Executive Remuneration. A Comparative Overview

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Abstract

In this chapter, we analyse current trends in the regulation and practice of executive remuneration. No doubt, the role of regulation in this area is on the rise, particularly after the recent financial crisis, and the standards as to pay governance and structures are spreading from the financial sector to the non-financial one. As a consequence, today's remuneration practices are shaped not only by the need to reduce managerial agency costs at listed companies through appropriate incentives, but also by the hard and soft laws tackling corporate governance and remuneration structures. Moreover, regulation also responds to social issues and political pressures, reflecting concerns about either inequality in the distribution of wealth or incentives to undertake "excessive" risks in the financial sector. We examine, in particular, the main policy questions concerning incentive pay, including the optimal design of stock options and the importance of longterm pay. Amongst the governance mechanisms, we consider both the role of boards and independent directors, and that of shareholders under say on pay rules, taking into account the rise of shareholder engagement in listed companies across the Atlantic. We also analyse regulatory developments in Europe over the last decade and current postcrisis proposals by the Commission, comparing the same with developments at member state level and in the US. In particular, we highlight the impact of say on pay rules on shareholder activism, expanding on the role of proxy advisors and the behaviour of large institutional investors. We lastly focus on the regulation of pay structures, showing that long-term incentives are clearly favoured for both financial and non-financial companies by either regulators or institutional investors. However, financial institutions are the main target of post-crisis reforms, firstly at international level and secondly in the US and the EU, where the FSB principles have been implemented along partially diverging routes. CRD IV, in particular, has marked a new trend in the regulation of bankers' pay, by imposing a bonus cap that we criticize from an economic perspective and which clearly goes beyond the international principles.

Keywords: Executive remuneration, corporate governance, banks, financial crisis, prudential regulation, supervision

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

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EXECUTIVE REMUNERATION.
A COMPARATIVE OVERVIEW

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October, 2014

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ABSTRACT

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I. INTRODUCTION

Executive pay lies at the heart of current discussion on corporate governance reform. Increased disclosure, monitoring by the media and institutional investor activism often suggest that the levels and structures of executive remuneration are divorced from corporate performance, and represent a sharp conflict of interest between management and shareholder interests. Moreover, "excessive" compensation at banks and other financial institutions is widely believed to have contributed to the financial crisis by incentivizing managers to take excessive risks. In the present chapter we consider executive remuneration from a transatlantic perspective, looking at corporate practices, regulation and investor behavior both in Europe and the US. The remainder of this introductory section introduces the main problems of executive pay from the perspective of agency costs theory, banking theory and corporate social responsibility. In section II, we analyze the main policy issues concerning executive pay, such as design problems, remuneration governance, disclosure of pay policies and amounts, and prudential regulation of pay structure at banks. In section III we examine the regulation of pay governance and disclosure, focusing on EU law, comparative law and international practice. In section IV we analyze the regulation of pay structure at financial institutions (banks in particular) focusing on the international principles and standards, on Dodd-Frank Act and CRD IV. Section V concludes.

1. **Agency costs**

The principal-agent model generates two competing views of executive pay.[1] Under the former, executive pay remedies the agency costs generated by the misalignment of management and shareholder interests in the dispersed ownership company. Shareholders in dispersed ownership systems have only a fractional interest in firm profits, are not fully incentivized to discipline and have limited opportunities to monitor management.[2] Management's unobserved actions, particularly where personal costly decisions (e.g. laying off employees) and private beneficial activities (e.g. consuming perquisites) are involved, can reduce shareholder wealth and give rise to agency costs. Whether, and the extent to which, a manager will fully pursue the shareholders' agenda depends on how she is incentivized. Agency theory suggests that the performance-based pay contract, which links pay to shareholder wealth via performance indicators such as share prices or accounting-based targets, is a powerful way of attracting, retaining, and motivating managers to pursue the shareholders' agenda.[3] In the dispersed ownership context, this approach has dominated the pay debate and pay practices since the early 1990s and still enjoys considerable support as making management more sensitive to shareholders' interests.[4]

However, executive pay can also be regarded as an agency cost in itself in that it provides a powerful and opaque device for self-dealing by conflicted managers.[5] In practice, pay is not set by

[1] Guido Ferrarini & Niamh Moloney, *Executive remuneration in the EU: The context for reform*, OXFORD REVIEW OF ECONOMIC POLICY, 21: 304-23 (2005).

[2] Michael Jensen & William Meckling, *Theory of the firm: Managerial behavior, agency costs and ownership structure*, JOURNAL OF FINANCIAL ECONOMICS 3: 305-360 (1976).

[3] Michael Jensen & Kevin Murphy, *Performance pay and top management incentives*, JOURNAL OF POLITICAL ECONOMY 98: 225-64 (1990); Michael Jensen & Kevin Murphy, *Remuneration: Where we've been, how we got to here, what are the problems, and how to fix them*, ECGI FINANCE WORKING PAPER 44 (2004), available at: www.ecgi.org; Martin Conyon & David Leech, *Top pay, company performance and corporate governance*, OXFORD BULLETIN OF ECONOMICS AND STATISTICS 56: 229-47 (1994); Brian Hall & Jeffrey Liebman, *Are CEOs really paid like bureaucrats?*, NBER WORKING PAPER 6213 (1997).

[4] Bengt Holmstrom & Steven Kaplan, *The state of US corporate governance: What's right and what's wrong?*, JOURNAL OF APPLIED CORPORATE FINANCE 15: 8–20 (2003); Rajesh Aggarwal & Andrew Samwick, *Executive Compensation, Strategic Competition, and Relative Performance Evaluation: Theory and Evidence*, JOURNAL OF FINANCE 54: 1999-2043 (1999); Conyon & Leech (1994).

[5] Lucian Bebchuk, Jesse Fried and David Walker, *Managerial power and rent extraction in the design of executive compensation*, UNIVERSITY OF CHICAGO LAW REVIEW 69: 751-846 (2002); Jennifer Hill & Charles Yablon, *Corporate governance and executive remuneration: Rediscovering managerial positional*

shareholders; instead it is set on their behalf by the board of directors, which should align shareholder and managerial incentives.[6] Nonetheless, a conflicted board may use the pay-setting process to influence pay and extract rents in the form of pay in excess of that what would be optimal for shareholders, given weaknesses in the design of pay contracts and in their supporting governance structures.[7] In other words, executive pay raises an additional agency problem: how can the effectiveness of the executive pay contract as a remedy for manager/shareholder agency costs be protected from conflicts between the board, as pay-setter, and the shareholders.[8] The equity-based incentive contract may, as post-Enron scholarship argues, deepen conflicts of interest between shareholders and managers by generating perverse management incentives to manipulate financial disclosure, particularly earnings, and distort share prices, which can lead to catastrophic corporate failures. The consequences of such a cycle of ever higher share prices, and their impact on pay, has been examined as "the agency costs of overvalued equity".[9]

The relationship between agency problems and the executive pay incentive contract takes on an additional complexity in continental European firms, characterized by concentrated shareholdings and long-term shareholder commitment.[10] Here, incentives and conflicts change, as concentration of control (possibly intensified by cross shareholdings, pyramidal ownership structures, proxy voting by financial institutions connected to the company, and voting pacts) recasts the agency problem which executive pay is designed to resolve. The agency costs which trouble the dispersed ownership company are reduced, as block-holding shareholders have both

conflict, UNIVERSITY OF NEW SOUTH WALES LAW JOURNAL, 25: 294 – 319 (2002); Lucian Bebchuk & Jesse Fried, *Pay Without Performance. The Unfulfilled Promise of Executive Compensation*, HARVARD UNIVERSITY PRESS, Cambridge and London (2004).

[6] Jensen & Murphy, 2004.

[7] Bebchuk *et al*. 2002; Bebchuk & Fried, 2004.

[8] Jensen and Murphy 2004; Jeffrey Gordon, *Executive Compensation: If there's a Problem, What's the Remedy? The Case for Compensation Disclosure and Analysis*, 30 JOURNAL OF CORPORATION LAW 675 (2005); Jensen & Murphy, 1990; Michael Jensen & Kevin Murphy, *CEO Incentives: It's not How Much You Pay but How*, 3 JOURNAL OF APPLIED CORPORATE FINANCE 36 (1990).

[9] Jensen & Murphy, 2004.

[10] Guido Ferrarini & Niamh Moloney, *Executive remuneration and corporate governance in the EU: Convergence, divergence, and reform perspectives*, EUROPEAN COMPANY AND FINANCIAL LAW REVIEW, 1: 251-339 (2004).

incentives and resources to monitor managers effectively. As a result, there is less need for an incentive contract to control the conflict between management and shareholder interests that is remedied by executive pay. There is also less probability of the agency problem which derives from executive pay arising.

