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Abstract

This paper, which was first presented as a conference paper at the Annual 2009 Supreme Court of New South Wales Conference in June 2009, considers the impact of the global financial crisis on the regulation of executive pay in a range of common law jurisdictions, including the United States, the United Kingdom and Australia.

As the paper shows, the current focus on executive pay reflects the fact that, as a result of the global financial crisis, business once again has "a legitimacy problem." Although opinion is divided about the extent to which executive remuneration practices actually contributed to the global financial crisis, there has nonetheless been an outpouring of regulatory responses to executive pay in the United States, United Kingdom and Australia. The paper compares the varying reforms and reform proposals across these jurisdictions, identifying common themes and differences in approach, and considering their implications for future regulation of executive remuneration around the world.

Keywords: Executive Compensation, Remuneration, Shareholders, Directors, Disclosure, Directors' Duties, Comparative Corporate Governance, Corporate Scandals, Global Financial Crisis, Regulation
JEL Classifications: G30, G34, J33, K22, K33, K40, M14, M52, 016

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New Trends in the Regulation of Executive Remuneration

Jennifer G. Hill*

1. Introduction

Everyone, it seems, is currently interested in executive pay. Indeed, it has become the zeitgeist of the global financial crisis, with a wide array of potential reform proposals about executive remuneration now on the regulatory table in jurisdictions around the world.

Executive remuneration first came onto the corporate governance radar screen in the 1990s. During this period, a growing international interest in the improvement of corporate governance standards and practices emerged, which paralleled a movement from legislative regulation to self-regulation in the corporate sphere.[1] There was also a radical paradigm shift concerning executive pay at this time. Executive pay, which had previously been treated as a corporate governance problem, was re-interpreted as an issue of misalignment between managerial and shareholder interests. This transformation, which was strongly influenced by Jensen and Murphy's seminal

* Professor of Corporate Law, University of Sydney; Visiting Professor, Vanderbilt Law School; Research Associate, European Corporate Governance Institute. This paper is based on a conference paper presentation at the 2009 Annual Supreme Court Corporate Law Conference on *Directors in Troubled Times*. I would like to thank Professors Randall Thomas and Ron Masulis, who are my co-researchers on a broad comparative research project on US and Australian remuneration contracts, and participants at an International Executive Remuneration Workshop, hosted by the University of Sydney and Vanderbilt University in Cambridge, England, in May 2009. I am grateful to Alice Grey for her excellent research assistance. All errors are my own. Funding for this research was provided by the University of Sydney and the Australian Research Council.

1 A number of reports and statements of best practice in relation to corporate governance and director and executive remuneration emerged during this period. See, for example, OECD, *Principles of Corporate Governance* (1999); Department of Trade and Industry, *Directors' Remuneration: A Consultative Document* (July 1999); *Committee on Corporate Governance: Final Report* (the Hampel Committee Report) (1998); *Directors' Remuneration: Report of a Study Group chaired by Sir Richard Greenbury* (1995); *Report of the National Association of Corporate Directors (NACD) Blue Ribbon Commission on Director Compensation: Purposes, Principles, and Best Practices* (June 1995).

article in this area, "CEO Incentives – It's Not How Much You Pay, But How",[2] envisaged pay for performance as a self-executing mechanism, which could effectively align the interests of management with shareholders. Executive remuneration had, in effect, evolved from corporate governance problem to solution.

This theoretical redefinition had major consequences in the commercial realm, with the development of *ex ante* bonding devices, to align shareholder and management interests through the design of optimal remuneration contracts.[3] In this respect, the transformation also served to legitimise executive pay, since, by adopting a "just deserts" approach to remuneration, it offered the prospect of reward for superior performance and financial penalties for inferior performance.[4]

Since the heyday of performance-based pay in the 1990s, there have been two major shocks to financial markets. The first involved the collapse of Enron, and analogous international corporate scandals around the turn of this decade. The second was to be the 2007-2009 global financial crisis.

Puzzling differences emerge in the international regulatory responses to these two sets of events. Professor John Coffee considered that executive remuneration was one of three possible causes of the Enron collapse.[5] Nonetheless, international regulatory responses to the issue of executive remuneration were relatively minor in the post-

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2 See Jensen and Murphy, "CEO Incentives – It's Not How Much You Pay, But How" (1990) 68 *Harv. Bus Rev* 138. See also Yablon, "Bonus Questions – Executive Compensation in the Era of Pay for Performance" (1999) 75 *Notre Dame L. Rev.* 271.

3 For useful surveys on executive remuneration structures, see generally Guay, Core and Larcker, "Executive Equity Compensation and Incentives: A Survey" (2003) 9 *Econ. Pol. Rev.* 27; Bebchuk, Fried and Walker, "Managerial Power and Rent Extraction in the Design of Executive Compensation" (2002) 69 *U. Chi. L. Rev.* 751; Murphy, "Executive Compensation", in Ashenfelter and Card (eds), *Handbook of Labor Economics* (1999).

4 Jensen and Murphy, "CEO Incentives – It's Not How Much You Pay, But How" (1990) 68 *Harv. Bus Rev* 138.

5 See generally Coffee, "What Caused Enron? A Capsule Social and Economic History of the 1990s" (2004) 89 *Cornell L. Rev.* 269. On the role of executive remuneration in Enron and other corporate scandals, see also Miller, "Catastrophic Financial Failures: Enron and More" (2004) 89 *Cornell L. Rev.* 423; Hill, "Regulatory Responses to Global Corporate Scandals" (2005) 23 *Wis. Int'l L.J.* 367. See also Report prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, United States Senate, *The Role of the Board of Directors in Enron's Collapse* (2002), 54.

Enron reform period. Other aspects of corporate governance, such as board structure and the role of auditors, received far greater attention.[6] This contrasts sharply with the current regulatory environment, in which remuneration has become a regulatory flashpoint, occasioning a vast array of potential reforms to address perceived problems in regard to executive pay.

2. Post-Enron Regulatory Responses to Executive Remuneration – The US, UK and Australia

Post-Enron legislators in the US paid relatively little attention to executive pay. Only two provisions of the *Sarbanes-Oxley Act* of 2002 (*Sarbanes-Oxley Act*), ss 304 and 402, addressed the issue directly.

The most prominent of these, s 304, is a clawback provision, permitting recovery of bonuses, incentives-based or equity-based compensation received by the CEO or CFO, if the corporation is required to restate earnings due to material noncompliance with financial reporting requirements, as a result of misconduct.[7] It does not appear that s 304 has been a regulatory success; rather, it is now widely regarded as a toothless tiger. There have been less than a handful of successful clawback actions under s 304,[8] although there have been several thousand financial restatements since the introduction of the *Sarbanes-Oxley Act*.[9] The provision's effectiveness has been undermined by a range of factors. These include the fact that courts have held that only the SEC has enforcement rights under the provision,[10] the limited range of

6 Coffee, *id*.

7 See generally Simmons, "Taking the Blue Pill: the Imponderable Impact of Executive Compensation Reform" (2009) 62 *SMU L. Rev.* 299, 347-349.

8 See Schwartz, "The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean" (2008) 64 *Bus. Law.* 1, 2, 13-15, noting that six years after the introduction of the *Sarbanes-Oxley Act*, the SEC had only obtained clawbacks on two occasions, against a former CEO of United Health Group Inc in 2007, and against the former CFO of Sycamore Networks, Inc in 2008. *Id*, 13-15.

9 *Id*, 2, 13-15.

10 The courts have definitively rejected private clawback actions by shareholders or corporations under s 304. *Ibid*; Gordon, "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In" (2009) 46 *Harv. J. on Legis.* 323, 334, n 39.

targeted corporate participants (namely CEOs and CFOs), and uncertainty as to whether the requirement of "misconduct" must be attributable to the executive from whom recovery is sought.[11] Interestingly, on 22 July 2009, the SEC filed its first suit seeking to recover US$4 million in incentive-based compensation from a CEO, who was not personally accused of wrongdoing, in *SEC v. Jenkins*.[12] It has been stated that the suit is "emblematic" of the SEC's newly aggressive stance on executive pay.[13]

Section 402 of the *Sarbanes-Oxley Act* imposed a prohibition on personal loans to directors or executive officers. This provision tracked the contours of problems identified at a number of US companies, including Enron and WorldCom, where executives had received huge loans, sometimes totalling hundreds of millions of dollars, from their corporation.[14] This was apparently a common, and relatively uncontroversial, remuneration technique in the US prior to the Enron and WorldCom scandals.[15]

Notably absent from the *Sarbanes-Oxley Act* was any provision according shareholders stronger powers, or greater corporate governance participatory rights.[16] The refusal of the Act to grant shareholders greater power in relation to matters such as the director elections process was described by two prominent Delaware judges at

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11 Simmons, "Taking the Blue Pill: the Imponderable Impact of Executive Compensation Reform" (2009) 62 *SMU L. Rev.* 299, 347; Schwartz, "The Clawback Provision of Sarbanes-Oxley: An Underutilized Incentive to Keep the Corporate House Clean" (2008) 64 *Bus. Law.* 1, 15*ff*.

12 No. CV 09-1510-PHX-JWS (D. Ariz. July 22, 2009) (available at http://www.wlrk.com/docs/comp21149.pdf).

13 Savarese, "SEC Pursues Unprecedented Sarbanes-Oxley 'Clawback'", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 1 August 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/08/01/sec-pursues-unprecedented-sarbanes-oxley-clawback/).

14 Romano, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114 *Yale L.J.* 1521, 1538.

15 *Ibid*.

16 The preamble to the *Sarbanes-Oxley Act* confirms a focus on protection of shareholder interests over shareholder participation in corporate governance. It is an Act, according to the preamble, "[t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes".

the time as the "forgotten element" of the US reforms.[17] If indeed this was the case post-Enron, shareholder participation is forgotten no more. It takes centre stage in a range of US reforms and reform proposals associated with the global financial crisis.

Enron also raised concerns about the effectiveness of the disclosure rules. In 2006, the SEC introduced stricter disclosure rules in relation to executive remuneration, designed to capture previously undisclosed executive perks.[18]

The US regulatory response to Enron provided an interesting contrast to reforms in Australia and the UK, where legislative rhetoric focused on the need to strengthen shareholder participation rights in corporate governance.[19] One of the clearest manifestations of this goal was the introduction of a non-binding shareholder vote on executive pay.[20] In Australia, the relevant provision, s 250R(2) of the *Corporations Act* 2001 (Cth) (*Corporations Act*),[21] requires shareholders of an Australian listed company to pass a non-binding advisory vote at its annual general meeting, indicating

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17 Chandler and Strine, "The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State" (2003) 152 *U. Pa. L. Rev.* 953, 999.

