may be unreliable. Reputational factors, which may result in an independent director who is regarded as "tough on pay" being blacklisted from other boards may arise. The empirical evidence on the effectiveness of independent directors is equivocal.[102] It has also been suggested that independent directors have not always controlled executive pay but rather presided over its explosion.[103]

One way out of this impasse is to impose rigorous controls on the independence of nominally independent directors, which can only be achieved to a limited degree in

[100] Guido Ferrarini & Marilena Filippelli, "Independent Directors and Controlling Shareholders around the World", in Hill, G. Jennifer; Thomas, S. Randall (eds), "Research Handbook on Shareholder Power" (Edward Elgar Publishing, 2015).
[101] Reinier Kraakmann, Disclosure and Corporate Governance: An Overview Essay, in Reforming Company and Takeover Law in Europe (Guido Ferrarini et al. eds., 2004).
[102] Roberta Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance", 114 Yale L. J. 1521 (2005).
[103] Sanjai Bhagat & Bernard Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance", 27 J. Corp. L. 231 (2002).

blockholding systems. Composed primarily of independent directors and exercising pay-setting functions delegated from the board, the remuneration committee can act as an objective control on the pay-setting process. However, the remuneration committee may be particularly ineffectual in blockholding companies playing, in effect, a fictional role as pay is set by the controlling shareholders directly, although it has a potentially important role in minority shareholder protection.

While external remuneration consultants provide expertise in the complex area of pay design and improve disclosure flows to the remuneration committee, they are also vulnerable to capture by the board and may exacerbate problems by acting as a camouflage mechanism to legitimize suboptimal pay decisions, unless selected by and accountable to the remuneration committee.[104]

6.2 Shareholders

The effectiveness of back-stop shareholder monitoring of the incentive contract and the pay-setting process lies at the core of the pay-setting problem in the dispersed-ownership context. As effective monitors, whether via direct shareholder voice mechanisms, such as votes on pay, or via indirect lobbying, shareholders suffer from the collective action problem and from lack of information. Collective action problems are exacerbated in the case of executive pay as shareholders are unlikely to see substantial individual gains from a potential reduction in executive pay, and may suffer if management incentives are damaged. An examination of the optimality of pay decisions requires careful case-by-case analysis of disclosure which, even where it is made available, can be difficult for shareholders. Institutional investors are, albeit controversially, often regarded as potentially strong

[104] Bebchuk et al. (2002); Jensen & Murphy (2004).

corporate monitors. The extent to which institutional investors can bear on the pay process is, however, doubtful.[105]

The collective action problem arises and is aggravated by the need for institutions to have diversified holdings,[106] which dilutes the ability of institutional investors to focus on company-specific issues. Institutions may not communicate effectively as a group and so fail to influence the board. Agency problems can also arise within an institutional investor, where, for example, an investor's corporate governance team faces pressure from other internal groups which provide services to a company's management.[107] Institutional investors may also be prone to short-termism and ill-equipped to undertake successful long-term monitoring of executive pay strategies. However, there is some US evidence that large shareholders (5 percent and over) can act as an effective governance mechanism with respect to remuneration.[108] Law, and particularly mandatory disclosure, appears to matter in this context, as the changes to UK company law in 2002 requiring a shareholder vote on the Director's Remuneration Report appeared to galvanize institutional investors into action, as we argue below.

A significant development in recent years has been the rise of shareholder engagement. This mainly depends on the re-concentration of ownership in the hands of institutional investors and on the willingness of many of these to behave as active

[105] Brian R. Cheffins & Randall S. Thomas, "Should Shareholders Have a Greater Say over Executive Pay? Learning from the US Experience", 1 J. Corp. L. Stud. 277 (2001); Jeffrey Gordon, "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In", 46 Harvard J. Legislation 323 (2009).
[106] Klaus Hopt, "Modern Company and Capital Market Problems. Improving European Corporate Governance after Enron", ECGI Working Paper No. 5 (2002), available at www.ecgi.org.
[107] Roberta Romano, "Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance", 18 Yale J. Reg. 174 (2001).
[108] Bertrand & Mullainathan (2001); Marinilka B. Kimbro & Danielle Xu, "Shareholders have a say in executive compensation: Evidence from say-on-pay in the United States", Journal of Accounting and Public Policy, Volume 35, Issue 1 (2016).

investors.[109] While there are also other issues to debate (such as corporate social responsibility), remuneration stands out as a topic on which investors have significant interest.[110] Generally, companies engage with shareholders on executive compensation well ahead of the annual general meeting. While initially engagement occurred primarily in cases in which a "no" recommendation had been issued by proxy advisors on a company's pay policy or other negative feedback had come from significant shareholders, it is accepted today that dialogue with shareholders should take place in all circumstances.[111] Indeed, not only pay practices but also corporate performance drive proxy advisors' recommendations and voting by institutional investors.[112] Therefore, a negative recommendation or vote could be issued simply on the basis of a perceived disconnect between pay and corporate performance or shareholder return, regardless of how carefully remuneration structures comply with best practices.

6.3 Disclosure

Disclosure may provide the least costly way to manage the range of potential agency costs by ensuring that shareholders have sufficient information on remuneration as well as on any potential conflicts in the remuneration-setting process. It is also a more limited form of intervention in governance, which would allow flexibility and increase transparency in

---

[109] Ronald J. Gilson & Jeffrey N. Gordon, "The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights", 113 Colum. L. Rev. 863 (2013); Brian R. Cheffins, "The Corporate Governance Movement, Banks and the Financial Crisis", ECGI Law Working Paper No. 232 (2014) available at: www.ecgi.org.

[110] European Commission, Summary of the informal discussions concerning the initiative on shareholders engagement (March 2013), available at http://ec.europa.eu.

[111] European Commission (2013).