2. Financial stability

The traditional agency approach does not fully explain the problems of bankers' pay and their possible impact on financial stability. No doubt, a widespread post-crisis view holds that the failure of banks both in Europe and the US may have been at least partially caused by flawed remuneration structures, including short-term incentives that may have led bank managers to take risks which in the long run appeared to be excessive. Nonetheless, empirical research has shown that banks that failed in the crisis often complied with best practices as to corporate governance and executive remuneration.[11] A paper by Rüdiger Fahlenbrach and René Stulz analyses a sample of ninety-eight large banks across the world and finds "no evidence that banks with a better alignment of CEOs' interests with those of their shareholders had higher returns during the crisis".[12] The authors rather identify "some evidence that banks led by CEOs whose interests were better aligned with those of their shareholders had worse stock returns and a worse return on equity." According to their study, CEOs had substantial wealth invested in their banks, with the median CEO portfolio including stocks and options in the relevant bank worth more than eight times the value of the CEO's total compensation in 2006. Similar equity holdings should have led CEOs to focus on the long term, avoiding too much risk and excessive leverage for their banks. Instead, the study shows that a bank's stock return performance in 2007-2008 was negatively related to the dollar value of its

[11] Andrea Beltratti & René Stulz, *The credit crisis around the globe: Why did some banks perform better?*, 105 JOURNAL OF FINANCIAL ECONOMICS 1: 1–17 (2012); Renée Adams, *Governance and the Financial Crisis*, ECGI Finance Working Paper N. 248 (2009), available at: www.ssrn.com.

[12] Rüdiger Fahlenbrach & René Stulz, *Bank CEO Incentives and the Credit Crisis*, 99 JOURNAL OF FINANCIAL ECONOMICS 1: 11-26 (2010).

CEO's holdings of shares in 2006, and that a bank's return on equity in 2008 was negatively related to its CEO's holdings in shares in 2006.

However, another stream of literature highlights possible agency costs in banks caused by inadequate remuneration structures. A paper by Lucian Bebchuk, Alma Cohen, and Holger Spamann on executive compensation at Bear Stearns and Lehman Brothers focuses on the link between substantial short-term incentives and excessive risk taking.[13] The authors argue that the large losses on shares that the top financiers suffered when their firms melted down do not offer a full picture of their payoffs, which should include what the same executives cashed out in the 2000-2008 period and what they owned initially. In the observed timeframe, the relevant executives received large amounts of cash bonus compensation and "regularly took large amounts of money off the table by unloading shares and options." Indeed, performance-based compensation paid to top executives at Bear Stearns and Lehman Brothers substantially exceeded the value of their holdings at the beginning of the period. Bebchuk et al. argue that this provides a basis for concern about the incentives of the two banks' executives. Rather than producing a "tight alignment" of their interests with long-term shareholder value, the design of performance-based compensation provided executives of the relevant firms with substantial opportunities "to take large amounts of compensation based on short-term gains off the table and retain it even after the drastic reversal of the two companies' fortunes."

In order to get the full picture, the remuneration of other bank employees should also be taken into account, particularly that of high-earners who contribute to risk taking by the firm.[14] Even though precise empirical data are lacking, it is well known that many of these employees were paid before the crisis short-term incentives in amounts much greater than that of their fixed salaries. As explained by Diamond and Rajan (2009): "Given the competition for talent, traders have to be paid generously based on performance. But many of the compensation schemes paid for short-term

[13] Lucian Bebchuk, Alma Cohen and Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 10 YALE JOURNAL ON REGULATION 27: 257-282 (2010).
[14] Ing-Haw Cheng, Harrison Hong and Jose Scheinkman, *Yesterday's Heroes: Compensation and Creative Risk-Taking*, ECGI FINANCE WORKING PAPER, N. 285 (2010), available at: www.ssrn.com.

risk-adjusted performance. This gave traders an incentive to take risks that were not recognized by the system, so they could generate income that appeared to stem from their superior abilities, even though it was in fact only a market-risk premium".[15]

No doubt, assuming that CEOs and other top managers were awarded the right incentive schemes – i.e. not only short-term, but also long-term incentives – the fact that other employees had mainly short-term incentives should not be a source of great concern, provided that sound risk management systems were in place and an effective oversight was exercised on risk-takers by their superiors. However, as widely acknowledged in the aftermath of the crisis, this was not always the case at large banks, where risk management systems were often deficient, and CEOs and top managers frequently did not have proper controls over the financial operations. Moreover, the problems were exacerbated by the huge amounts promised by banks to their employees. As colourfully described by Professor Alan Blinder, traders and other employees were often offered "the following sort of go-for-broke incentives when they place financial bets: Heads, you become richer than Croesus; tails, you get no bonus, receive instead about four times the national average salary, and may (or may not) have to look for another job… Faced with such skewed incentives, they place lots of big bets. If heads come up, they acquire dynastic wealth. If tails come up, OPM [other people money] absorbs almost all losses".[16]

3. Social issues

The criticism of excessive pay also concerns non-financial firms and, across sectors, portrays a social perspective. Indeed, populist and political resentment against income disparity is on the rise, particularly in the present context of economic uncertainty, leading to a lack of

[15] Douglas Diamond & Raghuram Rajan, *The Credit Crisis: Conjectures about Causes and Remedies*, 99 AMERICAN ECONOMIC REVIEW 2: 606-610 (2009).
[16] Alan Blinder, *After the Music stopped. The financial crisis, the response, and the work ahead*, PENGUIN BOOKS, New York (2014).

confidence in the integrity and fairness of large corporations. The US was the first to officially address the social implications of high executive pay.[17] In September 2013 the SEC proposed new rules on disclosure by public companies of the ratio of CEO pay to median employee pay, as required under Section 953(b) of the Dodd-Frank Act.[18] This approach has been the subject of intense debate and has garnered significant media attention.[19] Its supporters, including pension funds and other socially-minded investors, argue that the ratio represents material information for investors and that looking at the overall compensation framework of a single company can help rein in excessive executive pay.[20] In contrast, business organizations, major law firms, and other market constituencies argue that the pay ratio would provide little or no insight for investors, who are rather interested in the correlation between CEO pay and the company's financial performance, also in comparison with pay practices at other public companies.[21]

The reported ratio is expected to be very high, even for CEOs whose compensation is relatively modest. Whilst the US is attempting to deter excessive executive pay by holding boards accountable both to shareholders and society through mandated disclosure, some European countries target similar goals through different measures.[22] For example, France uses taxation as a means to rebalance pay differences between corporate executives (and high earners in general) and

[17] Kevin Murphy, *The Politics of Pay: A Legislative History of Executive Compensation*, in RESEARCH HANDBOOK ON EXECUTIVE PAY (Randall Thomas and Jennifer Hill eds.): 11-40, Edward Elgar Publishing (2012).

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

[19] AFL-CIO, *Dodd-Frank Section 953(b): Why CEO-to-Worker Pay Ratios Matter For Investors* (2013), available at: www.aflcio.org.

[20] For example, the Council of Institutional Investors recommends that compensation committees consider the "goals for distribution of awards throughout the company" and "the relationship of executive pay to the pay of other employees" as factors in developing their executive pay philosophy. Council of Institutional Investors, *Corporate Governance Policies* (2010), available at: http://www.cii.org/CouncilCorporateGovernancePolicies/.

[21] For an analysis of the debate including critics, Gary Shorter, *The "Pay Ratio Provision" in the Dodd-Frank Act: Legislation to Repeal It in the 113th Congress* (October 2013), available at: https://www.fas.org/sgp/crs/misc/R43262.pdf.

[22] Tower Watson, *Executive Remuneration – Europe. Corporate Governance Developments* (2014), available at: www.towerwatson.com.

other employees, through a 75% "super tax" payable by employers on compensation over €1m.[23] In Germany, changes to the Corporate Governance Code were effected requiring supervisory boards (i) to set maximum pay-out levels on the total and individual pay of executive board members and (ii) to consider the relationship between executive board members' remuneration and staff generally.[24] In Switzerland, following a public referendum against excessive salaries in March 2013 (the 'fat cat initiative'), the voters' majority called for new constitutional rules to control executive pay and improve the corporate governance of listed companies.[25] As the referendum's outcome was not directly enforceable, the Federal Council adopted an interim ordinance,[26] which intends to improve the corporate governance of Swiss listed companies and empowers shareholders to express a binding vote on executive compensation. The new ordinance is particularly striking as it includes penal provisions for breaches of its rules and for executives being granted or accepting excessive compensation.