18 See SEC, Press Release, *SEC Votes to Propose Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters*, 17 January 2006. Key elements of the reforms included:- alteration to the details of whose remuneration must be disclosed; alterations to the required presentation of material to enhance clarity; required disclosure of total compensation; expanded scope of components of executive remuneration requiring disclosure; quantification of termination and change in control payments; and a reduced threshold for disclosure of perquisites. See generally Lublin and Scannell, "They Say Jump: SEC Plans Tougher Pay Rules", *Wall Street Journal*, 11 January 2006, C1; Scannell and Francis, "Executive-pay Disclosure Takes Spotlight in U.S.", *Wall Street Journal Europe*, 17 January 2006, 1.

19 See generally Hill, "Regulatory Show and Tell: Lessons from International Statutory Regimes" (2008) 33 *Del. J. Corp. L.* 819, 826. The Explanatory Memorandum to the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill of 2004, stressed the importance of improving shareholder participation and activism in corporate governance. See Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Bill 2003, Explanatory Memorandum, paras. 4.271-4.280.

20 See generally Hill, "Regulatory Responses to Global Corporate Scandals" (2005) 23 *Wis. Int'l L. J.* 367, 413-414.

21 Section 250R(2) was introduced into the *Corporations Act* 2001 (Cth) by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act* 2004 *(CLERP 9 Act*). See also s 249L(2) and s 300A *Corporations Act* 2001 (Cth).

whether they adopt the directors' remuneration report.[22] This provision was based on an analogous provision introduced two years earlier in the UK.[23] Unlike the US, where precatory shareholder resolutions have a long pedigree,[24] Australia and the UK had no prior tradition in this regard.[25]

A range of other post-Enron reforms were introduced in Australia under the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act* 2004.[26] These included enhanced remuneration disclosure under s 300A of the *Corporations Act*, modification of provisions relating to termination pay,[27] and the introduction of a specific Remuneration Principle under the ASX Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice*, which exhorted companies to "remunerate fairly and responsibly".[28]

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22 See generally Chapple and Christensen, "The Non-Binding Vote on Executive Pay: A Review of the CLERP 9 Reform" (2005) 18 *Aust. J. Corp. L.* 263.

23 The Directors' Remuneration Report Regulations 2002, S.I. 2002, No. 1986 (UK). The provision is now found in s 439 of the UK *Companies Act* 2006. For a general discussion of post-Enron reform developments in the UK, see Ferran, "Company Law Reform in the UK: A Progress Report", European Corporate Governance Institute Law Working Paper No. 27/2005 (March 2005) (available at http://ssrn.com/abstract=644203), 24-28.

24 For historical background to precatory voting in the US under SEC Rule 14a-8, see Thompson and Edelman, "Corporate Voting" (2009) 62 *Vand. L. Rev.* 129, 143-144. See also Ryan, "Rule 14a-8, Institutional Shareholder Proposals, and Corporate Democracy" (1988) 23 *Ga. L. Rev.* 97. Since the inception of SEC Rule 14a-8, shareholder proposals have shifted from social responsibility to a focus on changing corporate governance. Thompson and Edelman, *id*, 144.

25 The courts had historically treated such resolutions as beyond shareholder power. See, for example, *NRMA v Parker* (1986) 6 NSWLR 517, 522.

26 See Sheehan, "The Regulatory Framework for Executive Remuneration in Australia" (2009) 31 *Syd. L. Rev.* 273, 275-276.

27 See generally Stapledon, "Termination Benefits for Executives of Australian Companies" (2005) 27 *Syd. L. Rev.* 683. See also Sheehan and Fenwick, "Seven: *The Corporations Act 2001* (Cth), Corporate Governance and Termination Payments to Senior Employees" (2008) 32 *Melb. U. L. Rev.* 199.

28 ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003), Principle 9. See also ASX Corporate Governance Council, *Revised Corporate Governance Principles and Recommendations* (2nd ed, 2007), Principle 8. See generally Ablen, "Remunerating 'Fairly and Responsibly': The 'Principles of Good Corporate Governance and Best Practice Recommendations' of the ASX Corporate Governance Council" (2003) 25 *Syd. L. Rev.* 555.

3. Two Interesting Current Questions

3.1 Are Corporate Excesses a "Foreign Phenomenon"?

Jurisdictions around the world, including Australia, are again grappling to find an appropriate response to the issue of executive remuneration in the light of the global financial crisis. Two interesting background questions have emerged from the regulatory ether in this regard.

The first question is one that is important in the Australian context, and was raised explicitly by the Australian Government Productivity Commission (Productivity Commission) in its April 2009 Issues Paper.[29] This is whether corporate excess, including excessive executive remuneration, is a problem for Australia, or whether it is a "foreign phenomenon".[30] The expression "foreign phenomenon" appears to be code for an "American problem".

At first sight, there appear to have been strongly convergent international trends in the structure of executive pay in recent years.[31] The rise, and subsequent waning, of stock options as a component of executive pay reflects this general trend.[32] Nonetheless, executive remuneration is also an area where culture matters.[33] Cultural

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29 Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009).

30 See Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009) 4.

31 For a general discussion of the theories of convergence versus path dependence theory in comparative corporate governance, see Gordon and Roe (eds), *Convergence and Persistence in Corporate Governance* (2004); Hill, "The Persistent Debate about Convergence in Comparative Corporate Governance" (2005) 27 *Syd. L. Rev.* 743.

32 See, for example, Johnston, "American-style Pay Moves Abroad: Importance of Stock Options Expands in a Global Economy", *New York Times*, 3 September 1998, C1; Ferrarini and Moloney, "Executive Remuneration in the EU: The Context for Reform" (2005) 21 *Oxf. Rev. Econ. Policy* 304. Use of stock options around the world in recent years has declined. See Mercer, *Executive Remuneration Perspective: Perfecting Long-Term Incentive Remuneration* (14 September 2008) (available at http://www.mercer.com/summary.htm?siteLanguage=100&idContent=1320865).

33 See, for example, Levitt, "Corporate Culture and the Problem of Executive Compensation" (2005) 30 *J. Corp. L.* 749, 750 (discussing the significance of culture in relation to the structure and operation of the board of directors).

differences between various jurisdictions are reflected in levels of pay, societal tolerance for income inequality,[34] and attitudes to remuneration disclosure.[35]

How do levels of executive compensation in the US and Australia compare? Interestingly, it was during the 1990s, the height of the corporate governance movement, that US executive remuneration skyrocketed. Between 1993 and 2003, the average CEO compensation at S&P 500 firms rose by a dramatic 146%.[36] The increase in CEO pay levels in real terms greatly outpaced increases in the pay of average US workers – there was a 45% growth in CEO pay, compared to 2.7% for the average worker.[37] This disparity was even more striking in some countries, which came to US-style stock compensation late in life. In the Netherlands, for example, real CEO pay grew by 192% compared to 2.4% for the average worker.[38] US CEOs have nonetheless tended to receive vastly higher levels of remuneration than their counterparts in other jurisdictions.[39]

In Australia, the disparity in growth of CEO pay compared to average worker pay was less pronounced. Executive salaries in Australia have risen approximately three times the amount of ordinary full-time employee wages.[40] From 2001-2007, both the

34 See, for example, Conyon and Murphy, "The Prince and the Pauper? CEO Pay in the United States and United Kingdom" (2000) 110 *Econ. J.* F640, F646-647.

35 See, for example, Ferrarini and Moloney, "Executive Remuneration in the EU: The Context for Reform" (2005) 21 *Oxf. Rev. Econ. Policy* 304.

36 See Bebchuk and Grinstein, "The Growth of Executive Pay" (2005) 21 *Oxf. Rev. Econ. Policy* 283. Average CEO compensation at S&P 500 firms rose from US$3.7 million to US$9.1 million between 1993 and 2003. The average compensation of the top five executives increased 125% from US$9.5 million to US$21.4 million during this period. *Id*.

37 See Ebert, Torres, Papadakis, International Institute for Labour Studies Discussion Paper DP/190/2008, *Executive Compensation: Trends and Policy Issues* (2008) (available at http://www.ilo.org/public/english/bureau/inst/publications/discussion/dp19008.pdf).

38 *Ibid.*

39 See Thomas, "Explaining the International CEO Pay Gap: Board Capture or Market Driven?" (2004) 57 *Vand. L. Rev.* 1171, 1173-1175. Various explanations have been given for the extreme escalation of pay in the US. See, for example, Bebchuk and Grinstein, "The Growth of Executive Pay" (2005) 21 *Oxf. Rev. Econ. Policy* 283, 298-302, discussing competing explanations offered by (i) the arm's length bargaining model and (ii) the managerial power model.

40 See Shields, "Setting the Double Standard: Chief Executive Pay the BCA Way" (2005) 56 *J. Aust. Pol. Econ.* 299, 303.

median fixed remuneration (ie non performance-based elements of Australian CEO pay) and the median total remuneration had increased by around 96% in total.[41] This compared to a 32% increase in average Australian adult weekly earnings during the same period.[42] Nonetheless, there has still been a significant escalation in CEO pay packages in Australia. A 2008 ACSI report on executive remuneration practices in the top 100 listed Australian companies found that average CEO pay had increased from A$3.77 million in 2005 to A$5.53 million in 2007.[43] A common explanation for this steep rise in executive pay is the fact that increasingly Australian companies need to compete internationally, and now appoint executives from a "mobile worldwide executive talent pool".[44]

Plato believed that no-one in a community should earn more than five times the pay of the lowest paid worker,[45] but this ideal has clearly taken root neither in the US, nor Australia. The 2008 annual reports of Australia's top fifteen companies reveal that, excluding share-based compensation, the CEOs earned approximately 135 times more than the average Australian employee.[46] In the US, the average executive manager in the largest fifteen US firms earned around 500 times more than an average employee in 2007.[47]

3.2 Did Executive Pay Cause or Contribute to the Global Financial Crisis?

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41 ACSI, Media Release, *Top 100 CEO Pay Research Released*, 27 October 2008.

42 *Ibid*. See also Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), 9.

43 See ACSI, Media Release, *Top 100 CEO Pay Research Released*, 27 October 2008.

44 Tarrant, "Payday Paralysis" (2009) 79 *INTHEBLACK* 28 (CPA Australia).

45 Cited in Crystal, *In Search of Excess: The Overcompensation of American Executives* (1991), 23-24.

46 Tarrant, "Payday Paralysis" (2009) 79 *INTHEBLACK* 28 (CPA Australia).

47 The disparity is considerably higher than in 2003, when the average executive manager in the largest 15 US firms earned approximately 300 times more than an average US employee. International Labour Organization and International Institute for Labour Studies, *World of Work Report 2008: Income Inequalities in the Age of Financial Globalization* (2008), Executive Summary, 3.

The second interesting current question about executive remuneration is the extent to which it actually caused, or contributed to, either the Enron scandal or the global financial crisis. Differences of opinion emerge about the role of executive compensation in these events.[48]

Professor Coffee considered that remuneration practices were one of three possible causes of the collapse of Enron (the others were gatekeeper problems and market "herding").[49] However, the US regulatory response to Enron suggests that audit failure was widely accepted as the real culprit.[50]

In relation to the global financial crisis, the Australian government has certainly suggested that executive compensation occupies a central role. In late 2008, for example, Kevin Rudd, the Australian Prime Minister, described the financial crisis as a consequence of "extreme capitalism",[51] characterised by "[o]bscene failures in corporate governance which rewarded greed without any regard to the integrity of the financial system".[52]

The most common view, however, seems to be that executive compensation at large financial institutions was simply one of many factors contributing to the global financial crisis, albeit a particularly important one.[53] For example, in June 2009, Timothy Geithner expressed the view that perverse incentives for short-term gain in

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48 See, for example, Tuna and Lublin, "Risk vs. Executive Reward – Obama Seeks Better Controls, but Experts Split over the Impact", *Wall Street Journal*, 15 June 2009, B6.