[112] Gomtsian, Suren, Executive Compensation, "Investor Preferences During Say-on-Pay Votes and the Role of Proxy Voting Advisors" (February 5, 2023). TILEC Discussion Paper No. 2023-02 (forthcoming in Legal Studies), Available at SSRN: https://ssrn.com/abstract=4351613; National Bureau of Economic Research (NBER), Investor Proxy Voting: Influences and Consequences (2023), available at: https://www.nber.org/system/files/working_papers/w31636/w31636.pdf

remuneration-setting in dispersed and blockholding ownership companies.[113] Disclosure requirements prompt the board to justify pay choices and the pay-setting process and can also enhance the accountability and visibility of the remuneration committee. They can also sharpen shareholder monitoring, particularly by inducing institutional shareholders to play a more active role. Disclosure of pay lowers the cost of monitoring by raising the reputation of institutional investor monitors by signalling or publicizing the results of their active approach and generating greater deterrence effects. It also facilitates communication between institutional investors and with company management.

While disclosure is traditionally associated with minimal regulatory intervention, there are costs involved. The benefits of potentially greater shareholder activism must be weighed against popular and political reaction to enhanced disclosure of executive pay. With enhanced disclosure, pay questions are played out in the media, influenced by labour, captured by private interests (such as those of political activists and union personnel), and politically infused. Remuneration committees may be vulnerable to responding to political and workforce pressures and adopting suboptimal remuneration structures which are not sufficiently sensitive to performance.[114] Disclosure which focuses on headline pay levels invites popular hostility and does not assist shareholders in assessing remuneration structures, and the pay-setting process is destabilizing.[115] By contrast, disclosure which makes it easier to assess the pay-performance relation/incentive structure and the effectiveness of governance can remedy some of the structural and process weaknesses of executive remuneration. Among other possible drawbacks of excessive disclosure, there is the risk that disclosure may result in an increase in pay due to a ratcheting effect.

[113] Ferrarini et al. (2009).
[114] Romano (2001).
[115] Murphy (1995).

7. Regulation of Pay Governance and Disclosure

7.1 The EU Commission's Recommendations

Disclosure, shareholder voice, and the independent remuneration process all appear in the EU's strategy regarding executive pay. The EU's initial approach, set out in the 2004 and 2005 Recommendations, was based on the governance of remuneration.[116] To achieve its objectives, the Commission initially employed non-binding Recommendations, avoiding a "one-size-fits-all" solution at the Member State and firm levels.

The 2004 Recommendation aimed to improve efficient pay through mechanisms such as disclosing company pay policies, detailed individual director pay disclosures, shareholder votes on pay policy, and prior approval of share-based schemes. The role of non-executive directors in pay setting was addressed in the 2005 Recommendation, emphasizing board composition, independence, and remuneration committee roles. 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 on the related "comply or explain" principle.[117] In fact, poor compliance need not necessarily follow from soft law implementation; companies that voluntarily adopt more rigorous corporate governance structures can be rewarded by a positive effect on firm value.[118]

---

[116] Ferrarini et al. (2010); Niamh Moloney, The EU and Executive Pay: Managing Harmonization Risks, in Research Handbook on Executive Pay 466 (Randall S. Thomas and Jennifer G. Hill eds., 2012).

[117] European 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 (COM SEC(2007) 1021) (2007).

[118] Manuel Ammann, David Oesch, & Markus M. Schmid, "Corporate Governance and Firm Value: International Evidence", 18 Journal of Empirical Finance 36 (2011); Reena Aggarwal & Rohan Williamson, Did New Regulations Target the Relevant Corporate Governance Attributes?, Georgetown University Research Paper (2006), available at www.ssrn.com; Valentina Bruno & Stijn Claessens, "Corporate Governance and Regulation: Can There Be Too Much of a Good Thing?", 19 J. Fin. Intermediation 461 (2010); Vidhi

Executive pay in non-financial firms was pulled into the Commission's wider financial crisis reform agenda with the adoption of a 2009 Recommendation on Directors' Remuneration, which introduced several important approaches on regulating executive remuneration. Through it the Commission moved closer to the problematic yet politically appealing design sphere. The 2009 Recommendation expanded on executive pay in non-financial firms, particularly amid the financial crisis, anticipating the stricter regulations that were adopted later on. Noting 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,[119] the Commission introduced voluntary principles for remuneration structure, emphasizing the link between pay and performance, long-term sustainability, and limiting excessive variable pay. The recommendation touched on remuneration policy disclosure, remuneration committee composition, and design considerations. However, it also suggested potential limitations on variable pay, proportionality of executive director remuneration, and intrusive deferral of pay.

The Recommendation goes further and appears imbued with a concern to reduce pay levels, suggesting that undefined "limits" should be placed on variable pay, given the benefits of incentive alignment. This was seen as an undue incursion into corporate autonomy.[120] 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. While efforts have been made by some Member States to address

Chhaochharia & Luc Laeven, "Corporate Governance Norms and Practices", 18 J. Fin. Intermediation 405 (2009).

[119] European Commission, Communication from the Commission accompanying Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector {C(2009) 3159} {C(2009) 3177} (April, 2009).

[120] Richard A. Posner, "Are American CEOs Overpaid, and, if So, What if Anything Can be Done about It?", 58 Duke L. J. 1013 (2009).

proportionality concerns, this has not been widespread and there has been little evidence that intervention in support of “reasonable” pay works.[121]

The Commission has also suggested that a certain number of shares be retained by directors until the end of their mandate. Performance share plans, particularly linked with director shareholding periods, have proved to be a very useful mechanism for aligning director interests more effectively with long-term performance and have been a feature of several Corporate Governance Codes.[122]

The EU regulatory framework based on non-binding recommendations proved unsuccessful in embedding good practices with respect to remuneration governance across Europe’s largest companies.[123] Significant differences continued to persist across Member States’ regulatory regimes and in pay governance practices.[124] Institutional investors were not persuasive in demanding better practices either, which may reflect the difficulties they faced in assessing industry-wide practices, given the generally poor disclosure.