II. POLICY ISSUES

1. Design problems

Performance pay suffers from a number of inherent design defects which damage the performance link at the heart of the incentive contract's effectiveness as an interest-alignment device, and which provoke conflicts between management and shareholders or, potentially, between management/controlling shareholders and minority shareholders (according to the particular

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[23] *French General Tax Code, Article 750*, PUBLIC FINANCES GENERAL DIRECTORATE TAX POLICY DIRECTORATE, Minister of Economy, Finance and Industry, available at: http://www.impots.gouv.fr/portal/deploiement/p1/fichedescriptive_1006/fichedescriptive_1006.pdf.

[24] *German Corporate Governance Code*, 2013, available at: www.corporate-governance-code.de

[25] Text of initiative (in German) Eidgenössische Volksinitiative 'gegen die Abzockerei', available at: http://www.admin.ch/ch/d/pore/vi/vis348t.html. Brief in English available at: http://www.lexology.com/library/detail.aspx?g=d97687f6-db1d-430e-b157-3c3432b5ed1a.

[26] *Ordinance against Excessive Compensation* with respect to Listed Stock Corporations. (OaEC, 2014).See information on http://www.lexology.com/library/.

shareholder/management profile in blockholding companies). These defects heighten the need for an effective governance and disclosure matrix for pay-setting if the alignment process is to work. We highlight three main design challenges: proxies for firm performance, stock options, and long-term pay.[27]

a) Proxies for firm performance

Share price is ordinarily the best available proxy for shareholder wealth and reflects overall corporate performance more effectively than business-line linked, target-specific bonuses. But the danger arises when generating incentives to inflate earnings and manage disclosure to generate short-term share-price increases. Equity-based compensation also risks over-compensation of executives who preside over a period of market growth and under-compensation of those caught in a period of overall poor market performance. It is, however, difficult to construct a better alternative for shareholder wealth, given that it does reflect the market's perception of the company's current and future cash flows, and so its perceptions of management performance and investment opportunities.[28] The risk of management inflating the share price, however, demands that the governance matrix, which monitors management and supports pay-setting, whether it be independent directors, institutional investors, or controlling shareholders, is robust.

b) Share options

Share options pose a second major design problem. They can create potentially powerful incentives by linking pay to shareholder returns expressed via the share price. They can incentivize executives to take efficient, but personally stressful decisions and promote greater efforts to

[27] Ferrarini & Moloney, 2005; Guido Ferrarini, Niamh Moloney and Maria Cristina Ungureanu, *Executive Remuneration in Crisis. A Critical Assessment of Reforms in Europe*, 10 JOURNAL OF CORPORATE LAW STUDIES 1: 73-118 (2010).

[28] Kevin Murphy, *Corporate Performance and Managerial Remuneration*, 7 JOURNAL OF ACCOUNTING AND ECONOMICS: 11-42 (1995); Jensen & Murphy, 1990

increase the global value of the company and the share price.[29] They have an attractively asymmetrical pay structure in that they reward success but do not appear to penalize failure: executives are not likely to equate the failure to make a gain with an actual loss. Options can also act as a powerful inducement to attract talent and can incentivize executives to stay. But share options also display a number of inherent inefficiencies,[30] such as the following:

(i) *Relative performance*. Fixed price options, where vesting is independent of performance, can deliver very large gains for executives whenever the market is rising, even if the company is under-performing its competitors.[31] This problem can be avoided by linking the option's exercise price to a market or peer-group index such that executives are rewarded only when they outperform the competition, or linking exercise to the achievement of performance conditions.

(ii) *Repricing*. The capacity for share options to be re-priced when the share price falls on poor corporate performance (rather than on sector-wide movements) further weakens the incentive justification and damages the alignment mechanism.[32] This was a common practice in the USA prior to changes in accounting regulations.[33]

(iii) *Impact on dividend policy*. If share options appropriately align shareholder and management incentives, management should be incentivized to allocate cash flow to shareholders in the form of dividends. Share options can distort this alignment as the value of options drops with dividend payment, incentivizing management to reduce dividends.[34]

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[29] Jeffrey Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 UNIVERSITY OF CHICAGO LAW REVIEW 1233-1250 (2002).
[30] Bebchuk *et al*. 2002.
[31] Alfred Rappaport, *New Thinking on How to Link Executive Pay with Performance* 77 HARVARD BUSINESS REVIEW 2: 91-101 (1999); Menachem Brenner, Rangarajan Sundaram and David Yermack, *Altering the Terms of Executive Stock Options*, 57 JOURNAL OF FINANCIAL ECONOMICS 108: 103-128 (2000); Don Chance, Ramar Kumar and Rebecca Todd, *The 'Repricing' of Executive Stock Options*, 57 JOURNAL OF FINANCIAL ECONOMICS 129: 65-101 (2000); Angela Morgan & Annette Poulsen, *Linking Pay to Performance - Compensation Proposals in the S&P 500*, 62 JOURNAL OF FINANCIAL ECONOMICS 3: 489-523 (2001); Kieth Chauvin & Cathy Shenoy, Stock Price Decreases Prior to Executive Stock Option Grants, 7 JOURNAL OF CORPORATE FINANCE 53-76 (2001).
[32] Brenner *et al*. 2000; Chance *et al*. 2000
[33] Mary Carter & Luann Lynch, *An examination of executive stock repricing,* 61 JOURNAL OF FINANCIAL ECONOMICS: 207-225 (2001).
[34] Richard Lambert, William Lanen and David Larcker, *Executive Stock Options Plans and Corporate Dividend Policy*, 24 JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 4: 409-425 (1989);

(iv) *Dilution*. Share options carry the risk of dilution and, therefore, of a reduction in earnings per share and entrenchment of management voting power.[35] Dilution also raises difficulties in blockholding companies, where controllers may see their dominant position weakened.

Option grants can, however, be structured to avoid incentive alignment weaknesses. The share option problem then becomes one of how to ensure good supporting governance in, and disclosure of, pay-setting, rather than a difficulty with the option as a tool of executive pay *per se*. Design problems are in the hand of the board, as pay-setter, and its allied monitoring structures. If the board is aligned with shareholder interests, structure problems can be mitigated. Although the connection between bad governance and suboptimal pay structures is not entirely clear,[36] the link between optimal shareholder interest alignment and good governance drives regulatory responses to remuneration.

c) Long term pay

One of the concerns in the recent discussion concerning executive pay design has been that it is insufficiently focused on the long term, leading to reckless, short-term decision making by executives and to financial bubbles.[37] However, combating short-termism appears to be high on the post-crisis agenda, as shown by the Kay Review in the UK, suggesting that 'companies should structure directors' remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be

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Scott Weisbenner, *Corporate Share Repurchases in the 1990: What Role Do Stock Options Play*, FEDS WORKING PAPER NO. 2000-29 (2000), available at: www.ssrn.com; Markus Arnold & Robert Gillenkirch, *Stock Options as Incentive Contracts and Dividend Policy*, UNIVERSITY OF FRANKFURT FINANCE & ACCOUNTING WORKING PAPER SERIES (2002), available at: www.ssrn.com.

[35] Morgan & Poulsen, 2001; Chauvin & Shenoy, 2001

[36] Brenner *et al*. 2000; Marianne Bertrand & Sendhil Mullainathan, *Agents With and Without Principals*, 90 AMERICAN ECONOMIC REVIEW 2: 203-208 (2000); Carter & Lynch, 2001.

[37] David Walker, *The Challenge of Improving the Long-term Focus of Executive Pay* 51 BOSTON COLLEGE L. REVIEW 2: 435-472 (2010); Bebchuk & Fried, 2004.

held at least until after the executive has retired from the business'.[38] Also corporate governance scholars suggest that executives should be encouraged to focus on the long term by holding a large fraction of their equity after it vests. Bhagat and Romano, in particular, recommend that incentive compensation should consist only of restricted stock and restricted stock options – restricted in the sense that the executive cannot sell the shares or exercise the options for two to four years after his or her last day in office. They contend that such an incentive compensation package will focus management's attention on the long-run and discourage investment in high-risk, value-destroying projects.[39] Bebchuk and Fried also focus on equity-based compensation as a way for tying incentives to long-term results.[40] They particularly analyze the optimal design of limitations on unwinding, arguing that an executive receiving an equity-based grant should not be free to unwind the received equity incentives for a specified period of time after vesting, after which she should be permitted to unwind the equity only gradually. Moreover, they advocate that firms adopt arrangements designed to ensure that executives cannot easily evade both the prescriptions that require executives to hold equity for the long term and those that prevent gaming.

2. Governance mechanisms

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

a) Boards

[38] *The Kay Review of UK Equity Markets and Long-Term Decision Making* (July 2012), available at: www.gov.uk; European Commission, *Communication on long term financing of the European economy*, available on: www. http://ec.europa.eu (March, 2014)

[39] Sanjai Baghat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long Term*, 26 YALE JOURNAL ON REGULATION: 359-372 (2009).