49 See generally, Coffee, "What Caused Enron?: A Capsule Social and Economic History of the 1990s" (2004) 89 *Cornell L. Rev.* 269.

50 See Coffee, "Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms" (2004) 84 *B.U. L. Rev.* 301, 321*ff*; Gordon, "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections" (2002) 69 *U. Chi. L. Rev.* 1233, 1237*ff*.

51 See Bartlett, "Global crisis 'failure of extreme capitalism': Australian PM", *Agence France Presse*, 15 October 2008, 16:43.

52 Bartlett, *ibid*.

53 *Cf*, however, Fahlenbrach and Stulz, "Bank CEO Incentives and the Credit Crisis", Charles A Dice Center Working Paper No. 2009-13 (July 2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439859), whose findings suggest that there is no correlation between remuneration incentives for bank CEOs and the global credit crisis.

compensation contracts "overwhelmed the checks and balances" designed to address the risk of excessive leverage.[54] The Financial Stability Forum (FSF, now known as the Financial Stability Board) has also stated that compensation practices at large financial institutions contributed to the global financial crisis, by providing perverse incentives for risk-taking.[55] In contrast, the Turner Review in the UK considered that remuneration was a far less important theme in the global financial crisis than other factors, such as inadequate regulation of capital, accounting and liquidity.[56] While acknowledging that remuneration-related policies may play a useful role in the regulation of executive pay, the Turner Review took the view that other reforms in the areas of capital, accounting and liquidity would have a more significant effect on remuneration in the future.[57]

4. Snapshot of Key Regulatory Developments around the World

In spite of divided opinions about the extent to which executive remuneration practices contributed to the global financial crisis,[58] regulation of executive pay has assumed a central position in current regulatory developments around the world. The following provides a snapshot of some of the current responses to executive pay and the perceived problem of "extreme capitalism".[59]

4.1 The Australian Response

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54 Braithwaite, "US will Appoint 'Pay Tsar' to Vet Executive Packages", *Financial Times*, 11 June 2009, 06.

55 Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) (available at http://www.financialstabilityboard.org/publications/r_0904b.pdf), 1. See also G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency: Final Report* (March 2009) (available at http://www.g20.org/Documents/g20_wg1_010409.pdf), 33.

56 See Financial Services Authority (FSA), *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), 80.

57 *Id*, 82.

58 Tuna and Lublin, "Risk vs. Executive Reward – Obama Seeks Better Controls, but Experts Split over the Impact", *Wall Street Journal*, 15 June 2009, B6.

59 See Bartlett, "Global Crisis 'Failure of Extreme Capitalism': Australian PM", *Agence France Presse*, 15 October 2008, 16:43, citing Kevin Rudd.

The Australian response to the issue of executive remuneration has been multi-faceted, producing a litany of government discussion papers, forthcoming reports and industry guidelines. These include the Australian Prudential Regulation Authority's (APRA)[60] release of a Discussion Paper in May 2009 (APRA Discussion Paper).[61] This paper describes proposed extensions to prudential standards for the governance of APRA-regulated institutions, to impose additional requirements concerning remuneration on the board of directors.[62] These proposed extensions would require boards of regulated institutions to have in place a written Remuneration Policy and to establish a Board Remuneration Committee, comprised entirely of independent directors with appropriate skills and knowledge.[63] APRA's supervisory and enforcement powers would include the ability to impose additional capital requirements for non-compliance.[64] The proposed changes are designed to implement the FSF's *Principles for Sound Compensation Practices*,[65] which were endorsed by G20 Leaders.[66]

60 APRA is the prudential supervisor of four key industries in Australia, namely deposit-taking, life insurance, general insurance and superannuation, under Australia's "twin peak" regulatory structure. See John F. Laker (Chairman, APRA), "APRA: The Year Ahead", Speech to the Australian British Chamber of Commerce, Sydney (26 February 2009), 2-3.

61 APRA, *Discussion Paper: Remuneration: Proposed Extensions to Governance Requirements for APRA-regulated Institutions* (May 2009). In late 2008, the Australian government announced, as part of its response to the global financial crisis, that it had asked APRA to develop a framework to control executive pay, by setting higher capital requirements for companies with remuneration incentives promoting short-termism or excessive risk-taking. Bartlett, "Global Crisis 'Failure of Extreme Capitalism': Australian PM", *Agence France Presse*, 15 October 2008, 16:43.

62 APRA, *Discussion Paper*, *id*, 3.

63 *Id*, 6, 8.

64 *Id*, 3.

65 Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) (available at http://www.financialstabilityboard.org/publications/r_0904b.pdf).

66 G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency: Final Report* (March 2009) (available at http://www.g20.org/Documents/g20_wg1_010409.pdf), 32-33.

In a related initiative, the Australian Productivity Commission[67] is due to issue a report in late 2009 on the remuneration framework for directors and executives of disclosing entities[68] under the *Corporations Act*.[69] The Productivity Commission report, which complements and extends the scope of APRA's review beyond regulated financial institutions,[70] will consider the existing regulatory structure of director and executive remuneration in Australia, including shareholder voting, disclosure and reporting practices.[71] In an Issues Paper released in April 2009, the Commission lists a number of key community concerns regarding executive remuneration,[72] noting that "governments clearly face pressure to respond to perceived corporate excesses".[73] Another government report due for release in December 2009 relates to the *Australia's Future Tax System Review* (Henry Review).[74] This constitutes a comprehensive appraisal of the tax system, including distributional and fairness issues.[75]

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67 Commissioners for the purposes of the inquiry into executive remuneration in Australia are Productivity Commission Chairman, Gary Banks, Commissioner Robert Fitzgerald and Associate Commissioner Allan Fels.

68 Under s 111AC of the Australian *Corporations Act*, "disclosing entities" are listed companies and managed investment schemes, with at least 100 investors.

69 See Treasurer, Joint Media Release with Assistant Treasurer and Minister for Competition Policy and Consumer Affairs and Minister for Superannuation and Corporate Law, *Productivity Commission and Allan Fels to Examine Executive Remuneration*, 18 March 2009, "Terms of Reference: Review into the Regulation of Director and Executive Remuneration in Australia".

70 *Id*.

71 *Id*.

72 Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), 3-4.

73 *Id*, 4.

74 Department of Treasury, *Australia's Future Tax System*, Consultation Paper: Summary (December 2008) (available at http://taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/Publications/Papers/Consultation_Paper_Summary/index.htm). The review is chaired by Dr Ken Henry AC.

75 The objectives and scope of the review are set out in Appendix A to *Australia's Future Tax System*, Consultation Paper: Summary (December 2008) (available at http://taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/publications/Papers/Consultation_Paper_Summary/Appendix_A.htm).

The Australian Institute of Company Directors (AICD) released Guidelines on Executive Pay in February 2009 (AICD Guidelines),[76] which reflect a strong preference by the corporate sector for self-regulation.[77] The guidelines focus predominantly on the process for determining executive remuneration,[78] and on the terms and structure of compensation packages.[79] In March 2009, the Australian Shareholders' Association (ASA) also released a policy statement on executive remuneration,[80] which recognised the increased likelihood of government intervention if the corporate sector fails to respond to public concerns over executive pay.[81]

Among the Australian proposals concerning executive remuneration, termination pay, or "golden handshakes",[82] has been singled out for particular attention.[83] Under Part 2D.2 of the *Corporations Act*, shareholder consent is currently required only for termination benefits exceeding seven times a director's annual remuneration package.[84] The generosity of the Part 2D.2 thresholds,[85] and the resultant risk of

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76 AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009).

77 According to the guidelines, the AICD is "firmly of the view that executive remuneration should remain a matter for boards, and that further regulation in this area is unnecessary and often counterproductive to the outcomes sought". *Id*, 5.

78 *Id*, 9-15.

79 *Id*, 16-25. In addition, the guidelines discuss "Reviewing arrangements" (*id*, 26-28) and "Other matters" (*id*, 29-32), such as the need to gauge public sentiment concerning executive remuneration (*id*, 30) and consider whether remuneration packages are publicly defendable and affect corporate reputation (*id*, 29, 31).

80 See Australian Shareholders' Association (ASA), *ASA Policy Statement: Executive Remuneration*, 23 March 2009.

81 *Ibid*.

82 See Bills Digest No 6 2009-10, *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009* (available at http://www.aph.gov.au/library/pubs/BD/2009-10/10bd006.htm), "Purpose".

83 For an overview of key policy issues relating to termination pay, see Stapledon, "Termination Benefits for Executives of Australian Companies" (2005) 27 *Syd. L. Rev.* 683.

84 See s 200F *Corporations Act*.

85 See Davies, "Disclosure, Auditor and Executive Remuneration: A Eurocentric View", Ross Parsons Address, Sydney Law School (2004), 8. For a discussion of the Part 2D.2 thresholds, see Sheehan and Fenwick, "Seven: The *Corporations Act 2001* (CTH), Corporate Governance and Termination Payments to Senior Employees" (2008) 32 *Melb. U. L. Rev* 199, 212-214.

"rewards for failure",[86] had been the subject of criticism from academics[87] and corporate governance advisors.[88] Commentators have treated the attempted use of shareholder consent to constrain excessive termination payments under Part 2D.2 as "in reality a dead letter".[89]

The Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 is designed to strengthen the regulatory framework, and address concerns and criticism, relating to termination pay.[90] Changes to the existing regulatory framework found in the May 2009 Exposure Draft of the Bill (Exposure Draft) included the following:- a radical lowering of the benefit threshold beyond which shareholder consent is required;[91] expansion and clarification of the definition of "termination benefit"; and expansion of the application of the provision to include not only directors, but also senior executives and management personnel.[92] Although there were some significant differences between the May 2009 Exposure Draft and

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86 This issue became topical following the release in 2003 of two UK government reports on the issue – (i) Department of Trade and Industry (DTI), *"Rewards for Failure": Directors' Remuneration – Contracts, Performance & Severance* (June 2003); (ii) UK Parliament, House of Commons, Trade and Industry Committee, *Rewards for Failure* (September 2003). See generally Stapledon, "Termination Benefits for Executives of Australian Companies" (2005) 27 *Syd. L. Rev.* 683, 691-693. The UK government subsequently announced that it did not intend to legislate to control termination payments. *Cf* Harrison, "Dismay as DTI Baulks at Limits on Fat Cat Pay", *The Independent*, 26 February 2004, 42; Tucker and Wright, "Excessive Pay-offs Decision Welcomed – Executive Rewards", *Financial Times*, 23 February 2004, 2.