7.2 Say on Pay. Origins

Pressure over dealing with “inappropriate” executive compensation, be it understood as either “excessive” or misaligned with shareholder value, has led to initiatives giving investors greater influence over executive pay through a vote on companies’ remuneration policies and packages, i.e., through the “say on pay” process.

---

[121] Randall Thomas, International Executive Pay: Current Practices and Future Trends, in International Executive Pay: Current Practices and Future Trends (Randall Thomas ed., 2009).

[122] The UK Corporate Governance Code, Financial Reporting Council (2014), Italian Corporate Governance Code, Italian Corporate Governance Committee (2011), French Corporate Governance Code of Listed Corporations, AFEP-MEDEF (2013).

[123] Commission, Report on the application by Member States of the EU of the Commission Recommendation on directors’ remuneration (2007) (SEC(2007) 1022); 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).

[124] Ferrarini et al. (2009, 2010); Roberto Barontini et al., Directors’ Remuneration before and after the Crisis: Measuring the Impact of Reforms in Europe, in Boards and Shareholders in European Listed Companies: Facts, Context and Post-Crisis Reforms 251 (Massimo Belcredi and Guido Ferrarini eds., 2013).

In the US, as a consequence of the 2007-2008 financial crisis, votes on pay have been mandatory since the adoption of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, but the voting result is not binding.[125] Most European jurisdictions introduced in their governance codes an advisory vote on the remuneration policy and a binding vote on equity-based incentive schemes. A few regulators went further, introducing binding votes on pay policy, in the hope that such votes would determine corporations to be more conservative with respect to the total amount paid to their executives and that this would be more driven by corporate performance. The Netherlands, Sweden and Norway, however, had already required binding "say on pay" before the financial crisis.[126]

Post-crisis and before the implementation of the SRD, reforms not only regarded the nature of the vote (binding or advisory), but also the possible shift of voting requirements from best practice principles to legislation. Spain and Italy were among the first countries to introduce a similar rule in their corporate laws, while France extensively debated the issue at government level.[127] The UK traditionally had the most extensive set of governance requirements in force with respect to executive compensation in Europe. Listed companies have been required to prepare a Directors' Remuneration Report since 2002 and submit it to the advisory vote of shareholders.[128] Despite similar regulatory measures, during the 2007-2008 financial crisis UK companies—banks in particular—raised serious concerns for what many observers considered as "excessive executive pay."[129] This led the government in 2011

[125] See note 13866 for references to the Act.
[126] David Larcker, Allan L. McCall, & Gaizka Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms", 58 J. L. & Econ. 173 (2015); Ertimur et al. 2013.
[127] Spain: CMVM Regulation No. 1/2010 Corporate Governance (2010); Italy: Art. 84-quarter, Consob. Regulation 11971/1999 implementing Italian Legislative Decree No. 58 of 24 February 1998, concerning the discipline of issuers; France: Consultation sur la remuneration des dirigeants d'enterprise (2012), available at www.tresor.economie.gouv.fr.
[128] The Directors' Remuneration Report Regulations (2002). Schedule 7A of the Companies Act 1985, re-enacted in Regulation 11 and Schedule 8 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008, available at www.legislation.gov.uk.
[129] Ferrarini & Ungureanu (2010).

and 2012 to announce a reform directed to curb executive pay through greater remuneration transparency, more shareholder powers, and more diverse board and remuneration committees.[130]

The effects of "say on pay" started to be felt soon after the launch of these reforms. The case of UK companies failing to receive majority support for their pay policies in 2011 could be considered representative for the history of "say on pay."[131] In the US, by comparison, the immediate impact of the first reforms introducing the vote on remuneration was modest. Amongst the Russell 3000 companies with "say on pay" votes occurring between September 2011 and June 2012, 2.4 percent failed to achieve shareholder support levels of 50 percent or higher. These results point to a slight rise in "say on pay" failure rates compared to 2011, when 1.6 percent of Russell 3000 companies failed over the same timeframe.[132]

7.3 Revision of the Shareholders Rights Directive (SRD II)

In 2014 the European Commission proposed a revision of the 2007 Shareholder Rights Directive, including measures to improve the corporate governance of listed companies in an effort to increase their transparency and long-term sustainability. The Shareholder Rights Directive as amended by the Shareholder Rights Directive 2017 (SRD II) aims to improve corporate governance and transparency by enhancing the rights of

[130] The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013. Department of Business, Innovation & Skills (2013).

[131] For example, at the AGM of Barclays, over 25 percent of shareowners voted against the company's pay plan at a very tumultuous meeting; Barclays Stung by Shareholder Pay Revolt, April 27, 2012, BBC News, available at www.bbc.co.uk/news/business. Shareholder discontent over pay also contributed to the exit of insurer Aviva's CEO, who resigned five days after 54 percent of shareowners voted against pay at the company's annual meeting; Aviva Rocked by Shareholder Rebellion over Executive Pay, Guardian, May 3, 2012, available at www.guardian.co.uk/business. Over 40 percent of WPP investors voted "no" on pay, prompting the company's compensation committee chair to reach out to investors prior to the upcoming AGM to defend a 30 percent pay raise for the company's CEO; WPP Shareholders Vote against £6.8m Pay Packet for Sir Martin Sorrell, Guardian, June 13, 2012, available at www.guardian.co.uk/media.

shareholders in EU listed companies, aiming to encourage shareholders to engage more with the companies they invest in and to take a longer-term perspective on their investments, while also promoting sustainable and responsible corporate governance.[133]

The directive calls companies to provide a clear, understandable remuneration policy, in line with the business strategy, long-term interests, and sustainability of the firm. The policy sets clear criteria and explanations for the award of fixed and variable remuneration; explains how the pay and employment conditions of employees of the company should be taken into account when establishing the remuneration policy; indicates the main terms of the contracts of directors and the decision-making process leading to their determination.