[40] Lucian Bebchuk & Jessie Fried, J, *Paying for Long-Term Performance* 158 UNIVERSITY OF PENNSYLVANIA LAW REVIEW: 1915-1959 (2010).

A board may become passive or captured by management, and hence poorly incentivized to bargain for optimal incentive pay in shareholder interests. The addition of independent directors to the board (or board remuneration committee) may provide a solution and is a dominant theme of regulatory responses to remuneration, albeit adjusted, in blockholding systems, to reflect the influence of controlling shareholders.[41] Independent, well-resourced, informed, and competent directors should be able to withstand any overbearing influence of senior management and be more likely to judge performance in the shareholders' interests and with respect to the company's performance.[42]

There are, however, certain impediments in optimizing the presence of independent directors. Independent directors may be reluctant to disturb the *status quo*, being friends of or appointed by the chief executive, or may be incentivized to set pay in a manner beneficial to them where they are serving executive directors. They may lack expertise on pay or have insufficient time to become expert. Disclosure flows to independent directors on performance may be unreliable. Reputational factors, which may result in an independent director who is regarded as 'tough on pay' being blacklisted from other boards may arise. The empirical evidence on the effectiveness of independent directors is equivocal.[43] It has also been suggested that independent directors have not controlled executive pay but rather presided over its explosion.[44]

One way out of this impasse is to impose rigorous controls on the independence of nominally independent directors, which can only be achieved to a limited degree in blockholding systems. Composed primarily of independent directors and exercising pay-setting functions delegated from the board, the remuneration committee can act as an objective control on the pay-

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[41] Guido Ferrarini & Marilena Filippelli, *Independent directors and controlling shareholders around the world* ECGI WORKING PAPER 258 (2014) available at: www.ssrn.com.

[42] Reinier Kraakmann, *Disclosure and Corporate Governance: An Overview Essay* in REFORMING COMPANY AND TAKEOVERLAW IN EUROPE, (Guido Ferrarini *et al*. eds.) Oxford University Press (2004).

[43] Roberta Romano, *The Sarbanes-Oxley Act and the making of quack corporate governance,* 114 THE YALE LAW JOURNAL 7: 1521-1611 (2005).

[44] Sanjai Bhagat & Bernard Black, *The Non-Correlation between Board Independence and Long Term Firm Performance*, 27 JOURNAL OF CORPORATION LAW: 231-274 (2002).

setting process. However, the remuneration committee may be particularly ineffectual in blockholding companies playing, in effect, a fictional role as pay is set by the controlling shareholders directly, although it has a potentially important role in minority shareholder protection.

While remuneration consultants provide expertise in the complex area of pay design, and improve disclosure flows to the remuneration committee, they are also vulnerable to capture by the board, and may exacerbate problems by acting as a camouflage mechanism to legitimize sub-optimal pay decisions, unless selected by and accountable to the remuneration committee.[45]

b) Shareholders

The effectiveness of back-stop shareholder monitoring of the incentive contract and the pay-setting process lies at the core of the pay-setting problem in the dispersed-ownership context. As effective monitors, whether via direct shareholder voice mechanisms, such as votes on pay, or via indirect lobbying, shareholders suffer from the collective action problem and from lack of information. Collective action problems are exacerbated in the case of executive pay as shareholders are unlikely to see substantial individual gains from a reduction in the pay bill, and may suffer if management incentives are damaged. An examination of the optimality of pay decisions requires careful case-by case analysis of disclosure which, even where it is made available, can be difficult for shareholders. Institutional investors are, albeit controversially, often regarded as potentially strong corporate monitors. The extent to which institutional investors can bear on the pay process is, however, doubtful.[46]

The collective-action problem arises and is aggravated by the need for institutions to have diversified holdings,[47] which dilutes the ability of institutional investors to focus on company-

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[45] Bebchuk *et al*. 2002; Jensen & Murphy, 2004.
[46] Brian Cheffins & Randall Thomas, *Should Shareholders have a Greater Say over Executive Pay? Learning from the US Experience*, 1 JOURNAL OF CORPORATE LAW STUDIES: 277-315 (2001); Jeffrey Gordon, *"Say on Pay": Cautionary Notes on the UK Experience and the Case for Shareholder Opt-in*, 46 HARVARD JOURNAL ON LEGISLATION, 2: 323 – 367 (2009).
[47] Klaus Hopt, *Modern Company and Capital Market Problems. Improving European Corporate Governance After Enron*, ECGI WORKING PAPER 5, available at: www.ecgi.org (2002).

specific issues. Institutions may not communicate effectively as a group and so fail to influence the board. Agency problems can also arise within an institutional investor, where, for example, an investor's corporate governance team faces pressure from other internal groups which provide services to a company's management.[48] Institutional investors may also be prone to short-termism and ill-quipped to undertake successful long-term monitoring of executive-pay strategies. However, there is some US evidence that large shareholders (5 per cent and over) can act as an effective governance mechanism with respect to remuneration.[49] Law, and particularly mandatory disclosure, appears to matter in this context, as the changes to UK company law in 2002, requiring a shareholder vote on the Director's Remuneration Report, appeared to galvanize institutional investors into action, as we argue below.

Moreover, a significant development in the last few years has been the rise of shareholder engagement. This mainly depends on the re-concentration of ownership in the hands of institutional investors and on the willingness of many of these to engage in shareholder activism.[50] While there are also other issues to debate (such as corporate social responsibility), remuneration stands out in particular as a topic on which investors can have much to say.[51] Generally, companies engage with shareholders on executive compensation well ahead of the annual general meeting. While initially engagement occurred primarily in cases in which a "no" recommendation had been issued by proxy advisors on a company's pay policy or other negative feedback had come from significant shareholders, it is accepted today that dialogue with shareholders should take place in all circumstances.[52] Indeed, not only pay practices, but also corporate performance drives proxy

[48] Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE JOURNAL OF REGULATION: 174-251 (2001).
[49] Bertrand & Mullainathan, 2001.
[50] Ronald Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUMBIA LAW REVIEW: 863-928 (2013); Brian Cheffins, *The Corporate Governance Movement, Banks and the Financial Crisis*, ECGI LAW WORKING PAPER 232 (2014) available at: www.ecgi.org.
[51] European Commission, *Summary of the informal discussions concerning the initiative on shareholders engagement* (March 2013), available at: http://ec.europa.eu.
[52] European Commission, 2003.

advisors' recommendations and voting by institutional investors.[53] Therefore, a negative recommendation or vote could be issued simply on the basis of a perceived disconnect between pay and shareholder return, regardless of how carefully remuneration structures comply with best practices.

3. Disclosure

Disclosure may provide the least costly way to manage the range of potential agency costs by ensuring that shareholders have sufficient information on remuneration as well as on any potential conflicts in the remuneration-setting process. It is also a more limited form of intervention in governance, which would allow flexibility and increase transparency in remuneration-setting in dispersed and blockholding ownership companies.[54] Disclosure requirements prompt the board to justify pay choices and the pay-setting process, and can also enhance the accountability and visibility of the remuneration committee. They can also sharpen shareholder monitoring, particularly by including institutional shareholders to play a more activist role. Disclosure of pay lowers the cost of monitoring by raising the reputation of institutional investor monitors by signalling or publicizing the results of their activism and generating greater deterrence effects. It also facilitates communication between institutional investors and with management.

While disclosure is traditionally associated with minimal regulatory intervention, there are costs involved. The benefits of potentially greater shareholder activism must be weighed against popular and political reaction to enhanced disclosure of executive pay. With enhanced disclosure, pay questions are played out in the media, influenced by labour, captured by private interests (such as those of political activists and union personnel), and politically infused. Remuneration committees may be vulnerable to responding to political and workforce pressures and adopting

[53] ISS (International Shareholder Services), *2011 U.S. Post Season Report* (2011), available at: www.iss.com; ISS (International Shareholder Services) *2012 Proxy Season Review. World Markets* (2013), available at: www.iss.com.
[54] Ferrarini *et al.* 2009.

suboptimal remuneration structures which are not sufficiently sensitive to performance.[55] Disclosure which focuses on headline pay levels invites popular hostility and does not assist shareholders in assessing remuneration structures, and the pay-setting process is destabilizing.[56] By contrast, disclosure which makes it easier to assess the pay-performance relation/incentive structure and the effectiveness of governance can remedy some of the structural and process weaknesses of executive remuneration. Among other possible drawbacks of excessive disclosure there is the risk that disclosure may result in an increase in pay due to a ratcheting effect.