87 See, for example, Sheehan and Fenwick, "Seven: The *Corporations Act 2001* (CTH), Corporate Governance and Termination Payments to Senior Employees" (2008) 32 *Melb. U. L. Rev* 199.

88 See RiskMetrics Group, Press Release, *Shareholders Pay the High Cost of Failure: Average CEO Gets $3.4 Million to Walk*, 26 November 2008.

89 Paatsch and Lawrence, "Money for Nothing", *Business Spectator*, 17 July 2008.

90 See generally Parliament of the Commonwealth of Australia, Explanatory Memorandum, Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009, 7, 11*ff*; Bills Digest No 6 2009-10, *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009*, "Purpose", "Background" (available at http://www.aph.gov.au/library/pubs/BD/2009-10/10bd006.htm).

91 Under the Exposure Draft, the threshold for shareholder consent was reduced from seven times a director's annual remuneration package to one year's average base salary. *Id*, 12.

92 *Ibid*.

the Bill introduced into parliament in June 2009 (June Bill),[93] these key provisions remained unaltered.[94]

4.2 The US Response

The US reform environment in relation to executive pay is fluid and evolving. Although the US response was originally rapid and highly targeted towards financial institutions receiving federal bail-out funding, it has now become far more wide-ranging, with application to the corporate sector generally. The reform proposals have also become increasingly complex and demonstrate significant overlap.

The early US reforms were closely tied to emergency federal funding assistance to prevent the failure of financial institutions and restore confidence in US financial markets. Between October 2008 and February 2009, an array of legislation and guidelines were introduced by the US Treasury and Congress, aimed at controlling executive pay at institutions receiving federal financial assistance under an array of government bail-out programs. These included rules created under the *Emergency Economic Stabilization Act* of 2008 (EESA),[95] which was signed into law on 3 October 2008 and authorised Treasury to access up to US$700 billion to protect and

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93 The Corporations Amendment (Improving Accountability on Termination Payments Bill 2009 was introduced into the House of Representatives on 24 June 2009. One notable difference between the Exposure Draft and the June Bill was that a restriction on the timing of shareholder approval under the Exposure Draft was subsequently removed in the June Bill. Under the Exposure Draft, a shareholder vote on termination pay could only be held after the director or executive had left office. *Ibid*. This requirement was, however, jettisoned in the June Bill, following criticism from the business community, to the effect that the proposed provision would *prima facie* compel companies to wait until the next annual general meeting to obtain shareholder approval, by which time such approval might be unreasonably withheld. See AICD, Media Release, *AICD Says Draft Termination Payments Legislation is Unworkable*, 2 June 2009. The AICD welcomed the Government's decision not to implement this proposed provision, but voiced other concerns in relation to the June Bill. See AICD, Media Release, *AICD Says Termination Payments Legislation Still Flawed*, 24 June 2009.

94 For succinct summaries of the main differences between the Exposure Draft and the June Bill, see Freehills, "Limits on Termination Payments: Bill Introduced into Parliament", 26 June 2009 (available at http://www.freehills.com/5121.aspx); Mallesons Stephen Jaques, "Government Introduces Executive Termination Payment Laws into Parliament", 24 June 2009 (available at http://www.mallesons.com/publications/2009/Jun/9966946W.htm).

95 See Davis Polk & Wardell, "Executive Compensation Rules under the Emergency Economic Stabilization Act of 2008", 23 October 2008 (available at http://www.dpw.com/1485409/10.23.08.epg.tarp.memo.pdf).

restore confidence in US financial markets.[96] The first program under the EESA, the Capital Purchase Program, introduced new rules on executive compensation for participating institutions.[97] The initial participants in the Capital Purchase Program were nine of the largest US banks, which received US$125 billion under the program.[98]

On 4 February 2009, Treasury released new guidelines (Treasury guidelines) under the EESA, restricting executive pay at companies receiving future federal financial assistance.[99] The guidelines create a two-tier assistance regime, distinguishing between institutions receiving funds under "generally available" capital programs, and those requiring "exceptional assistance",[100] for which stricter constraints apply.[101] For example, although both categories of funding assistance attract a senior executive pay cap of US$500,000 on total annual compensation (excluding restricted stock), this cap could in certain circumstances be waived by shareholders of institutions receiving financial assistance under generally available capital access programs.[102]

In addition to the Treasury guidelines, the *American Recovery and Reinvestment Act* of 2009 (ARRA), commonly referred to as the "stimulus bill", was signed into law on

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96 *Ibid*.

97 For a summary of EESA rules on executive remuneration applying to various categories of EESA participants, see *id*, 15-18.

98 *Id*, 2.

99 See US Department of the Treasury, Press Release, *Treasury Announces New Restrictions On Executive Compensation*, 4 February 2009 (available at http://www.treasury.gov/press/releases/tg15.htm); Davis Polk & Wardell, "New Executive Compensation Restrictions under the Emergency Economic Stabilization Act of 2008", 6 February 2009 (available at http://www.dpw.com/1485409/clientmemos/2009/02.05.09.ec.pdf).

100 For firms receiving exceptional assistance, a range of new restrictions apply under the guidelines. These include a strict pay cap, under which senior executives are limited to US$500,000 total annual salary (excluding restricted stock); a non-binding "say on pay" shareholder vote requirement; expanded clawback and golden parachute restrictions; certification that the compensation does not encourage excessive risk taking; and disclosure of policies on luxury expenditures. See generally Farrell, "US Bank Chiefs Face $500,000 Limit", *Financial Times*, 5 February 2009, 05; Davis Polk & Wardell, *ibid*.

101 Davis Polk & Wardell, *id*, 3*ff*.

102 *Id*, 3. For criticism of this waiver power, see Bebchuk, "Pay Caps Debate: They Don't Go Far Enough…", *Wall Street Journal*, 6 February 2009, A11.

17 February 2009. Despite its name, this Act contained certain provisions which were not strictly related to financial recovery. These included additional limitations on executive compensation, demanded by Congress, for institutions participating in the Troubled Asset Relief Program (TARP).[103] One controversial aspect of the stimulus bill was the fact that it limited bonus payments to one third the value of total annual compensation.

Since May 2009, US reform proposals have become more broad-ranging and complex. These later reform proposals relate not only to executive pay, but also to the issue of shareholder power. The earlier TARP reforms have proven to be merely the tip of the regulatory iceberg, serving as a blueprint for more general reforms in the corporate sector.

One example of the recent trend in US reform proposals towards granting shareholders more power over corporate governance is the Shareholder Bill of Rights, which was introduced by US Democrat Senators, Charles Schumer and Maria Cantwell, on 19 May 2009. The Shareholder Bill of Rights seeks to increase shareholder powers to counteract excessive risk-taking and executive compensation.[104] Although some provisions of the Shareholder Bill Of Rights relate directly to

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[103] See generally Bachelder, "Executive Compensation under TARP", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 28 April 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/04/28/executive-compensation-under-tarp/#more-966); Morphy, "Economic 'Stimulus' Legislation to Impose New Executive Compensation Restrictions", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 16 February 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/02/16/economic-%e2%80%9cstimulus%e2%80%9d-legislation-to-impose-new-executive-compensation-restrictions/#more-870).

[104] See Senator Charles E. Schumer, Press Release, *Schumer, Cantwell Announce 'Shareholder Bill of Rights' to Impose Greater Accountability on Corporate America*, 23 May 2009 (available at http://schumer.senate.gov/new_website/record.cfm?id=313468).

executive remuneration in public companies,[105] many others are more general corporate governance provisions.[106]

Increased shareholder participation in the director nomination process is also on the US reform agenda. The Shareholder Bill of Rights includes a provision to this effect.[107] One day after the introduction of this Bill, the SEC ended over 50 years of prevarication,[108] by voting[109] to propose SEC Rule 14a-11, which would grant shareholders access to the company's proxy materials to nominate directors.[110] In late July 2009, another Bill dealing specifically with executive pay, the *Corporate and Financial Institution Compensation Fairness Act* of 2009, was passed by the US House of Representatives.[111]

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105 The Shareholder Bill of Rights includes, for example, a requirement for a mandatory annual non-binding shareholder vote on executive compensation in public companies. US Senate, 111th Congress, "S. 1074, A Bill to Provide Shareholders with Enhanced Authority over the Nomination, Election and Compensation of Public Company Executives" (available at http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf), s 14A.

106 These provisions include, for example, elimination of staggered boards; separation of the position of CEO and Chairman in public company boards and the presence of a risk committee for public company boards. US Senate, 111th Congress, "S. 1074, A Bill to Provide Shareholders with Enhanced Authority over the Nomination, Election and Compensation of Public Company Executives" (available at http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf).

107 See US Senate, 111th Congress, "S. 1074, A Bill to Provide Shareholders with Enhanced Authority over the Nomination, Election and Compensation of Public Company Executives", (available at http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf), s 4.

108 The issue was first addressed by the SEC in 1942. For a history of the debate, see Sundquist, "Comment: Proposal to Allow Shareholder Nomination of Corporate Directors: Overreaction in Times of Corporate Scandal" (2004) 30 *Wm. Mitchell L. Rev.* 1471, 1473*ff* .

109 In a 3-2 split along party lines.

110 See US Securities and Exchange Commission, Press Release, *SEC Votes to Propose Rule Amendments to Facilitate Rights of Shareholders to Nominate Directors*, 20 May 2009 (available at http://www.sec.gov/news/press/2009/2009-116.htm); Nathan, "The Battle for Shareholder Access: The Current State of Play", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 30 May 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/05/30/the-battle-for-shareholder-access-the-current-state-of-play/).

111 US House, 111th Congress, "H.R. 3269, Corporate and Financial Institution Compensation Fairness Act of 2009". The Bill was passed by the House of Representatives on 31 July 2009, and has been referred to the Senate Committee on Banking, Housing and Urban Affairs. It proposes to amend the *Securities Exchange Act* of 1934 to allow an annual, non-binding shareholder vote on executive compensation, and a similar non-binding vote on "golden

Many of these reforms have provoked criticism on the basis of the encroachment of federal legislation into the traditionally state-based domain of corporate law.[112]

4.3 Some Key UK, European and Global Regulatory Responses

In the post-Enron period, the London Stock Exchange acquired considerable cachet as a centre for international capital raising.[113] This development challenged New York's historical dominance and caused consternation in the US, resulting in several reviews to consider the decline of US competitiveness in financial markets.[114] By 2008, however, the picture had again altered, with the collapse of Northern Rock tarnishing London's much vaunted principle-based, or "light touch", regulatory system.[115]

Since that time, UK regulatory responses have focused particularly on the banking and financial sector, which required massive government funding to avert collapse.[116] Two reviews commissioned by the UK government are noteworthy. The first is the Turner Review into the global banking crisis.[117] In October 2008, the government

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parachute" compensation. Other reforms are also contained within the Bill, including a proposal to require financial institutions to disclose information on their pay structures, and on how these structures relate to risk. See generally Luce and O'Connor, "Control of Executive Pay is Handed to Regulators", *Financial Times*, 1 August 2009, 6; Bebchuk, "Regulate Financial Pay to Reduce Risk-taking", *Financial Times*, 4 August 2009, 7.