One of the key provisions of the SRD II is the "say on pay" vote. Shareholders have been attributed the right to vote on director remuneration policy at least every four years. The vote could be binding or advisory, at the choice of the EU country. In either case, when a policy is rejected by shareholders, a revised policy must be submitted for approval at the following general meeting. Once the shareholders have approved the remuneration policy, a company will not be permitted to pay remuneration to directors other than in accordance with that policy. Through the SRD II shareholders are also enabled to vote on a company's remuneration report, which describes how the remuneration policy has been applied in the last year, their vote being advisory only. Where the shareholders vote against the remuneration report, boards need to explain in their next remuneration report how the vote of the shareholders has been taken into account. The remuneration report needs to be clear and understandable, including information on the total remuneration split out by component; the relative proportion of fixed and variable remuneration; how the total remuneration complies with the adopted remuneration policy; and how the performance criteria were applied.

---

[133] Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

The SRD II applies the proportionality principle, EU countries allowing small- and medium-sized enterprises to have a discussion at the general meeting as an alternative to a vote.The directive does not regulate the level of remuneration, leaving decisions on this to companies and their shareholders. The SRD II was transposed by EU Member States starting in 2019. As a result, in all EU jurisdictions investors are enabled to vote on issuer companies' remuneration. In some jurisdictions the "say on pay" proposals have evolved from being advisory to binding, securing investors a significant opportunity to voice and forcing companies to implement their concerns about pay structures.

Looking at EU jurisdictions, we can observe some differences in adoption. While most countries, including France,[134] Italy (for banks and insurance companies)[135] and Sweden[136] adopted a binding vote on the remuneration policy, some jurisdictions such as Germany,[137] Spain,[138] Finland,[139] opted for an advisory vote on the policy. France went further by requiring an annual binding vote on the remuneration policy, which is stricter than the SRD requirement of a vote every four years followed by most countries. The Dutch Law has stricter requirements: a remuneration policy needs the support of at least 75 percent of votes cast to be approved.[140] Additionally, Dutch companies must explain how the board accounted for "social acceptance" and the advice of work councils when formulating the remuneration policy.

---

134 Law No. 2019-1728 of December 28, 2019, relating to the growth and transformation of companies, also known as the PACTE law, 2019
135 Legislative Decree 49/2019, 2019
136 Shareholder Rights Act (Aktiebolagslagen) amended in 2019
137 The German Act Implementing the Second Shareholder Rights Directive (Gesetz zur Umsetzung der zweiten Aktionärsrechterichtlinie – ARUG II), 2020
138 Law 5/2021 of 12 April, which modifies the consolidated text of the Capital Companies Act, approved by Royal Legislative Decree 1/2010 of 2 July, and other financial regulations, regarding the promotion of shareholders' long-term involvement in listed companies, 2021
139 Securities Markets Act (SEAD), amended in 2019
140 The Dutch Act to implement the revised EU Shareholders Rights Directive of 5 November 2019

In 2019, the UK adopted a binding vote on the remuneration policy.[141] After Brexit, the UK is no longer subject to EU law, including the SRD II, which means that the UK is free to set its own laws on executive compensation. At the time of writing, the UK government has not yet announced any plans to change the law on executive compensation. The UK continues to be governed by the Companies Act 2006 and the Corporate Governance Code, which provide a framework for the determination of executive compensation in the UK.

No doubt, “say on pay” has increased the power of proxy advisory firms, especially the two largest, Institutional Shareholder Services (ISS) and Glass Lewis and Co. Similar to rating agencies prior to the financial crisis, these firms have implicitly acquired significant power as to the shaping of corporate governance policies in US public companies and their influence has spread over to Europe and Asia as well.[142] Research conducted during the advent of the “say on pay” regulations showed a strong correlation between recommendations of proxy advisors and proxy voting by institutional shareholders.[143] Proxy advisors have had a "significant influence" on institutional investors' votes on proposals related to a variety of issues, including executive compensation, shareholder rights, and corporate governance.[144]

However, there is evidence that such influence may not be for the better in terms of shareholder value enhancement. For example, research found that, when public companies implement certain principles defined by proxy advisers as “best practices” (in this case with

---

[141] Companies (Shareholders' Rights) (Amendment) Regulations 2019

[142] Ertimur et al. 2013; Massimo Belcredi et al., “Say-on-Pay in a Context of Concentrated Ownership. Evidence from Italy”, CONSOB Working Papers No. 76 (2014), available at www.ssrn.com.

[143] Larcker et al. (2015); Ertimur et al. (2013).

[144] Chong Shu, "The Power of Proxy Advisors: Myth or Reality?", Journal of Financial Economics, Vol. 132, No. 3, 2020, pp. 645-668; Reena Aggarwal, “The Influence of Proxy Advisors on Institutional Investors’ Voting Behavior”, Journal of Financial Economics, Vol. 119, No. 2, 2015, pp. 283-305; Andrei Malenko and Andrey Malenko, "The Influence of Proxy Advisors on Institutional Investors' Voting: A Multifactor Analysis", Journal of Corporate Finance, Vol. 48, 2019, pp. 1-17; Jennifer E. Bethel & Stuart L. Gillan, The Impact of Institutional and Regulatory Environment on Shareholder Voting, 31 Financial Management 29 (2002); Jie Cai, Jacqueline L. Garner, & Ralph A. Walkling, “Electing Directors”, 64 J. Fin. 2389 (2009); David F. Larcker, Allan L. McCall, & Brian Tayan, The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions, The Conference Board: Trusted Insights for Business Worldwide (2012), available at http://www.gsb.stanford.edu.