4. Mandatory Pay Structure

In a previous paper we argued that the case for regulating the structure of bankers' pay appears to be rather weak.[57] Firstly, it is far from proven that pay structures generally contributed to excessive risk-taking before the recent crisis. According to some of the studies cited above, corporate governance and compensation structures of CEOs at banks that failed were not necessarily flawed. Secondly, even assuming that compensation structures were flawed – in particular, those of traders and other middle-managers taking excessive risks for banks - the need for their regulation would not be automatically established. In fact, excessive risk taking could be curbed directly through prudential regulation of banking activities, rather than by modelling the incentives of bank employees, also given that regulators may not be professionally qualified for designing pay structure.[58] Thirdly, mandating pay structures hampers the flexibility of compensation arrangements, which need tailoring to individual firms and managers, also in light of the latter's portfolios of their own bank securities. Moreover, in this context, bank boards may lose one of their key governance functions, finding it more difficult to align executives' incentives to

[55] Romano, 2001.
[56] Murphy, 1995.
[57] Guido Ferrarini & Maria Cristina Ungureanu, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks*, 62 VANDERBILT LAW REVIEW 2: 431-502 (2011).
[58] Blinder, 2013

corporate strategy and risk profile. This may also create problems in keeping and attracting managerial talent, particularly from countries that adopt a more liberal stance or from firms that are not subject to regulatory constraints (such as hedge funds or private equities).

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

III. REGULATING PAY GOVERNANCE AND DISCLOSURE

1. EU law

Disclosure, shareholder voice and the independent director all appear in the EU's strategy for executive pay. The EU's initial approach, set out in the 2004 and 2005 Recommendations, was based on pay governance.[59] A number of directives adopted under the Financial Services Action Plan also form part of the EU's pay matrix by improving disclosure, both generally and with respect to pay, and by addressing insider dealing risks.[60]

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[59] Ferrarini *et al.* 2010.

[60] Niamh Moloney, *The EU and Executive Pay: Managing Harmonisation Risks*, in RESEARCH HANDBOOK ON EXECUTIVE PAY: 466 (Randall Thomas and Jennifer Hill eds.), Edward Elgar Publishing (2012).

a) The 2004-2005 Recommendations

To achieve its objectives, the Commission employed a non-binding Recommendation, avoiding a "one-size-fits-all" solution at the firm and Member State levels. The 2004 Recommendation was the EU's first attempt to address best practice with respect to pay governance. It uses disclosure and shareholder voice mechanisms to support efficient pay and recommends: disclosure of company pay policy, either in a distinct remuneration report or in the annual report; detailed disclosure concerning individual directors' pay; a shareholders' vote on company pay policy, which can be either binding or advisory; and *a priori* approval of share-based schemes. The Recommendation does not engage with pay design, although support for performance-based pay is implicit across the Recommendation.

The role of the board in pay-setting is addressed by the parallel 2005 Recommendation on the role of non-executive directors, which highlights remuneration as an area in which the "potential for conflict of interest is particularly high" and recommends that: boards should have an "appropriate balance" of executive and non-executive directors such that no individual or group of individuals can dominate decision-making and there is a "sufficient" number of "independent" non-executive directors; board committees should be created for issues particularly vulnerable to conflict of interest (including remuneration); and the remuneration committee (its functions are delineated in some detail) should be composed exclusively of non-executive or supervisory directors, a majority of whom should be independent. The Recommendation also provides guidelines on the notion of "independence".

Member States were free to adopt the Recommendations (implementation was not mandatory) either through legislation or, as has been the dominant method, through soft law, typically based on the local Corporate Governance Code and, for many Member States though not all, on the related "comply or explain" principle.[61] Poor compliance need not necessarily follow

[61] European Commission, *Report on the Application by the Member States of the EU of the Commission Recommendation on the Role of Non-executive or Supervisory Directors of Listed Companies and on the Committees of the (Supervisory) Board (COM SEC(2007) 1021)* (2007).

from soft law implementation; companies that voluntarily adopt more rigorous corporate governance structures can be rewarded by a positive effect on firm value.[62]

b) The 2009 Recommendation

Executive pay in non-financial firms was pulled into the Commission's wider financial crisis reform agenda with the adoption of a 2009 Recommendation on Directors' Remuneration, which had to be implemented by the Member States by the end of 2009. Through it the Commission moved closer to the problematic, but politically appealing, design sphere. Noting that remuneration structures have become increasingly complex, too focused on the short term and leading, in some cases, to "excessive" remuneration not justified by performance,[63] the Commission adopted a series of voluntary principles concerning the structure of remuneration. The 2009 Recommendation focuses in particular on the pay/performance link, on long-term sustainability and on restricting "excessive" variable pay.

The Recommendation addresses remuneration policy disclosure, suggesting that the remuneration policy be clear and easily understandable, that an explanation be provided concerning how performance criteria relate to firms' long-term interests and with respect to whether those criteria were fulfilled, and that "sufficient information" be provided concerning termination payments, vesting and other restrictions, and concerning the peer groups on which the remuneration policy is based. The Recommendation touches upon the remuneration committee, buttressing its independence and suggesting that one member have knowledge and experience concerning

[62] Manuel Ammann, David Oesch and Markus Schmid, *Corporate Governance and Firm Value: International Evidence* , 18 JOURNAL OF EMPIRICAL FINANCE 1: 36-55 (2011); Reena Aggarwal & Rohan Williamson, *Did New Regulations Target the Relevant Corporate Governance Attributes?*, GEORGETOWN UNIVERSITY RESEARCH PAPER (2006), available at www.ssrn.com; Valentina Bruno & Stijn Claessens, *Corporate Governance and Regulation: Can There be Too Much of a Good Thing?*, 19 JOURNAL OF FINANCIAL INTERMEDIATION 4: 461-482 (2010); Vidhi Chhaochharia & Luc Laeven, "Corporate Governance, Norms and Practices", 18 JOURNAL OF FINANCIAL INTERMEDIATION 3: 405-431 (2009).

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

remuneration. The Recommendation also considers design issues, suggesting that performance criteria promote long-term sustainability and include relevant non-financial criteria, that variable pay be withheld when performance criteria are not met and that arrangements be made to claw back variable pay awarded on the basis of data which proves to be misstated. Moreover, termination payments should not exceed a fixed amount and, in general, not be higher than two years of non-variably pay.

However, the Recommendation goes further and appears imbued with a concern to reduce pay levels. The suggestion that undefined "limits" should be placed on variable pay is particularly troubling, given the benefits of incentive alignment, and represents an undue incursion into corporate autonomy.[64] The Recommendation similarly suggests that remuneration committees should ensure that executive director remuneration is "proportionate" to that of other executive directors and other staff members. While efforts have been made by some Member States to address proportionality concerns, this is not widespread and there is little evidence that intervention is support of "reasonable" pay works.[65]

The Recommendation's suggestions with respect to the deferral of pay are similarly intrusive. It suggests: that the "major part" of variable pay should be deferred for a "minimum period" of time; restrictions on share-based pay and that the vesting of shares and the exercise of share options be subject to predetermined and measurable performance criteria; that shares should not vest for at least three years after their award and that share options or similar rights should not be exercisable for three years. The Commission has also suggested that a certain number of shares be retained by directors until the end of their mandate. Performance share plans, particularly linked with director shareholding periods, have proved to be a very useful mechanism for aligning director

[64] Richard Posner, *Are American CEOs Overpaid and, If So, What if Anything Can be Done about It?* 58 DUKE LAW JOURNAL 1013: 1013-147 (2009).
[65] Randall Thomas, *International Executive Pay: Current Practices and Future Trends*, in INTERNATIONAL EXECUTIVE PAY: CURRENT PRACTICES AND FUTURE TRENDS (Randall Thomas ed.) Elgar Publishing (2009).

interests more effectively with long-term performance and are already a feature of several European Codes.[66]

c) *Recent proposals*

In 2014 the European Commission proposed a revision of the Shareholder Rights Directive, including measures to improve the corporate governance of listed companies in an effort to improve the competitiveness and long-term sustainability of these companies.[67] Proposed reforms aim to encourage shareholders to engage more with the companies they invest in, and to take a longer-term perspective for their investments.

The Commission proposes to strengthen shareholder rights to exercise proper control over management, including a binding "say on pay". This comes as a reaction to the insufficient link between management pay and performance, which has determined harmful short-term tendencies. The new directive would enhance transparency on remuneration policy and the actual remuneration of individual directors, and improve shareholder oversight of directors' remuneration. Each listed company in the EU would be required to put its remuneration policy to a binding shareholder vote at least every three years. Shareholders would also vote on a company's remuneration report, which describes how the remuneration policy has been applied in the last year, but their vote would be advisory only. Where the shareholders vote against the remuneration report, boards would need to explain in their next remuneration report how the vote of the shareholder has been taken in account.