112 See, for example, Paredes, "The Proper Limits of Shareholder Proxy Access", *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, 30 June 2009 (available at http://blogs.law.harvard.edu/corpgov/2009/06/30/the-proper-limits-of-shareholder-proxy-access/). See also Veasey, "What Would Madison Think? The Irony of the Twists and Turns of Federalism" (2009) 34 *Del. J. Corp. L.* 35, 42-51, discussing federalism tensions in contemporary US corporate governance.

113 See, for example, Furse, "Sox is Not to Blame – London is Just Better as a Market", *Financial Times*, 18 September 2006, 19.

114 See Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation*, 30 November 2006, revised version released 5 December 2006, xi; McKinsey & Company, *Sustaining New York's and the U.S.' Global Financial Services Leadership*, Report to MR Bloomberg & CE Schumer (2007).

115 See Masters, "Northern Rock Woes Take Toll on City's Reputation", *Financial Times*, 27 August 2008, 03.

116 See HM Treasury, *Speech by the Financial Services Secretary to the Treasury, Paul Myners, to the Association of Foreign Banks*, 11 June 2009.

117 FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009).

asked Lord Turner, Chairman of the Financial Services Authority (FSA), to undertake a systematic examination of the banking crisis, assess whether regulatory deficiencies were a contributing factor and make reform proposals.[118] The Review, which was delivered in March 2009,[119] recommended radical strengthening of financial system regulation and supervision, including increased capital requirements.[120] Remuneration constituted an important feature of the report. The Turner Review considered that bank regulators around the world had, in the past, paid insufficient attention to remuneration structure and its potential for creating unacceptable incentives for risk-taking.[121]

The FSA has also taken specific, targeted action concerning executive remuneration. In October 2008, the FSA wrote to CEOs of financial institutions concerning remuneration policies.[122] This "Dear CEO" letter commenced by stating:-

> There is widespread concern that inappropriate remuneration schemes, particularly but not exclusively in the areas of investment banking and trading, may have contributed to the present market crisis … The FSA shares these concerns.[123]

The letter urged all targeted firms to consider their remuneration policies in the light of the financial crisis, to ensure that those policies reflected "sound risk

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118 See Turner, *Turner Review Press Conference: Speaking Notes and Slides for the Press*, 18 March 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0318_at.shtml).

119 See *ibid*, for an overview of findings of the Turner Review. See also Hill and Leahy, "FSA Bids Farewell to Light-touch Financial Regulation", *Financial Times*, 19 March 2009, 17.

120 The Turner Review's recommendations have been described as a "watershed" in this regard. See Wolf, "Why the Turner Report is a Watershed for Finance", *Financial Times*, 20 March 2009, 11.

121 FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), 2.5(ii), "Remuneration: Requiring a risk-based approach", 79-81.

122 FSA, CEO Letter, *Remuneration Policies*, 13 October 2008 (available at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf).

123 *Id*, paras [1]-[2].

management".[124] It included an annexure, which comprised criteria for good and bad remuneration policies, against which firms could assess their own policies.[125] In March 2009, in conjunction with the release of the Turner Review,[126] the FSA published a Consultation Paper[127] and draft code on remuneration practices (FSA draft code).[128] The FSA released its final code of remuneration practice, which will apply directly to large banks, building societies and broker dealers, in August 2009.[129] The code will commence operation from the beginning of 2010.[130]

The second major UK report is the Walker Review.[131] The Walker Review, which was released in July 2009, focuses on improving corporate governance in the banking and financial sector, with measures to strengthen boards and enhance institutional investor activism.[132] According to Sir David Walker, the proposals

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124 The letter further stated that non-alignment of remuneration policies with sound risk management was unacceptable, and would necessitate "[i]mmediate action" to change those policies. *Id*, para [6].

125 "Annex: Criteria for Good and Bad Remuneration Policies", *id*, 4-5.

126 See FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009), 2.5(ii), "Remuneration: Requiring a risk-based approach", 80-81.

127 FSA, Consultation Paper 09/10 (CP09/10), *Reforming Remuneration Practices in Financial Services* (March 2009).

128 FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009 (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf). The Code was originally published on 26 February 2009. See also FSA, Press Release, *FSA Publishes Consultation Paper on Remuneration*, FSA/PN/038/2009, 18 March 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/038.shtml). For background to the Code on Remuneration Practices, and the consultation process, see FSA, Consultation Paper Newsletter 09/10, *Reforming Remuneration Practices in Financial Services* (March 2009).

129 FSA, Policy Statement 09/15, *Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules* (August 2009) (available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf).

130 See FSA, Media Release, *FSA Confirms Introduction of Remuneration Code of Practice*, FSA/PN/108/2009, 12 August 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/108.shtml).

131 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf).

132 See HM Treasury, Press Notice, *Walker Review Proposes Fundamental Changes to Strengthen Bank Governance*, 16 July 2009 (available at http://www.hm-treasury.gov.uk/walker_review_pn_160709.htm). See also Financial Reporting Council (FRC), *Review of the Effectiveness of the Combined Code: Progress Report and Second*

> … are designed to improve the professionalism and diligence of bank boards, increasing the importance of challenge in the board environment. If this means that boards operate in a somewhat less collegial way than in the past, that will be a small price to pay for better governance.[133]

Remuneration issues feature prominently in the Walker Review,[134] which is consistent with the approach taken in the FSA draft code.[135]

Executive remuneration has also been on the European reform agenda.[136] In the post-Enron era, the European Commission (EC), as part of the 2003 Company Law Action Plan, adopted two important Recommendations – the 2004 Recommendation on directors' pay,[137] and the 2005 Recommendation on non-executive directors.[138] More recently, in April 2009, the Committee of European Banking Supervisors (CEBS) published principles on remuneration policy,[139] and the EC released a new 2009

Consultation (July 2009), 21-24, the third review of the *Combined Code on Corporate Governance*, which discusses recent reports and developments concerning executive remuneration, including the Walker Review.

133 HM Treasury, *ibid*.

134 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), Chapter 7, "Remuneration".

135 *Id*, para [7.7].

136 See generally Ferrarini, Moloney and Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis", Law Working Paper No. 126/2009 (August 2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463).

137 Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC).

138 Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board (2005/162/EC). For a detailed discussion of the operation of the 2004 and 2005 Recommendations, see Ferrarini, Moloney and Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis", Law Working Paper No. 126/2009 (August 2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463), 24-29.

139 Committee of European Banking Supervisors, *High-level Principles for Remuneration Policies*, 20 April 2009 (available at http://www.c-ebs.org/getdoc/34beb2e0-bdff-4b8e-979a-5115a482a7ba/High-level-principles-for-remuneration-policies.aspx).

remuneration Recommendation,[140] complementing and extending the 2004 and 2005 Recommendations.[141]

There has also been a push for stronger global regulation of remuneration in major financial institutions.[142] The FSA stated that it is "mindful that to be effective action on this subject needs to be taken internationally",[143] and that regulatory success depends on its ability "to gain international agreement to enforce similar principles in all major financial markets".[144] There are a number of current global initiatives.[145] The FSF *Principles for Sound Compensation Practices*,[146] for example, have been strongly endorsed by the G20.[147] The FSB (the new incarnation of the former FSF) has

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140 See Commission of the European Communities, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (SEC (2009) 580 and SEC (2009) 581), 30 April 2009 (available at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf). See also RiskMetrics Group, "EC Issues New Pay Guidelines", *Risk & Governance Weekly*, 8 May 2009 (available at http://99r43uej.issueatlas.com/content/subscription/fridayreportfiles/fridayreport05082009.html); Financial Reporting Council (FRC), *Review of the Effectiveness of the Combined Code: Progress Report and Second Consultation* (July 2009), 22.

141 See generally Ferrarini, Moloney and Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis", Law Working Paper No. 126/2009 (August 2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463), 28-30, comparing the operation of the 2009 remuneration Recommendation with the 2004 and 2005 Recommendations.

142 See Paletta, "Details Set for Remake of Financial Regulations", *Wall Street Journal*, 15 June 2009, A1 (stating that President Obama will call for the adoption of certain global regulations, such as stricter capital requirements for the largest financial institutions).

143 FSA, CEO Letter, *Remuneration Policies*, 13 October 2008 (available at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf), para [12].

144 FSA, Policy Statement 09/15, *Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules* (August 2009) (available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf), para [5.1].

145 For an overview of developments relating to international implementation of remuneration principles, see *id*, Chapter 5.

146 Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) (available at http://www.financialstabilityboard.org/publications/r_0904b.pdf), 1. For background on the FSF Principles, see FSA, Policy Statement 09/15, *Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules* (August 2009) (available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf), paras [5.4]-[5.5].

147 See G20 Working Group 1, *Enhancing Sound Regulation and Strengthening Transparency: Final Report* (March 2009) (available at http://www.g20.org/Documents/g20_wg1_010409.pdf), 33; FSA, Policy Statement 09/15, *Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final*

proposed that implementation of its remuneration principles should be advanced by the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO).[148] Although the FSA is optimistic about the possibility of full international regulatory harmonisation,[149] inevitable tensions and differences of approach between some G20 members are evident.[150]

5. Central Themes and Some Regulatory Techniques for the Control of Executive Pay

A number of central themes emerge in this panoply of regulatory responses and reform proposals around the world. These themes, many of which are inter-connected, include:- (i) risk-based approach to executive pay; (ii) long-term focus and sustainability; (iii) re-evaluation of the concept of interest alignment in executive pay; (iv) re-evaluation of performance measures; and (v) income inequality.

5.1 Regulatory Themes

(i) Risk-based Approach to Executive Pay

A major theme in the current re-evaluation of executive pay involves the idea that executive pay, rather than being a corporate governance tool,[151] is itself a risk-management problem. The Turner Review into the global banking crisis, for example, adopted a predominantly risk-based approach to executive remuneration design,[152] highlighting the danger posed by remuneration packages creating

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Rules (August 2009) (available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf), paras [1.26], [5.4].

148 See FSA, *id*, paras [5.17] – [5.19].

149 *Id*, para [5.20].

150 See Cohen, Benoit and Daneshku, "Hurdles Remain for G20 Pact", *Financial Times*, 7 September 2009, 02.

151 On this view of executive remuneration, it is seen as a mechanism for aligning shareholder and management interests.

152 FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009).

unacceptable incentives for risk-taking.[153] This message also reverberated through the FSA draft code,[154] which had an almost exclusively risk-based focus,[155] viewing executive remuneration as a critical element of corporate risk.[156]

Financial institutions have been singled out as a special case within the context of this risk-based approach, and it has been argued that they should therefore be subject to greater governmental intervention in executive pay than corporations generally. Professor Lucian Bebchuk has argued that enhanced regulation of pay in financial institutions is justified on the basis of moral hazard concerns,[157] and because failure of such institutions imposes substantial costs on taxpayers.[158] The Walker Review also raises this issue, noting that the taxpayer has provided UK banks with nearly £1.3 trillion in funding, resulting in a reduced tolerance for "unsafe remuneration

153 *Id*, 2.5(ii), "Remuneration: Requiring a risk-based approach", 79-81. See also the APRA Discussion Paper, which states that recent international financial failures have raised awareness of "unsound risk-seeking behaviour" in some remuneration practices, which have prompted financial regulators around the world to seek to manage this risk effectively. APRA, *Discussion Paper: Remuneration: Proposed Extensions to Governance Requirements for APRA-regulated Institutions* (May 2009), 6.