regard to stock option exchange programs), gains in shareholder value are on average 50 percent to 100 percent less than at other firms.[145] Conflicts of interest of proxy advisory firms have also become an issue, so that regulators from Europe and the US have proposed to regulate these firms; and the policy debate continues.[146]

As a result of the ambiguous benefits of proxy advisors and of increased shareholder activism, several investors have reduced their reliance on advisors' recommendations in recent years. In fact, research in 2023 by the UK Financial Reporting Council (FRC) into the proxy voting advisory industry found that, while its voting recommendations "undoubtedly have some influence on behaviour and voting decisions", the "nature and extent of the influence may be more nuanced and less clearcut" than many companies, stakeholders and other commentators believe it to be.[147] The FRC research found that while almost all investors polled used the services of proxy advisors, 75 percent of them ask for voting research to be based on the their own in-house voting polices rather than the advisors' standard or benchmark policies.

7.4 US Regulation

During the 2007-2008 financial crisis, historically high executive compensation created political headwinds for companies receiving taxpayer-funded bailouts. Certain provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act on July 21, 2010,[148] address such concerns and promote corporate responsibility by requiring that public

---

[145] Larcker et al. (2015).
[146] For EU see ESMA, An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options (March 2012), available at http://www.esma.europa.eu/. For US see SEC, Opening Statement at the Proxy Advisory Services Roundtable (December 2013), available at www.sec.org
[147] Financial Reporting Council, "The influence of proxy advisors and ESG rating agencies on the actions and reporting of FTSE350 companies and investor voting", available at: https://www.frc.org.uk/news/june-2023/frc-publishes-research-on-impact-of-proxy-advisers
[148] The Dodd–Frank Wall Street Reform and Consumer Protection Act ("The Act"), Pub. L. No. 111-203, enacted July 21, 2010.

companies provide stockholders with additional information and the opportunity to express their opinions on public company executive compensation practices. Among other things, Dodd-Frank tasked the SEC with adopting rules to provide stockholders the opportunity to vote, on a non-binding advisory basis, on executive compensation, as well as require that public companies disclose pay-versus-performance information, the ratio of the compensation of CEOs to the median employee compensation, and "golden parachute" compensation arrangements in connection with merger transactions, in each case to inform stockholder voting decisions.

On August 25, 2022, the SEC released its final rules implementing Section 14(i) of the Securities Exchange Act of 1934, which requires companies to provide a clear description of the relationship between executive compensation and company performance, in particular the relationship between compensation actually paid to executives and company financial performance across multiple metrics.[149]

The new rules require additional disclosures in annual proxy statements consisting of a table that provides specified executive compensation and financial performance measures for the five most recent fiscal years (three years for smaller reporting companies), as well as details intended to illustrate a clear relationship between executive compensation and performance. Prior to the new rule, public companies were not required to provide investors with comparisons between the company's performance and executives' pay. The rule is complex and certain features, including newly required compensation calculations (including the new concept of executive compensation "actually paid") will require issuers to expend significant resources on compliance.

In October 2022 the SEC adopted Rule 10D-1 under the Securities Exchange Act of 1934, as amended, pursuant to Section 954 of the Dodd-Frank Wall Street Reform and

[149] Item 402(v) of Regulation S-K, Dodd-Frank Wall Street Reform and Consumer Protection Act

Consumer Protection Act of 2010.[150] The rule aims to ensure that executive officers do not receive "excess compensation" if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements. The rule requires issuers to "claw back" excess compensation for the three fiscal years before the determination of a restatement regardless of whether an executive officer had any involvement in the restatement. Listed issuer disclosure requirements include a description of the policy, filing the policy as an exhibit to annual reports, and additional disclosures in the event a recovery analysis is triggered under the policy. The concept of clawbacks is not new. Section 304 of the Sarbanes-Oxley Act of 2002 contains a recovery provision that is triggered when an accounting restatement results from an issuer's misconduct.

8. Financial Institutions

8.1 Regulating Pay Structures. The FSB Principles

The structure of pay is generally set by contract between the corporation and its managers. In a previous paper on executive pay at European banks, we argued that the case for regulating the structure of bankers' pay through prudential regulation appears to be rather weak.[151] First, it is far from proven that pay structures generally contributed to excessive risk taking before the financial crisis. According to some of the studies cited above, corporate governance and compensation structures of CEOs at banks that failed were not necessarily flawed. Second, even assuming that compensation structures were flawed—in particular, those of traders and other middle-managers taking excessive risks for banks—the need for

[150] Section 10D to the Securities Exchange Act of 1934
[151] Guido Ferrarini & Maria Cristina Ungureanu, "Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks", 62 Vand. L. Rev. 429 (2011).

their regulation would not be automatically established. In fact, excessive risk taking could be curbed directly through prudential regulation of banking activities, rather than by modelling the incentives of bank employees, also given that regulators may not be professionally qualified for designing pay structure.[152] Thirdly, mandating pay structures hampers the flexibility of compensation arrangements, which need tailoring to individual firms and managers, also in light of the latter's portfolios of their own bank securities. Moreover, in this context, bank boards could lose one of their key governance functions, finding it more difficult to align executives' incentives to corporate strategy and risk profile. This could also create problems in keeping and attracting managerial talent, particularly from countries that adopt a more liberal stance.

Nonetheless, competent authorities are expected to supervise bankers' compensation from the perspective of bank safety and soundness. Rather than designing compensation structures ex ante, which is a matter for institutions and their boards, they should analyse the impact of actual remuneration structures on risk taking and conduct their surveillance activities accordingly, for instance by imposing higher capital requirements to institutions adopting "aggressive" or inappropriate remuneration mechanisms. Moreover, supervisors should check bank compliance with compensation governance requirements and with the disclosure requirements concerning remuneration policies. Rather than interfering with pay structures, this type of regulation aims to ensure that organizational structures and procedures are in place for the setting of pay in compliance with safety and soundness requirements.