Companies would have to provide a clear, understandable remuneration policy, in line with the business strategy, objectives, values and long-term interests of the company, and adopt measures to avoid conflicts of interest. The policy would set clear criteria and explanations for the

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

[67] *Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement*, COM(2014)213 final; (at the time of writing not officially published), available at: http://eur-lex.europa.eu/.

award of fixed and variable remuneration; indicate the maximum amounts of total remuneration that can be awarded; explain the ratio between the average remuneration of directors and the average remuneration of full time employees, the main terms of the contracts of directors, and the decision-making process leading to their determination. The remuneration report also would need to be more clear and understandable, including explanations on the link between total remuneration and long-term performance, the relative change of the remuneration of directors over the last three financial years and the mechanisms adopted to reclaim pay. Once the shareholders have approved the remuneration policy, a company would not be permitted to pay remuneration to directors other than in accordance with that policy.

The directive does not regulate the level of remuneration and leaves decisions on this to companies and their shareholders. The transparency and voting requirements are similar to those already in place for UK quoted companies. Unlike the UK position, there are no detailed requirements for disclosure, although the European Commission may develop these once the Directive comes into force. Other Commission proposals also have an impact on the approach to remuneration policies by the companies. Notably, the Recommendation on the quality of corporate governance reporting ('comply or explain' principle) provides guidance to listed companies, investors and other interested parties so as to improve the overall quality of corporate governance statements.[68]

2. Comparative regulation

[68] *Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting ('comply or explain')* (2014/208/EU), OJ L 109/43.

Member States were free to implement the EU recommendations either through legislation or, as has been the dominant method, through soft law, typically based on the local Corporate Governance Code and the related “comply or explain” principle.[69]

Consequently implementation by companies was not mandatory and in fact the EU regulatory framework based on non-binding recommendations proved unsuccessful in embedding good practices with respect to remuneration governance across Europe’s largest companies. These mechanisms, often ‘tentative’, were confined to the regional and national levels, without any international approach to the matter. Significant differences continued to persist across Member States’ regulatory regimes and in pay governance practices.[70] Institutional investors were not persuasive in demanding better practices either, which may reflect the difficulties they face in assessing industry-wide practices given generally poor disclosure.

a) *From soft to mandatory regulation*

Either anticipating or following the Commission’s most recent proposals, Belgium, Portugal, Spain, Italy and the UK were the first jurisdictions to consider moving remuneration governance and disclosure into law. Belgium adopted a law aimed primarily at reinforcing boards in listed companies,[71] which lifted a number of the national Corporate Governance Code provisions to the legislative level. As a result, the creation of a remuneration committee became mandatory and the publication of a corporate governance statement including a remuneration report was required. The Portuguese market regulator issued a 2010 Regulation on Corporate Governance, which provides for mandatory description of the remuneration policy and disclosure of individual director

[69] *Commission, Report on the application by Member States of the EU of the Commission Recommendation on directors’ remuneration* (2007) (SEC(2007) 1022); *Commission, Report on the application by the Member States of the EU of the Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board* (2007) (COM SEC(2007) 1021).

[70] Ferrarini *et al.* 2009, 2010; Roberto Barontini, Stefano Bozzi, Guido Ferrarini and Maria Cristina Ungureanu *Directors' Remuneration Before and After the Crisis: Measuring the Impact of Reforms in Europe*, in BOARDS AND SHAREHOLDERS. FACTS, CONTEXT AND REFORMS (Massimo Belcredi and Guido Ferrarini eds.): 251-314, Cambridge University Press (2013).

[71] *Law on the reinforcement of corporate governance in listed companies*, (2010).

remuneration.[72] The regulation also requires firms to report on the composition of the remuneration committee and the fact that at least one of its members has knowledge and experience in remuneration policy issues. In Spain, the Law on Sustainable Economy, in effect since March 2011, delegated the Ministry of Economy and Finance and the market supervisor (CNMV) to determine the structure and content of companies' remuneration report.[73] The CNMV issued a regulation requiring disclosure of remuneration in a standard annual report format.[74] Similarly, in 2011 in Italy the Securities Commission (CONSOB) adopted new rules on transparency of remuneration,[75] requiring uniform and detailed disclosure of compensation practices and setting standards characteristics to be included in the remuneration report. The regulation also makes provisions for shareholder vote on both the previous year's policy and the proposed future policy.

The UK has traditionally had the most extensive set of governance requirements in force with respect to executive compensation in Europe. Listed companies have been required to prepare a Directors' Remuneration Report since 2002, and to submit it to the advisory vote of shareholders.[76] Despite similar regulatory measures, during the recent crisis, UK companies – banks in particular – raised serious concerns for what many observers considered as 'excessive executive pay'.[77] This led the Government in 2011 and 2012 to announce a reform directed to curb executive pay through greater remuneration transparency, more shareholder powers and more diverse board and remuneration committees.[78]

b) Say on pay

[72] *CMVM Regulation No. 1/2010 Corporate Governance* (2010).
[73] *Law No. 2/2011 of 4 March 2011 on Sustainable Economy* (last amended by Law No. 2/2012 of 29 June 2012).
[74] New section 61ter, *Securities Market Law* ("Ley del Mercado de Valores"), CNMV (1989).
[75] Article. 84-quarter, Consob. Regulation 11971/1999 implementing Italian Legislative Decree No. 58 of 24 February 1998, concerning the discipline of issuers.
[76] *The Directors' Remuneration Report Regulations* (2002). Schedule 7A of the Companies Act 1985, re-enacted in Regulation 11 and Schedule 8 of the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008, available at: www.legislation.gov.uk.
[77] Ferrarini & Ungureanu, 2010.
[78] The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013. Department of Business, Innovation & Skills (2013).

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

In the US, votes on pay are mandatory under the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, but the voting result is not binding. Most European jurisdictions, in their governance codes, introduced an advisory vote on the remuneration policy and a binding vote on equity-based incentive schemes. Few regulators went further, introducing binding votes on pay policy, in the hope that such votes would determine corporations to be more conservative with respect to the total amount paid to their executives and that this would be more driven by corporate performance. The Netherlands, Sweden and Norway, however, had already required binding say on pay before the crisis.[79]

Post-crisis reforms not only regard the nature of the vote (binding or advisory), but also the possible shift of voting requirements from best practice principles to legislation. Spain and Italy were among the first countries to introduce a similar rule in their corporate laws, while France has extensively debated the issue at government level.[80] For a long time, in the UK the shareholder advisory vote on executive compensation has been non-binding on companies and their boards. Since spring 2012, however, the government moved toward a binding regime through a range of proposals, including: an annual binding vote on future remuneration policy; an annual advisory vote on how the company's pay policy was implemented in the previous year; and a binding vote on 'exit payments' of more than one year's salary.

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[79] David Larcker, Allan L. McCall and Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, ROCK CENTER FOR CORPORATE GOVERNANCE AT STANFORD UNIVERSITY WORKING PAPER No. 119 (2013), available at: www.ssrn.com; Yonca Ertimur, Fabrizio Ferri and David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 JOURNAL OF ACCOUNTING RESEARCH 5: 951-996 (2013).

[80] *Consultation sur la remuneration des dirigeants d'enterprise* (2012), available at www.tresor.economie.gouv.fr.

The effects of say on pay started to be felt soon after the launch of these reforms. The case of UK companies failing to receive majority support for their pay policies in 2011 could be considered representative for the history of 'say on pay'.[81] In the US, by comparison, the impact of the recent reform introducing say on pay may be seen as modest. Amongst the Russell 3000 companies with say-on-pay votes occurring between September 2011 and June 2012, 2.4 per cent failed to achieve shareholder support levels of 50 per cent or higher. These results point to a slight rise in say-on-pay failure rates compared to 2011, when 1.6 per cent of Russell 3000 companies failed over the same time frame.[82]

No doubt, "say-on-pay" has increased the power of proxy advisory firms, especially the two largest, Institutional Shareholder Services (ISS) and Glass Lewis and Co. Similar to rating agencies prior to the financial crisis, these firms have implicitly been granted by regulators significant power as to the shaping of corporate governance policies in US public companies and their influence has spread over to Europe and Asia as well.[83] Research has consistently shown a strong correlation between recommendations of proxy advisors and proxy voting by institutional shareholders.[84] The influence of these firms is enhanced by the fact that investors may find it less costly to pay a fee for the advisory firms' reports and rely on their recommendations especially in highly technical, if not arcane, matters like incentives structure for top executives and the link between incentives and corporate performance. However, large institutional investors such as Fidelity, Vanguard,

[81] For example, at the AGM of Barclays, over 25 per cent of shareowners voted against the company's pay plan at a very tumultuous meeting; *Barclays stunned by shareholder pay revolt*, 27 April 2012, BBC NEWS, available at www.bbc.co.uk/news/business; Shareholder discontent over pay also contributed to the exit of insurer Aviva's CEO, who resigned five days after 54 per cent of shareowners voted against pay at the company's annual meeting; *Aviva rocked by shareholder rebellion over executive pay*, THE GUARDIAN, 3 May 2012, available at www.guardian.co.uk/business. Over 40 per cent of WPP investors voted 'no' on pay, prompting the company's compensation committee chair to reach out to investors prior to the upcoming AGM to defend a 30 per cent pay raise for the company's CEO; *WPP shareholders vote against £6.8m pay packet for Sir Martin Sorrell*, THE GUARDIAN, 13 June 2012, available at www. guardian.co.uk/media.
[82] Institutional Shareholder Services, 2011 and 2012.
[83] Ertimur *et al.* 2013; Massimo Belcredi, Stefano Bozzi, Angela Ciavarella and Valerio Novembre, *Say-on-Pay in a Context of Concentrated Ownership. Evidence from Italy*, CONSOB WORKING PAPERS No. 76 (2014), available at: www.ssrn.com.
[84] Larcker *et al.* 2013; Ertimur *et al.* 2013.