154 FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009 (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf). The Code was originally published on 26 February 2009. See also FSA, Press Release, *FSA Publishes Consultation Paper on Remuneration,* FSA/PN/038/2009, 18 March 2009 (available at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/038.shtml). For background to the Code on Remuneration Practices, and the consultation process, see FSA, Consultation Paper Newsletter 09/10, *Reforming Remuneration Practices in Financial Services* (March 2009).

155 Almost every proposed rule and principle in the FSA draft code related in some way to the implementation of effective risk management. *Ibid.*

156 According to the FSA, for example, "[t]he risks arising from the way employees are recruited and managed, including the risks posed by remuneration policies, constitute some of the most important risks faced by firms". FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009 (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf), 3.

157 This is due to the fact that shareholders have perverse incentives to prefer higher levels of risk-taking than is socially desirable, given that taxpayers, rather than shareholders, will bear the costs of failure. See Bebchuk, "Regulate Financial Pay to Reduce Risk-taking", *Financial Times*, 4 August 2009, 7; Wolf, "Reform of Regulation Has to Start by Altering Incentives", *Financial Times*, 24 June 2009, 11. See also Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [1.3], referring to the problems of moral hazard and public interest externalities in the financial industry sector.

158 Bebchuk, *ibid*. For an opposing view, however, see Zingales, "Pay Regulation is Not the Best Way to Address Moral Hazard", *Financial Times*, 17 August 2009, 08.

policies".[159] The Walker Review also recommends that the remuneration committee's responsibility should be "extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension".[160]

(ii) Short-termism versus Long-termism

The corporate scandals and collapses over the last decade highlighted a range of problems and inadequacies in the structure of executive remuneration, including the danger of providing incentives for short-termism.[161]

Many recent regulatory responses and proposals exhibit concern about the issue of short-termism. Short-termism is raised, for example, as a significant problem in the Productivity Commission's Issues Paper,[162] and the ASA has stated that "[s]hort-term incentives … are questionable as incentives for CEOs".[163] There is correspondingly a strong focus on the need to promote long-term and sustainable corporate performance. The Walker Review states that, in view of the massive injection of taxpayer funding into the UK banking system, it is imperative that remuneration practices should be restructured to provide incentives for sustainable performance.[164] Long-term

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159 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [7.1].

160 *Id*, Recommendation 28.

161 See, for example, Hill, "Deconstructing Sunbeam – Contemporary Issues in Corporate Governance" (1999) 67 *U. Cin. L. Rev.* 1099, 1123-1125; Hill and Yablon, "Corporate Governance and Executive Remuneration: Rediscovering Managerial Positional Conflict" (2002) 25 *UNSW L.J.* 294. For discussion of executive pay in bubble markets, see Bolton, Scheinkman and Xiong, "Executive Compensation and Short-Termist Behavior in Speculative Markets" (2006) 73 *Rev. Econ. Stud.* 577.

162 See Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), 4, 11.

163 See Australian Shareholders' Association (ASA), *ASA Policy Statement: Executive Remuneration*, 23 March 2009, "The ASA Position", para [6].

164 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [7.1].

sustainability also lies at the heart of the EC's new 2009 remuneration Recommendation, which focuses on the structure and design of pay packages.[165]

(iii) Re-evaluation of the Concept of Interest Alignment in Executive Pay

The "alignment of interests" paradigm for executive pay, which became dominant over the last two decades, sought to solve the agency problem between management and shareholders by using remuneration techniques to align their interests.[166]

Following the global credit crisis, however, the rhetoric accompanying the alignment goals of executive remuneration has shifted, and alignment with shareholder interests is no longer treated as the sole touchstone. The US Treasury, for example, has stated that its February 2009 guidelines under the EESA[167] were designed to ensure that the remuneration of executives in the financial community is aligned, not only with the interests of shareholders and financial institutions, but also with the taxpayers providing financial assistance to those institutions.[168] In Australia, the APRA Discussion Paper announced that it proposes to require boards to adopt a remuneration policy which aligns remuneration arrangements with "the long-term financial soundness of the regulated institution and its risk management framework".[169] Finally, under its Terms of Reference,[170] the Productivity

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165 See Commission of the European Communities, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (SEC (2009) 580 and SEC (2009) 581), 30 April 2009 (available at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf), Section II, "Remuneration Policy".

166 See Jensen and Murphy, "CEO Incentives – It's Not How Much You Pay, But How" (1990) 68(3) *Harvard Bus. Rev.* 138. See also Yablon, "Bonus Questions – Executive Compensation in the Era of Pay for Performance" (1999) 75 *Notre Dame L. Rev.* 271.

167 See US Department of the Treasury, Press Release, *Treasury Announces New Restrictions On Executive Compensation*, 4 February 2009 (available at http://www.treasury.gov/press/releases/tg15.htm); Davis Polk & Wardell, "New Executive Compensation Restrictions under the Emergency Economic Stabilization Act of 2008", 6 February 2009 (available at http://www.dpw.com/1485409/clientmemos/2009/02.05.09.ec.pdf), 1.

168 See US Department of the Treasury, *ibid*.

169 APRA, *Discussion Paper: Remuneration: Proposed Extensions to Governance Requirements for APRA-regulated Institutions* (May 2009), 6.

Commission has been asked to report on mechanisms that would better align the interests of management with the interests of both shareholders and "the wider community".[171]

(iv) Re-evaluation of Performance Measures

The incentives provided by remuneration structures have real consequences. Professor Niall Ferguson has made this point cogently in describing how 17th century Dutch domination of the spice trade in Indonesia was partly attributable to remuneration practices. According to Professor Ferguson, the Dutch East India Company, unlike its British rival, rewarded managers on the basis of gross revenue rather than net profits, thereby encouraging the Dutch to maximise business volume by rapid expansion.[172]

As a corollary to the burgeoning risk-based/long-term approach to executive pay, there has been a dramatic re-evaluation of appropriate measures of performance. The current regulatory responses to the issue of executive pay strongly favour the adoption of performance criteria which promote long-term and sustainable goals.[173] The FSA has also suggested finetuning performance measures to include non-financial metrics, including adherence to effective risk management and compliance requirements.[174] In Australia, the AICD Guidelines stress the need to have appropriate performance measures that promote long-term corporate goals and sustainability (through, for

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170 Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), "Terms of Reference", 33.

171 *Id*, 19-20, 22-23.

172 Ferguson, *Empire: How Britain Made the Modern World* (2004), 19.

173 See, for example, Commission of the European Communities, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (SEC (2009) 580 and SEC (2009) 581), 30 April 2009 (available at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf), Section II, "Remuneration Policy", para [3.2].

174 See FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009, (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf), 6-7. See also FSA, Policy Statement 09/15, *Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules* (August 2009) (available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf), 30-31, where the FSA reports that respondents to the FSA *Draft Code on Remuneration Practices* were universally in favour of this principle.

example, deferred remuneration elements),[175] and that are resistant to manipulation by executives.[176] The AICD, too, contemplates performance that is both financial and non-financial, using improved workplace safety as an example of a non-financial performance metric that might be appropriate for some companies. [177]

(v) Income Inequality

There is a growing gap between the pay of executives and average workers. As previously noted, the 2008 annual reports of Australia's top fifteen companies reveal that, excluding share-based compensation, the CEOs earned approximately 135 times more than the average Australian employee,[178] and in the US, this multiple is 500.[179] The Wall Street Journal/Hay Group 2007 CEO Compensation Study described the wage disparity in the US as "outrageous".[180]

The issue of income inequality arises frequently in several of the Australian responses to executive pay. The ASA states that the gap between the pay of Australian CEOs and the general workforce has become "huge", and is the subject of justifiable criticism.[181] The Productivity Commission raises the issue of equitable distribution within the corporation itself, querying the organizational effects of large pay disparities between executives and other employees.[182] The AICD suggests that the

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175 AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 19, 22, 24.

176 *Id*, 18-19.

177 *Id*, 19, n 8.

178 Tarrant, "Payday Paralysis" (2009) 79 *INTHEBLACK* 28 (CPA Australia).

179 International Labour Organization and International Institute for Labour Studies, *World of Work Report 2008: Income Inequalities in the Age of Financial Globalization* (2008), Executive Summary, 3.

180 See The Wall Street Journal and Hay Group, *The Wall Street Journal/Hay Group 2007 CEO Compensation Study* (April 2008), 5. See also Plender, "Mind the Gap: Why Business May Face a Crisis of Legitimacy", *Financial Times*, 8 April 2008, 9.

181 See Australian Shareholders' Association (ASA), *ASA Policy Statement: Executive Remuneration*, 23 March 2009.

182 Australian Government Productivity Commission, *Regulation of Director and Executive Remuneration in Australia*, Issues Paper (April 2009), 10. The Commission asks, for example, "[d]o big disparities serve to motivate or de-motivate other employees?" *Ibid*. See also Yablon, "Overcompensating: The Corporate Lawyer and Executive Pay" (1992) 92

board of directors should consider the impact of material pay disparities between the CEO and other executives within the context of the corporation's culture and succession planning.[183] The issue of income disparity also has resonance in the UK and Europe.[184]

5.2 Regulatory Techniques and Commercial Backlash

An array of regulatory techniques to address the perceived problems of executive remuneration are either under consideration, or have now been implemented, in various jurisdictions around the world.

Perhaps the most severe regulatory device is the imposition of a pay cap. As discussed previously, such pay caps have been introduced for institutions receiving US federal bail-out funding. Under guidelines released by the US Treasury in February 2009, US institutions receiving funds under "generally available" capital programs, and those requiring "exceptional assistance",[185] are subject to a total annual compensation pay cap of US $500,000 for senior executives.[186] Also, the US

Colum L Rev 1867, 1877, n26, discussing the impact of significant pay differentials within organisations. According to Professor Yablon, although adverse morale effects are difficult to quantify, "this does not mean, however, that they should be ignored".

183 See AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 24-25. The recommendation of the Walker Committee that the remit of the remuneration committee should, where necessary, extend to cover all aspects of remuneration policy on a firm-wide basis is also interesting in relation to this debate. See Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009), (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), Recommendation 28.

184 Walker, *id*, paras [7.29] – [7.30].

185 See generally Farrell, "US Bank Chiefs Face $500,000 Limit", *Financial Times*, 5 February 2009, 05; Davis Polk & Wardell, "New Executive Compensation Restrictions under the Emergency Economic Stabilization Act of 2008", 6 February 2009 (available at http://www.dpw.com/1485409/clientmemos/2009/02.05.09.ec.pdf).