The compensation structures at financial institutions are considered under international soft law by the FSB principles along lines that largely reflect general best practices already adopted before the crisis.[153] However, pre-crisis practices mainly

[152] Blinder (2013).
[153] Ferrarini & Ungureanu (2011).

emphasized the alignment of managers' incentives with shareholder wealth maximization. When issued, the principles broke new grounds by requiring financial institutions to align compensation with prudent risk taking.[154] Accordingly, compensation should be adjusted for all types of risk, including those considered difficult to measure, such as liquidity risk, reputation risk, and capital cost. Compensation outcomes should be symmetric with risk outcomes. Deferment of compensation, traditionally used as a retention mechanism (on the basis that a "bad leaver" would generally lose unpaid deferrals), should make compensation pay out schedules sensitive to the time horizon of risks. A substantial portion of variable compensation (i.e., 40–60 percent) should be payable under deferral arrangements over a period of not less than three years, provided that this period is correctly aligned with the nature of the business, its risks, and the activities of the employee in question. Furthermore, a substantial portion (i.e., more than 50 percent) of variable compensation should be awarded in shares or share-linked instruments, if the same create incentives aligned with long-term value creation and the time horizons of risk. In any event, awards in shares or share-linked instruments should be subject to an appropriate retention policy.

The principles also tackle concerns relative to bonuses, which famously emerged during the recent crisis. They require "malus" and "clawback" mechanisms, which enable boards to reduce or reclaim bonuses paid because of results that are unrepresentative of the company's performance over the long term or later prove to have been misstated. They consider "guaranteed" bonuses (i.e., contracts guaranteeing variable pay for several years) as conflicting with sound risk management and the pay-for-performance principle. Severance packages need to be related to performance achieved over time and designed in a way that does not reward failure.

[154] FSB Principles for Sound Compensation Practices (2009), available at: https://www.fsb.org/

The FSB principles represent a political compromise between the various interests at stake in compensation, incorporating traditional criteria and adapting them to new circumstances by focusing on long-term incentives, in order to counter the role allegedly played in the crisis by short-term incentives. They track already existing practices but extend the same to a greater number of bank employees, and widen the powers of supervisors by explicitly making pay at financial institutions subject to prudential supervision. Like other international financial standards, the principles remain at a sufficient level of generality and allow for flexibility in implementation; in several instances, financial institutions are permitted to depart from a given principle or standard, if application of the same would lead to unsound consequences.

8.2 Dodd–Frank

The FSB principles were implemented along different models.[155] Some jurisdictions follow a primarily supervisory approach to implementation, involving principles and guidance and the associated supervisory reviews. In other jurisdictions the model includes a mix of regulation and supervisory oversight, with new regulations often supported by supervisory guidance that illustrates how the rules can be met. The US initially followed the supervisory model of implementation. However, with the enactment of the Dodd Frank Act a mixed model of implementation was adopted.[156] The Act includes two sets of provisions on executive compensation. On the one side, there are those applicable to all listed companies,[157] touching upon issues like "say on pay"; independence of compensation committees; enhanced proxy disclosure; "clawbacks" of incentive compensation; and

[155] Financial Stability Board, Thematic Review on Compensation: Peer Review Report (2010), available at www.financialstabilityboard.org.
[156] See note 66 for references to the Act.
[157] Provisions contained in Title IX of the Act: sections 951, 952, 953, 954, 955 of the Act.

disclosure of employee and director hedging. On the other, Section 956 of the Act (headed "Enhanced Compensation Structure Reporting") requires Federal regulators of financial institutions to issue new rules in two areas.[158] First, they must jointly prescribe regulations or guidelines requiring each covered financial institution to disclose to the appropriate federal regulator the structure of all incentive-based compensation arrangements in a manner sufficient to determine whether the same provide an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation or could lead to material loss to the covered institution. Second, they must prescribe regulations or guidelines that prohibit any type of incentive-based payment arrangements that encourage inappropriate risks by covered financial institutions by providing an executive officer, employee, director, or principal shareholder with excessive compensation or that could lead to material financial loss to the covered financial institution.

In February 2011 the federal agencies jointly exercised their mandate by approving a proposal on incentive-based compensation arrangements for "covered financial institutions."[159] These are institutions under the supervision of the respective federal regulator, with total consolidated assets of $1 billion or more.[160] The Rule supplements existing rules and guidance adopted by the relevant agencies regarding compensation, including the Interagency Guidance on Sound Incentive Compensation Policies referred to above.

The use of "standards" rather than "rules" analytically defining the compensation structure not only reflects the international Principles, but also the federal regulators'

[158] The FED, the OCC, the OTS, the FDIC, the NCUA, the SEC, and the FHFA are mandated by section 956 of the Act to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions.
[159] The FDIC issued Notice of Proposed Rulemaking on incentive-based compensation arrangements (February, 2011), available at http://www.fdic.gov/news/news/press/2011/pr11027.html. In similar lines with the FDIC proposal, the SEC issued Rules on Incentive-based Compensation for Large Broker-Dealers and Investment Advisors (2011); available at http://www.sec.gov/news/press/2011/2011-57.htm.
[160] Explanatory definitions S. III, § 3, section 956 of the Act.

willingness to avoid a "one-size-fits-all" approach and keep the needed flexibility in compensation arrangements. Under the standards of "reasonable" (as opposed to "excessive") compensation, "balanced" arrangements, and "appropriate" risk taking, the institutions concerned have to tailor their remuneration policies to their businesses and risks, assuming responsibility for the relevant arrangements through good corporate governance and internal control mechanisms. At the same time, the regulators are in a condition to influence the supervised institutions' compensation practices through general guidance and individual inspections. To this effect, the Rule also requires the covered financial institutions to submit an annual report to regulators describing the structure of incentive-based compensation arrangements.