BlackRock, and T. Rowe Price still assign analysts to study executive compensation at their portfolio companies, develop internal policies, and make voting determinations.

Studies show that, historically, a negative recommendation from ISS will, on average, influence between 13.6 percent and 20.6 percent of votes cast on management-sponsored proposals.[85] Companies that receive a negative recommendation from ISS almost always fail their say-on-pay vote, whereas no company that receives a positive ISS recommendation fails its say-on-pay vote. The policies that advisory firms prefer also influence decisions by the non-executive directors of public companies. However, there is evidence that such influence may not be for the better in terms of shareholder value enhancement. For example, research found that, when public companies implement certain principles defined by proxy advisers as "best practices" (in this case with regard to stock option exchange programs), gains in shareholder value are on average 50% to 100% less than at other firms.[86] Conflicts of interest of proxy advisory firms have also become an issue, so that regulators from Europe and the US have proposed to regulate these firms; and the policy debate continues.[87]

As a result of the ambiguous benefits of proxy advisors and of increased shareholder activism, several investors have reduced their reliance on advisors' recommendations. In 2013 Blackrock (the world's largest asset manager) announced that they were no longer following ISS recommendations and released their comprehensive voting policies for each main jurisdiction.[88] These policies sometimes go against practices which, in a given jurisdiction, are generally accepted, such as for example: performance based remuneration for non-executive directors in German

[85] Jennifer Bethel & Stuart Gillan, *The Impact of Institutional and Regulatory Environment on Shareholder Voting*, FINANCIAL MANAGEMENT: 29-54 (2002); Jie Cai, Jacqueline Garner and Ralph Walking, *Electing Directors*, JOURNAL OF FINANCE 64 2,389-2,421 (2009); David F. Larcker, Allan L. McCall and Brian Tayan, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions*, THE CONFERENCE BOARD: TRUSTED INSIGHTS FOR BUSINESS WORLDWIDE (2012), available at: http://www.gsb.stanford.edu.
[86] Larcker et al. 2013.
[87] For EU see ESMA, *An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options* (March 2012), available at: http://www.esma.europa.eu/. For US see SEC, *Opening Statement at the Proxy Advisory Services Roundtable* (December 2013), available at: www.sec.org.
[88] BlackRock, *Proxy voting guidelines for European, Middle Eastern and African securities* (2014), available at: www.blackrock.com.

companies; poor disclosure of remuneration policies at Greek companies; excessive severance payments at Italian companies. They also emphasize the importance of aligning the performance metrics of variable pay to the execution of strategy at UK companies, where long-term compensation plans are known to be rather complex.

Several investors and representative associations have put forward principles with regard to remuneration, setting out their own views on the role of shareholders and directors in relation to remuneration and the manner in which remuneration should be determined and structured. For example, the National Association of Pension Funds (NAPF) in the UK updated its remuneration guidelines and published a 'Remuneration Principles' document. The Guidelines track the Principles of the UK Corporate Governance Code, give guidance on how each principle should be applied and what investors might look for in particular, followed by a voting recommendation. The revisions of the NAPF's remuneration guidelines include a new list of practices that are likely to cause investor concern and may even trigger a vote against Directors' Remuneration Reports and/or new share plans.[89] Investors often act in concert when addressing governance issues of investee companies, with the aim of building a meaningful voice, as in the case of the GC100 and Investor Group (Group formed by GC100 representing FTSE100 companies and the Corporate Governance Forum, a network of leading institutional investors) who issued their own Directors' Remuneration Reporting Guidance.[90] The guidelines substantially change the requirements for the contents of the directors' remuneration report and include some significant new disclosures, expecting companies not to adopt a "boilerplate" approach and be innovative in order to meet their specific needs.

Other large investors – including Fidelity, Legal & General and Vanguard – went as far as sending alerts to the CEOs of large companies, communicating changes in their voting policy on remuneration and conditioning a positive vote on specific provisions, which largely go beyond the current regulatory and governance requirements, and try to ensure a better alignment between

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[89] NAPF *Coporate Governance Policy and Voting Guidelines* (2013), available at: http://www.napf.co.uk.
[90] GC100/Investors group, *Directors' Remuneration Reporting Guidance* (2013), available at: http://uk.practicallaw.com/groups/uk-gc100-investor-group.

executive compensation and the longer-term performance of the company. In 2013, Fidelity sent a letter to Europe's 350 largest companies requiring them (and anticipating otherwise a negative vote) to lengthen the required term of the LTIP by distinguishing between "vesting periods" and "holding periods" of the incentive, requiring a holding period of minimum 5 years and a minimum 3-year vesting period. Legal & General sent a letter to FTSE 250 companies calling them to provide certain enhancements in their remuneration disclosure, warning them in regard to: unclear explanations on the performance measures behind incentive schemes; making significant 'golden hello' payments; providing matching schemes to new recruits; not considering the experience of the individual when recruiting external candidates. L&G specifically anticipates voting against remuneration at companies that do not provide sufficient information on performance measures, unless full explanation on the lack of transparency is provided. In anticipation of the 2014 proxy season, Vanguard sent letters to approximately US 350 companies to proactively engage with them on governance issues. The letters are tailored to the individual companies and identify governance practices at the companies that Vanguard believes are not in line with what the asset manager views as best practices.

Clearly, we have entered into a new chapter of executive pay governance and the ways in which companies respond to shareholder engagement has evolved significantly: "the process has become less defensive and more proactive."[91]

3. Some empirical data

In this paragraph, we summarize the outcomes of our previous paper on firms' remuneration practices before and after the crisis, with particular emphasis on the governance process and the quality of disclosure.[92] Our original paper compared the data collected for the years 2007 and 2010,

[91] Michael Segal *Compensation Season 2014: Shareholder Engagement* (2013), available at: http://blogs.law.harvard.edu/corpgov/2013/12/20/compensation-season-2014-shareholder-engagement/#!
[92] Barontini *et al.* 2013.

thus providing evidence on the evolution of pay practices in response to the recent financial crisis and to the remuneration reforms adopted by European policy makers.

a) *Statistics on governance*

Following the 2005 Recommendation, most EU corporate governance codes endorsed the setting-up of a remuneration committee with a majority of independent directors. Only the German Corporate Governance Code did not specifically recommend the formation of a remuneration committee. Moreover, the 2009 German Act on the Appropriateness of Management Board Remuneration marked a departure from European corporate law and practice by requiring that the full supervisory board decide on individual management board pay (including salary and incentive-based pay).[93] Reflecting this regulatory framework, our analysis found a widespread recourse to the remuneration committee, both before and after the crises, in all countries except Germany, where only about half of the companies in our sample established this committee, with a slight increase in 2010. Again with the exception of German firms, the independence requirement (i.e. the committee should only include non-executive members, with a majority of independent directors) was fulfilled by most of the companies having a remuneration committee (about 80 per cent of the sample, with a small increase from 2007). However, several compensation committees still did not fulfil the composition criteria established by either best practice or regulation.