186 As discussed earlier, the cap may in certain circumstances be waived by shareholders of institutions receiving financial assistance under generally available capital access programs. See Davis Polk & Wardell, *id*, 3.

stimulus bill limited bonus payments to no more than one third of the value of total annual compensation for companies receiving TARP funding.[187]

Nonetheless, in announcing a raft of new regulations relating to executive pay on 10 June 2009, Treasury Secretary Timothy Geithner, stressed that, outside the bail-out arena, the US government has no intention to introduce pay caps.[188] Many others take the view that capping executive remuneration in general would be inappropriate or counter-productive. The Walker Review explicitly states that it makes no recommendation that pay levels should be capped, but is focused instead on the structure of remuneration.[189] The FSA has said that it has no desire to become involved in setting pay levels, and that this is a matter for the board of directors.[190] Professor Bebchuk has argued that the most appropriate way to address concerns about excessive remuneration is to increase shareholder powers in relation to executive pay.[191]

In spite of the general regulatory antipathy towards the idea of mandatory pay caps outside the bail-out context, some recent reports and guidelines, including the AICD Guidelines,[192] have suggested that companies should themselves either introduce,[193]

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187 See Solomon and Maremont, "Bankers Face Strict New Pay Cap – Stimulus Bill Puts Retroactive Curb on Bailout Recipients; Wall Street Fumes", *Wall Street Journal*, 14 February 2009, A1.

188 See "White House Won't Try to Directly Limit Exec Pay", *Associated Press*, 10 June 2009. See, however, Sanati, "House Panel Clashes Over Pay Restrictions", *New York Times*, 12 June 2009, 4, noting the "ideological clash" in a hearing before the US House Financial Services Committee, in which some lawmakers favoured extending a pay cap beyond companies receiving federal funding.

189 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009), (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [7.1].

190 FSA, CEO Letter, *Remuneration Policies*, 13 October 2008 (available at http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf), para [3].

191 See Bebchuk, "Regulate Financial Pay to Reduce Risk-taking", *Financial Times*, 4 August 2009, 7.

192 AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009).

193 Commission of the European Communities, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (SEC (2009) 580 and SEC (2009) 581), 30 April 2009 (available at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf), Section II, "Remuneration Policy", para [3.1], which

or at least consider introducing,[194] an upper limit on variable components of executive remuneration, to guard against market "surprises".[195]

Another regulatory approach adopted in the bail-out context has been the introduction of governmental pay oversight. In June 2009, the US government appointed Kenneth R. Feinberg as soi-disant "Pay Czar",[196] to oversee executive remuneration at institutions receiving federal financial assistance.[197] Mr Feinberg has authority in relation to the setting of salaries and bonuses of the five most senior, and twenty five most highly paid, employees of such institutions.[198] His appointment has been variously described as in the financial press as a "hard-to-believe turn" for the US "market" economy,[199] and evidence of the US federal government's "increasingly visible hand in corporate affairs".[200]

Stricter capital, liquidity and leverage requirements are also firmly on the regulatory agenda. The main focus of the Turner Review[201] in the UK was on reforming the

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states that the remuneration policies of listed companies should set limits on variable components.

194 According to the AICD, listed companies should "think about" placing an upper limit on variable incentive rewards. See AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 24.

195 *Ibid*.

196 Mr Feinberg formerly had responsibility for compensation claims made by families of the victims of the September 11 terrorist attacks. See Story and Labaton "Overseer of Big Pay Is Seasoned Arbitrator", *New York Times*, 11 June 2009, 1.

197 Companies subject to Mr Feinberg's authority include AIG, Citigroup, Bank of America, GM and Chrysler. See Solomon, "US Pay Czar to Rework Contracts Deemed High", *Wall Street Journal*, 27 July 2009, A1; Labaton and Andrews, "Treasury to Set Executives' Pay at 7 Ailing Firms", *New York Times*, 11 June 2009, 1.

198 Labaton and Andrews, *ibid*.

199 "The New Wage Controls", *Wall Street Journal*, 12 June 2009, A14. Republicans on the US House Financial Services Committee, for example, have accused the Obama Administration of using the financial crisis to effect further government encroachment in the private sector. Cyrus Sanati, "House Panel Clashes Over Pay Restrictions", *New York Times*, 12 June 2009, 4.

200 Story and Labaton "Overseer of Big Pay Is Seasoned Arbitrator", *New York Times*, 11 June 2009, 1.

201 Financial Services Authority (FSA), *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009).

international capital adequacy framework for banks.[202] The Turner Review considered that fundamental reforms to rules of minimum liquidity and minimum capital standards were urgently needed to ensure financial system stability.[203] The issue of capitalisation has also been raised in Australia. The Australian government's reference to APRA in October 2008 involved developing a framework to control executive pay, by setting higher capital requirements for companies with remuneration incentives promoting short-termism or excessive risk-taking.[204] The APRA Discussion Paper[205] acknowledges that institutions failing to comply with the proposed extensions to governance standards may be subject to supervisory action by APRA, which could include additional capital requirements.[206]

The Walker Review has noted that, in addition to matters relating to capital adequacy and liquidity, regulators are also deeply interested in the effectiveness of the corporate governance procedures of organisations.[207] In the context of executive pay, the structure of the board and pay-setting procedures are of critical importance.[208] Several recommendations of the Walker Review are interesting in this regard. Recommendation 28, for instance, suggests that the scope of the remuneration committee's responsibility should be broadened to include setting compensation

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202 *Id*, para [1.3].

203 *Id*, 61. See generally *id*, Chapter 3, "The Role of Inadequate Capital and Liquidity in Causing Instability". See also Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), 8, which supports continued regulation under the UK Combined Code, in conjunction with "tougher capital and liquidity requirements and a tougher regulatory stance on the part of the FSA."

204 APRA, Press Release, *APRA Outlines Approach on Executive Remuneration*, 9 December 2008 (available at http://www.apra.gov.au/media-releases/08_32.cfm); Prime Minister Kevin Rudd, *Address to National Press Club, Canberra: Global Financial Crisis*, 15 October 2008.

205 APRA, *Discussion Paper: Remuneration: Proposed Extensions to Governance Requirements for APRA-regulated Institutions* (May 2009).

206 *Id*, 9.

207 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), para [1.6]. The Walker Review includes, for example, a number of recommendations concerning the composition, functioning and performance evaluation of the board of directors. See *id*, Recommendations 1-13.

208 According to the Walker Review, substantial improvement of board oversight is needed in relation to executive remuneration policies, in the light of past deficiencies. *Id*, 9.

policy and packages on a firm-wide basis, not simply for board-level executives.[209] The Review further recommends that the remuneration committee should pay particular attention to the risk dimension of remuneration,[210] and seek advice on an arm's-length basis from the board risk committee to guard against the possible perverse incentives in performance measures.[211]

The AICD Guidelines are primarily concerned with board structure and pay-setting procedures.[212] A central tenet of the AICD guidelines is that legislative intervention in this area is undesirable, and that the board of directors should continue to have full responsibility for determining executive pay.[213] The guidelines make a range of recommendations that are designed to enable the board to fulfil this role, while ensuring procedural integrity.[214] These include the following recommendations:- that executive remuneration should be determined by a remuneration committee comprised solely of non-executive directors;[215] that the board should obtain expert advice, independent of management, in entering into executive employment contracts;[216] that executives should have no involvement in setting their own pay, given the inherent conflict of interest;[217] and that the board should provide an executive candidate with the draft contract, rather than vice versa.[218]

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209 *Id*, para [7.8]; Recommendation 28. See also AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 22, which recommend examining executive remuneration in the context of general employment contracts within the firm.

210 *Id*, Recommendation 28.

211 *Id*, paras [7.20] – [7.21]; Recommendation 35.

212 AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009).

213 *Id*, 5.

214 The AICD guidelines state, for example, that while some of the processes advocated may "sound unduly strict", they are vital in ensuring integrity of practices and avoiding conflicts of interest. *Id*, 11.

215 *Id*, 6.

216 *Id*, 6. See also *id*, 13-14.

217 *Id*, 12.

218 *Id*, 13.

Another key regulatory issue in the current debate on executive pay relates to the design of executive pay, and the need to encourage closer links between pay and long-term performance. Two remuneration techniques merit particular attention in this regard – deferred remuneration elements and clawbacks. A number of the reports and guidelines discussed in this paper recommend the adoption of deferred remuneration elements. The FSF's *Principles for Sound Compensation Practices*,[219] for example, recommend deferral of variable compensation components, to ensure that pay is adequately aligned with long-term effects of executive action and long-term risk.[220] The FSA draft code has also recommended deferral, for a minimum vesting period, of at least two-thirds of any bonus constituting a significant proportion of the fixed component of a remuneration package.[221] There have also been calls for mandatory holding periods for equity-based compensation in recent academic literature.[222]

Clawback provisions can also be useful in preventing remuneration based on short term results. The February 2009 US Treasury guidelines introduced expanded clawback and golden parachute[223] restrictions for institutions receiving "exceptional assistance" under the federal funding program.[224] The FSF *Principles for Sound*

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219 Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) (available at http://www.financialstabilityboard.org/publications/r_0904b.pdf).

220 *Id*, 3, 11. See also AICD, *Executive Remuneration: Guidelines for Listed Company Boards* (2009), 19, 24.

221 FSA, *FSA Draft Code on Remuneration Practices*, updated 18 March 2009 (available at http://www.fsa.gov.uk/pubs/other/remuneration.pdf), 7-8, Principle 9. See also FSA, Policy Statement 09/15, *Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules* (August 2009) (available at http://www.fsa.gov.uk/pubs/policy/ps09_15.pdf), 33, discussing opposition to the specification that at least two-thirds of bonuses should ideally be deferred. In spite of this opposition, the FSA retained this deferment level as a "reasonable objective". *Ibid*.

222 See, for example, Bhagat and Romano, "Reforming Executive Compensation: Focusing and Committing to the Long-Term" (2009) 26 *Yale J. on Reg.* 359, recommending that incentive plans should contain only restricted stock and stock options, with mandatory holding periods of two to four years after the executive leaves office.

223 The term "golden parachutes" refers to large payments made to executives upon termination of office. According to the FSF, such payments will be "prudentially unsound" if they lack sensitivity to performance or risk. Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) (available at http://www.financialstabilityboard.org/publications/r_0904b.pdf), 13.

224 See generally Farrell, "US Bank Chiefs Face $500,000 Limit", *Financial Times*, 5 February 2009, 05; Davis Polk & Wardell, "New Executive Compensation Restrictions Under the

Compensation Practices have recommended provisions of this kind,[225] while acknowledging that clawback provisions may be legally difficult to implement in some jurisdictions.[226] The Walker Review recommends that such provisions be used to recover funds only in the limited situations of misstatement and misconduct.[227] In regard to golden parachutes, the ASA has stated that they are "totally unacceptable to shareholders".[228]

Two other important regulatory techniques are enhanced disclosure and increased shareholder involvement in executive pay. A number of jurisdictions increased disclosure requirements for executive pay in response to the Enron scandal. Disclosure constituted an important regulatory strategy, for example, in both Australian[229] and European[230] post-Enron reforms. In late 2006, the US announced major changes to its remuneration disclosure rules,[231] designed to ensure that perks

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Emergency Economic Stabilization Act of 2008", 6 February 2009 (available at http://www.dpw.com/1485409/clientmemos/2009/02.05.09.ec.pdf).