Specific rules apply to "larger covered financial institutions,"[161] such as bank holding companies with consolidated assets of more than $50 billion. In addition to mandating wider disclosure to the Federal regulators, the Rule requires similar institutions to defer at least 50 percent of the incentive-based compensation payments to executive officers over a period of a minimum three years, with the release of the deferred amount to occur no faster than on a pro-rata basis.[162] A "malus" mechanism also applies, in that the deferred amount should be adjusted for actual losses incurred by the institution or other measures of performance during the deferral period. Moreover, if the covered financial institution has consolidated assets of $50 billion or more, the board of directors (or a board committee) shall identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible "substantial" losses. These covered persons may include, for example, traders with large position limits and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution. The board of directors (or

[161] For the federal banking agencies and the SEC, the term "larger covered financial institution" refers to those covered financial institutions with total consolidated assets of $50 billion or more. Section 956, the Act.
[162] S. III, § 5, section 956 of the Act.

a board committee) must approve the incentive-based compensation arrangements for covered persons after determining that the same effectively balance the financial rewards and the range and time horizon of risks associated with the covered person's activities.

8.3 Capital Requirements Directive

The European regulation in this area was deeply overhauled by the Capital Requirements Directive (CRD). The regime applies on a consolidated basis, i.e., to "institutions at group, parent company and subsidiary levels, including those established in offshore financial centres" (Article 92(1)). The ratio for an EU-wide scope of application is "to protect and foster financial stability within the Union and to address any possible avoidance of the requirements laid down in this Directive" (67th considerandum). The regime applies to different categories of staff including senior management, risk takers, staff engaged in control functions, and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile (Article 92(2)). In this regard, the Commission adopted a delegated Regulation including regulatory technical standards on the identification of risk takers.[163]

Article 92(2) requires inter alia that the remuneration policy should be consistent with sound and effective risk management and should not encourage risk taking in excess of the tolerated risk level of the institution. Moreover, the remuneration policy should be in line with the business strategy, objectives, values, and long-term interests of the institution, and incorporate measures to avoid conflicts of interest.

[163] Commission Delegated Regulation of 4.3.2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on an institution's risk profile, available at http://ec.europa.eu/.

Article 94, para. 1 provides several requirements for the variable elements of remuneration. Some of them are rather generic, such as the one requiring performance pay to be based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the institution. In addition, performance should be assessed in a multi-year framework to ensure that the assessment process is based on longer-term performance and that the actual payment of performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks. Moreover, the total variable remuneration should not limit the ability of the institution to strengthen its capital base. Furthermore, the fixed and variable components of total remuneration should be appropriately balanced and the fixed component should represent a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component.

Other requirements in Article 94, para. 1 are more specific, particularly regarding the "bonus cap" that the European Parliament asked to include in CRD IV.[164] Under Article 94(1)(g), the variable component should not exceed 100 percent of the fixed component of the total remuneration for each individual. However, Member States may set a lower maximum percentage (as Belgium and the Netherlands did, by setting 50 percent and 20 percent respectively). Moreover, Member States may allow shareholders of the institution concerned to approve a higher maximum level of the ratio between fixed and variable remuneration provided the overall level of the variable component shall not exceed 200 percent of the fixed component of the total remuneration for each individual. Member States

---

[164] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32013L0036.
Sources for all updates of the Directive can be found on European Banking Authority (EBA) website: https://www.bankofengland.co.uk/prudential-regulation/key-initiatives/capital-requirements-directive-iv.

may also set a lower percentage. In any case, approval of a higher percentage should occur through a special procedure that is described in detail by Article 94(1)(g)(ii).

The official justification for this bonus cap is to avoid excessive risk taking (65th considerandum). However, the provision has generated some debate, particularly on whether the bonus cap is suitable to prevent excessive risk taking by bank managers and traders. As stated by Kevin Murphy, several arguments show that neither the objective to reduce excessive risk taking nor the one to reduce perceived excesses in the level of banking remuneration will be achieved by capping variable remuneration.[165]

First, the bonus cap may lead to an increase in the level of fixed remuneration, making banks more vulnerable to business cycles and therefore increasing the risk of bank failure. Anecdotal evidence shows that fixed pay at large European banks has been on the rise[166]. Secondly, the traditional bonus system at investment banks, which is characterised by below-market salaries and high bonus opportunities, provides strong incentives to avoid "bad" risks and to take "good" ones. On the contrary, the system set by the Directive, characterized by above-market salaries and "capped" bonuses, provides incentives to take "bad" risks and avoid "good" ones. In fact, if bad risks materialize, the bank manager will not suffer, for her remuneration is largely fixed. But, if the bank shuns good risks and the relevant profits, the responsible manager will not be worse off given that his bonus is capped. Indeed, the bonus cap reduces incentives to create value, which is the main purpose of variable pay. Third, executive remuneration is largely set by the markets, so that a bonus cap could also have unintended consequences on the firms' ability to hire people of adequate standing in the international market for managers. In the end, remuneration "will reflect a

[165] Murphy (2013).