225 See, for example, Financial Stability Forum, *FSF Principles for Sound Compensation Practices* (2 April 2009) (available at http://www.financialstabilityboard.org/publications/r_0904b.pdf), 12-13.

226 *Id*, 13.

227 Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), Recommendation 33.

228 Australian Shareholders' Association (ASA), *ASA Policy Statement: Executive Remuneration*, 23 March 2009, para [9].

229 These post-Enron reforms were predominantly found in the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act* 2004 (Cth) (*CLERP* 9 *Act*) and ASX, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003). In August 2007, the ASX released revised principles, which are now titled *Corporate Governance Principles and Recommendations* (2nd ed, 2007). The Australian post-Enron reforms focused on use of disclosure as a regulatory strategy for achieving fair and reasonable remuneration. See generally, Ablen, "Remunerating 'Fairly and Responsibly': The 'Principles of Good Corporate Governance and Best Practice Recommendations' of the ASX Corporate Governance Council" (2003) 25 *Syd. L. Rev.* 555.

230 The 2004 Recommendation on directors' pay adopted a high level of disclosure in relation to remuneration policy, structure and performance criteria. See Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC); Ferrarini, Moloney and Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis", Law Working Paper No. 126/2009 (August 2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463), 24-25.

231 These were the most significant changes to the SEC's disclosure rules since 1992. See SEC, Press Release, *SEC Votes to Propose Changes to Disclosure Requirements Concerning*

and other previously *sub rosa* benefits came within the scope of the rules.[232] This trend towards greater transparency of executive pay is continuing. In June 2009, the SEC announced that it was considering proposals for greater disclosure in the area of executive compensation and risk.[233] The 2009 EC remuneration Recommendation[234] requires more nuanced disclosure of matters such as selection and fulfilment of performance criteria in remuneration contracts.[235] A number of the recommendations of the Walker Review also specifically relate to enhanced disclosure.[236]

Closely aligned to the issue of disclosure is the question of increased shareholder voice, or "say on pay". A non-binding shareholder vote on remuneration was introduced in the UK[237] and Australia[238] in 2002 and 2004 respectively, and has now become a familiar part of the regulatory landscape in these jurisdictions.[239] In Europe, too, the 2004 Recommendation on directors' pay provided for a shareholder

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Executive Compensation and Related Matters, 17 January 2006; Lublin and Scannell, "They Say Jump: SEC Plans Tougher Pay Rules", *Wall Street Journal*, 11 January 2006, C1; Scannell and Francis, "Executive-pay Disclosure Takes Spotlight in U.S.", *Wall Street Journal Europe*, 17 January 2006, 1.

232 See Scannell and Francis, *ibid*.

233 See SEC, Press Release, *Chairman Schapiro Statement on Executive Compensation*, 10 June 2009 (available at http://www.sec.gov/news/press/2009/2009-133.htm); Lynch, "SEC Plan Aims to Better Foretell Risks – Public Companies Would Need to Reveal Pay Incentives with Material Impact", *Wall Street Journal*, 2 July 2009, C3.

234 See Commission of the European Communities, Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (SEC (2009) 580 and SEC (2009) 581), 30 April 2009 (available at http://ec.europa.eu/internal_market/company/docs/directors-remun/directorspay_290409_en.pdf).

235 *Ibid*.

236 See, for example, Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), Recommendations 27, 30, 31, 32.

237 The Directors' Remuneration Report Regulations 2002, S.I. 2002/1986 (UK). The provision is now found in s 439 of the UK *Companies Act* 2006.

238 Section 250R(2) *Corporations Act* 2001 (Cth). See also ss 249L(2) and 300A *Corporations Act* 2001 (Cth). See generally Chapple and Christensen, "The Non-Binding Vote on Executive Pay: A Review of the CLERP 9 Reform" (2005) 18 *Aust. J. Corp. L.* 263.

239 For recent developments concerning the operation of the non-binding shareholder vote in the UK and Australia, see Hill, "Regulatory Show and Tell: Lessons from International Statutory Regimes" (2008) 33 *Del. J. Corp. L.* 819, 829-835.

vote on remuneration policy.[240] Although some commentators doubt the utility of a non-binding shareholder vote,[241] early empirical research suggests that it has been effective as an outrage constraint on pay packages diverging from best practice principles[242] and as a restraint on "rewards for failure".[243] There has been considerable resistance to the introduction of a "say on pay" rule in the US.[244] Nonetheless, in spite of tenuous beginnings,[245] the non-binding shareholder vote has now become a tangible expression of public ire about excessive pay during the global financial crisis. At first restricted to financial institutions receiving TARP funding, under the February 2009 stimulus bill,[246] more recent US reform proposals, such as

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240 The shareholders' vote may be binding or non-binding: Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC), para [11]. See also Ferrarini, Moloney and Ungureanu, "Understanding Directors' Pay in Europe: A Comparative and Empirical Analysis", Law Working Paper No. 126/2009 (August 2009) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1418463), 25.

241 See, for example, Gordon, "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In" (2009) 46 *Harv. J. on Legis.* 323.

242 See Sheehan, "Is the Outrage Constraint an Effective Constraint on Executive Remuneration? Evidence from the UK and Preliminary Results from Australia" (March 2007) (available at http://ssrn.com/abstract=974965), 3.

243 See Balachandran, Ferri and Maber, "Solving the Executive Compensation Problem through Shareholder Votes? Evidence from the U.K.", Columbia University Center for International Business Education and Research Working Paper (November 2007) (available at http://www.columbia.edu/cu/ciber/research/balchandranCIBER_Grant_Paper_UK_Voting.pdf).

244 See, for example, Gordon, "'Say on Pay': Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-In" (2009) 46 *Harv. J. on Legis.* 323; Bainbridge, "Remarks on Say on Pay: An Unjustified Incursion on Director Authority", UCLA School of Law, Law & Economics Research Paper No. 08-06 (March 2008) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1101688#).

245 The US origins of "say on pay" date back several years. The Paulson Committee suggested that a shareholder vote of this kind should be considered in the US. See Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (30 November 2006, revised version released 5 December 2006), 109. An Act to this effect, the *Shareholder Vote on Executive Compensation Act* (HR 1257) (2007) was subsequently passed by the House of Representatives in April 2007. See Scannell and Hughes, "House Clears an Executive-Pay Measure", *Wall Street Journal*, 21 April, 2007, A3. However, the Bill's passage stalled in the Senate, due to opposition by the Bush Administration at that time. Scannell and Hughes, *id*.

246 Pub. L. No. 111-5. See letter dated 20 February 2009 from Christopher J. Dodd to The Honorable Mary Schapiro (available at http://www.complianceweek.com/s/documents/DoddSchapiro.pdf).

the 2009 Shareholder Bill of Rights[247] and the *Financial Institution Compensation Fairness Act* of 2009 would introduce a general "say on pay" provision for listed companies outside the bail-out context.

Finally, remuneration consultants have now been targeted for regulatory attention. The SEC has recently announced that it is considering increased disclosure requirements concerning potential conflicts of interest among remuneration consultants[248] and the Walker Review has recommended the introduction of a draft code of conduct for remuneration consultants as a professional body.[249]

Regulation is not a one way street; rather, it is a dynamic and relational process.[250] The barrage of regulatory developments concerning executive pay has inevitably provoked some commercial push-back. In the light of the stringent rules relating to executive remuneration introduced in the US bail-out context, many institutions have recently escaped the federal funding net. In June 2009, ten large US financial institutions, including JP Morgan Chase & Co, Goldman Sachs Group Inc and Morgan Stanley, repaid approximately US$68 billion in federal aid to avoid TARP regulatory restrictions.[251] This development, and the easing of the global financial

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247 See US Senate, 111th Congress, "S. 1074, A Bill to Provide Shareholders with Enhanced Authority over the Nomination, Election and Compensation of Public Company Executives" (available at http://law.du.edu/documents/corporate-governance/legislation/bill-text-shareholders-bill-of-rights-act-of-2009.pdf).

248 See SEC, Press Release, *Chairman Schapiro Statement on Executive Compensation*, 10 June 2009 (available at http://www.sec.gov/news/press/2009/2009-133.htm).

249 See Walker, *Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industry Entities* (July 2009) (available at http://www.hm-treasury.gov.uk/d/walker_review_consultation_160709.pdf), Recommendations 38 and 39; *id*, [7.34] – [7.38].

250 See, for example, Skeel, "Governance in the Ruin" (2008) 122 *Harv. L. Rev.* 696, 696, discussing law's complex "iterative process of action and strategic reaction" as identified in Milhaupt and Pistor, *Law and Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World* (2008), 6.

251 See Sidel and Solomon, "Treasury Lets 10 Banks Repay $68 Billion in Bailout Cash", *Wall Street Journal*, 10 June 2009, A1. See also Bowley and Dash, "The Banks Push Back", *New York Times*, 29 April 2009, 1.

crisis, has been accompanied new upward pressure on executive pay and the return of big bonuses to Wall Street.[252]

6. Conclusion

We are in the midst of a complex, and developing, story about executive remuneration, corporate governance and regulation. The current focus on executive pay reflects the fact that, in the face of the global financial crisis, business once again has "a legitimacy problem".[253] Over the last two decades, there has been tension between an efficiency, and an accountability, model of corporate governance.[254] The global financial crisis has prompted a remarkable level of government intervention in financial markets[255] and brought accountability to the forefront. A wide range of reforms are now on the table around the world. It remains to be seen whether these developments will result in a long-term cultural shift in relation to executive pay.

252 In July 2009, for example, Goldman Sachs announced its best ever quarterly profit and said that it had allocated US$11.4 billion for employee salaries. See generally Bowley, "$3.4 Billion Profit at Goldman Revives Gilded Pay Packages", *New York Times*, 15 July 2009, 1; Lucchetti, "Big Pay Packages Return to Wall Street – Compensation on Track to Soar as Earnings Recover from Crisis", *Wall Street Journal*, 2 July 2009, C1; Dash, Citigroup Has a Plan to Fatten Salaries", *New York Times*, 24 June 2009, 1. See also Bebchuk and Cohen, "Back to the Good Times on Wall Street", *Wall Street Journal*, 31 July 2009.

253 Plender, "Mind the Gap: Why Business May Face a Crisis of Legitimacy", *Financial Times*, 8 April 2008, 9.

254 See Hill, "Regulatory Responses to Global Corporate Scandals" (2005) 23 *Wis. Int'l L.J.* 367, 397-398.

255 See Plender, "Shut Out", *Financial Times*, 18 October 2008, 11.

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