[166] Steve Slater, London Banks Are Responding to Bonus Caps with Higher Salaries, Reuters (Nov. 28, 2013), available at www.reuters.com; Nicholas Comfort, Bloomberg News, "Deutsche Bank Seeks Shareholders' Permission to Ease Bonus Cap." (April 10, 2014).

less-talented workforce as the top producers leave for better-paying opportunities in financial firms not subject to the pay restrictions.” In other words, the cap “will not lead to lower levels of overall remuneration after adjusting for ability and the risk of the remuneration package.”[167] Furthermore, the cap on variable pay may reduce the competitiveness of the EU banking sector relative to non-EU banks and other nonbank financial intermediaries which are not subject to similar restrictions. Fourth, the mandatory cap also reflects a “one-size-fits-all” approach, which is clearly too rigid for different types of credit institutions that are presented with different levels of risk exposure, so that an incentive structure which is appropriate for one firm is not necessarily suited to another. Moreover, the EU bonus-cap applies to all credit institutions, without regard to their size and therefore to systemic risk.

The provisions and changes introduced by the CRD V aim to enhance risk management, align remuneration practices with long-term stability, and promote equality within the financial sector.[168] The Directive introduces several clarifications and changes related to material risk takers and remuneration policies in financial institutions. It provides better clarification on individuals who could have a material impact on an institution's risk profile, i.e. material risk takers, and aims to identify specific functions performed by these individuals, ensuring that their roles and responsibilities are clearly defined.

The maximum ratio between fixed and variable remuneration, commonly known as the "bonus cap," continues to apply to all risk takers in all institutions, remaining at 100 percent of an individual's basic salary while, with shareholder approval, it can be extended up to 200 percent of the basic salary. The minimum deferral periods for variable remuneration increase from the previous range of 3-to-5 years to 4-to-5 years, meaning that a portion of the

[167] Id.
[168] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures

variable remuneration will be withheld and paid out over an extended period, to align with long-term risk and performance.

Under CRD V, listed institutions are allowed to use share-linked instruments to fulfil the requirement of paying a portion of remuneration in instruments. Previously, this option was limited to unlisted institutions only. This change aims to provide more flexibility in the types of instruments that can be used for remuneration purposes.

The Directive also aims to address gender disparities and promote fair and inclusive practices within financial institutions. CRD V emphasizes the importance of gender equality and requires remuneration policies to be gender-neutral, meaning that remuneration should be based on equal pay for women and men for equal work or work of equal value.

The revised proportionality principle exempts smaller institutions and certain staff members from certain provisions of the directive related to instruments, retention, and deferral. This recognizes the differing scales and complexities of institutions, allowing for a more tailored approach.

8.4 EBA Guidelines

The second revision of the European Banking Authority (EBA) Guidelines on sound remuneration policies, released in 2021, incorporates the amendments introduced by the CRD V.[169] The guidelines aim to promote sound and equitable remuneration policies within the banking sector, taking into account various risk factors and societal considerations. The guidelines provide further clarification on the application of the proportionality principle concerning remuneration. This includes a more detailed analysis of ‘risk takers’, taking into

[169] European Banking Authority, Final report on Guidelines on sound remuneration policies under Directive 2013/36/EU, available at: https://www.eba.europa.eu/activities/single-rulebook/regulatory-activities/remuneration/guidelines-sound-remuneration

account the scope of application specific to the institution and the potential use of the exemption limit for individual risk takers.

Apart from providing further clarification on the proportionality principle, they emphasise gender-neutral remuneration policies and acknowledge the importance of incorporating ESG criteria into remuneration practices. This indicates the growing recognition of the significance of sustainable and responsible practices within the banking sector. Institutions are encouraged to consider ESG factors when determining remuneration structures and processes.

9. CONCLUSIONS

In this chapter we analysed the recent trends in the regulation and practice of executive remuneration. No doubt, the role of regulation has been on the rise, particularly after the 2007-2008 financial crisis, and the standards as to pay governance and structures have spread from the financial sector to the non-financial one. ESG-related performance metrics are also becoming a practice. Consequently, today’s remuneration practices are shaped not only by the need to reduce managerial agency costs at listed companies through appropriate incentives, but also by the hard and soft laws tackling corporate governance and remuneration structures. While the governance prescriptions (such as those on remuneration committees and “say on pay”) are mainly intended to reduce the agency costs relative to incentive pay, the regulation of pay structures has an impact on incentives and the quantum of remuneration. Moreover, this type of regulation also responds to social issues and political pressures, thus reflecting concerns about inequality in the distribution of wealth and incentives to undertake “excessive” risks in the financial sector.

We then examined the main policy questions concerning incentive pay, including the optimal design of stock options, their impact on dividends and dilution, and the importance of long-term pay. Amongst the governance mechanisms, we have considered both the role of boards and independent directors, and that of shareholders under “say on pay” rules, considering the rise of shareholder engagement in listed companies. As to the structure of pay, we have highlighted the special problems of banks and the main policy issues concerning regulation of pay at financial institutions.

We focused on the regulation of pay structures, showing that long-term incentives are clearly preferred for both financial and non-financial companies by either regulators or institutional investors. However, financial institutions are the main target of post-crisis reforms, first at the international level through soft-law initiatives like the FSB principles and standards, and second at US and EU levels, where the FSB principles have been implemented along partially diverging routes. The Capital Requirements Directive has marked a new trend in the regulation of bankers’ pay, by imposing a bonus cap that we have criticized from an economic perspective, and which clearly goes beyond what is required by the international principles.

We analysed regulatory developments concerning executive pay in Europe and in the US after the financial crisis. In particular, we highlighted the impact of “say on pay” rules on shareholder activism, expanding on the role of proxy advisors and the behaviour of the largest institutional investors, who have shown an autonomous and active stance on executive remuneration issues at large listed companies.

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

ECGI Working Paper Series in Law

Electronic Access to the Working Paper Series

The full set of ECGI working papers can be accessed through the Institute's Web-site (https://ecgi.global/content/working-papers) or SSRN:

Finance Paper Series	http://www.ssrn.com/link/ECGI-Fin.html
Law Paper Series	http://www.ssrn.com/link/ECGI-Law.html