Requirements concerning the presence and role of compensation consultants in continental European countries are weak compared to the UK.[94] In the UK, the Directors' Remuneration Report Regulations of 2002 require that firms disclose consultant information. Although the Commission supports the presence and independence of remuneration consultants in its 2004 and 2009 Recommendations, strong disclosure requirements are not found in Continental Europe, where the relevant provisions are rather patchy. Our analysis showed that all UK companies used a third-party

[93] *Act on the Appropriateness of Management Board Remuneration* (*Gesetz zur Angemessenheit der Vorstandsvergütung*, 'VorstAG') (2009).
[94] Conyon, 2011.

consultant to advise them on compensation levels and design since before the crisis. Furthermore, all UK firms in our sample make a statement regarding their independence, i.e. non-engagement in other consulting services for the management. In the other jurisdictions, the presence of an external consultant is usually not disclosed. Similar disclosure gaps bar an accurate review of the remuneration governance process.

b) *Statistics on disclosure*

Current disclosure criteria require remuneration statements to be clear and easily understandable, to provide detail on the alignment between pay and performance and to be transparent about the individual directors' compensation packages. However, significant differences existed amongst national jurisdictions as to pay disclosure before the financial crisis. In our paper, we found that disclosure of remuneration generally improved post-crisis in all jurisdictions, even though the levels of compliance vary greatly across countries. We showed that compliance with the remuneration statement requirement was quite strong across jurisdictions before the crisis and improved post-crises at the few non-compliant firms. All of the remaining variables for the remuneration policy showed a significant increase in compliance for the whole sample, with the exception of performance criteria for bonuses.

As to individual disclosure, increased compliance (even though not statistically significant) was observed for the two variables capturing disclosure of the annual compensation components for executive and non-executive directors. On average, disclosure of individual share schemes is lower, although some countries (in particular the UK, Italy and France) show significant improvements. However, the jurisdictions where remuneration disclosure and governance standards were lower prior to the crisis (Greece and Portugal in partucular) did not show substantial improvements post-crisis.

These findings show that the firms' approach to compliance is strongly dependent on their home country's approach to regulation and governance culture. Firms generally tend to reflect the way in which EU regulations are implemented at the national level – either through mandatory legislative requirements or best practice guidelines – and the level of detail in the formulation of the relevant standards.

IV. REGULATING PAY STRUCTURE

1. Long-term remuneration

Investor initiatives and political developments continue to exert pressure over executive compensation, especially on the design and structure of long-term incentives.[95] The public debate and regulatory initiatives have resulted in heightened scrutiny of executive pay by the shareholders and shareholder advisory groups, particularly focusing on the relationship between executive pay and firm performance. A related theme for investors is that a greater portion of incentive pay should relate to long-term performance, as it is widely believed that anything less than three-year performance periods would carry the risk of significant compensation being paid for performance that is not truly sustainable.[96]

The combination of these forces has accelerated the adoption of performance-linked long-term incentive programs. A decade ago, plain-vanilla stock options filled-up the compensation packages of executives, while terms such as restricted stock, full-value awards, or performance shares were almost unheard of.[97] Research has shown that a majority of individuals view stock

[95] Barontini *et al.* 2013; Massimo Belcredi & Guido Ferrarini, *Corporate Boards, Incentive Pay and Shareholder Activism in Europe: Main Issues and Policy Perspectives*, in BOARDS AND SHAREHOLDERS IN EUROPEAN LISTED COMPANIES. FACTS, CONTEXT AND POST-CRISIS REFORMS (Massimo Belcredi and Guido Ferrarini eds.): 1-66, Cambridge University Press (2013); Steven Kaplan, *CEO pay and corporate governance in the U.S.: Perceptions, facts, and challenges*, 25 JOURNAL OF APPLIED CORPORATE FINANCE 2: 8-25; Murphy, 2013.

[96] Association of British Insurers (ABI), *Principles for Executive Remuneration* (2013), available at: https://www.ivis.co.uk/guidelines; Ertimur *et al.* 2013.

[97] Hamid Mehran & Joseph Tracey, *The Effect of Employee Stock Options on the Evolution of Compensation in the 1990s*, 7 ECONOMIC POLICY REVIEW 3: 17-34 (2001).

options as a "gift."[98] As a result, they significantly discount the value of stock options and view them as something that is a "nice to have" rather than an essential element of their compensation plan. Today, plain-vanilla options are on the decline, while restricted stock and performance shares are a regular part of the long-term incentive lexicon, especially in public companies.[99] In a pay-for-performance world, equity compensation is increasingly becoming a reward for achievement of success. The problem with paying for upside potential is not only reflected in cash bonuses but also in short-term gains through stock options.[100] Initial values mean far less than what is finally delivered (or not) to the employee. Performance criteria add another layer of complexity to a compensation program, but performance may also add the secret ingredient of direct alignment that allows for a compelling discussion between the company and its stakeholders on current and potential value.

The key condition to any reward is making sure that the linkage between achievement and payout is reasonable and comprehensible. Investors pay more attention to changes in the proportion of shares issued and shares conveyed to employees, they scrutinize time-based stock plans (i.e. restricted stock, time-vested stock) and performance share plans with a lower than three-year performance period.[101] They value stock ownership and retention requirements, which are considered to reinforce executives "shareholder mindset". Similar concerns have led to legal changes and governance codes reviews in major markets over the last few years, either requiring or recommending deferral of annual incentives and/ or longer vesting periods for long-term incentives

[98] Peter Cappelli & Martin Conyon, *Stock Option Exercise and Gift Exchange Relationships: Evidence for a Large U.S. Company*, NBER WORKING PAPER No. 16814 (2011), available at: http://www.nber.org/papers/w16814

[99] David Walker, *Evolving Equity Compensation and the Limits of Optimal Contracting*, 64 VANDERBILT LAW REVIEW: 611-674 (2011).

[100] Patrick Bolton, José Scheinkman and Wei Xiong, *Executive Compensation and Short-Termist Behaviour in Speculative Markets*, THE REVIEW OF ECONOMIC STUDIES 577–610 (2006).

[101] David Yermack, *Shareholder voting and corporate governance*, ANNUAL REVIEW OF FINANCIAL ECONOMICS, 2: 103-125 (2010); ISS (International Shareholder Services), *2011 U.S. Post Season Report* (2011), available at www.iss.com; ISS (International Shareholder Services) *2012 Proxy Season Review. World Markets* (2013), available at www.iss.com.

for senior executives in all listed companies (not just financial services). As we move into the era of 'say-on-pay', performance hurdles are also being added to these awards.[102]

As a result, companies are working to balance their compensation philosophy and executive pay programs have come under closer scrutiny. Equity compensation has become more volatile and complex during the past two decades, requiring more planning, expertise and pragmatism.[103] The growing focus on aligning pay with long-term performance has driven many companies to grant performance-vested long-term incentives,[104] apply not lower than three-year performance measurement periods, align plans with two or more performance measures, make executive directors maintain a substantial ownership interest for the duration of their employment, establish stock ownership plans for directors. Several companies are moving away from full-vesting and towards pro-rata vesting of equity, towards more disciplined target setting and greater consideration of strategic, nonfinancial performance measures in annual and long-term incentives.[105]

2. FSB Principles

Compensation structures at banks are considered by the FSB principles along lines that reflect, to a large extent, general best practices already adopted before the crisis.[106] However, pre-crisis practices mainly emphasised the alignment of managers' incentives with shareholder wealth maximization. The principles break new grounds by requiring financial institutions to align compensation with prudent risk taking. Accordingly, compensation should be adjusted for all types of risk, including those considered difficult-to-measure, such as liquidity risk, reputation risk, and capital cost. Compensation outcomes should be symmetric with risk outcomes. Deferment of

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[102] Barontini *et al*. 2013.

[103] Walker, 2010; Jeffrey Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay*, COLUMBIA LAW AND ECONOMICS WORKING PAPER 373 (2010); available at: www.ssrn.com.

[104] Clearbridge, *The ClearBridge 100 Report* (2013), available at: http://www.clearbridgecomp.com.

[105] Equilar, *Equity Trends Report* (2013) available at: www.equilar.com; GMI Ratings, *2013 CEO Pay Survey* (2013) available at: www3.gmiratings.com; BlackRock, *Time to Rethink Executive Incentive Programs* (2012), available at: www2. blackrock.com.

[106] Ferrarini & Ungureanu, 2011.

compensation, traditionally used as a retention mechanism (on the basis that a 'bad leaver' would generally lose unpaid deferrals), should make compensation pay-out schedules sensitive to the time horizon of risks. In particular, a substantial portion of variable compensation (i.e. forty to sixty per cent) should be payable under deferral arrangements over a period of not less than three years, provided that this period is correctly aligned with the nature of the business, its risks, and the activities of the employee in question. Furthermore, a substantial portion (i.e. more than fifty per cent) of variable compensation should be awarded in shares or share-linked instruments, as long as the same create incentives aligned with long-term value creation and the time horizons of risk. In any event, awards in shares or share-linked instruments should be subject to an appropriate retention policy.

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

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

3. Dodd Frank

The FSB principles were implemented along different models.[107] Some jurisdictions follow a primarily supervisory approach to implementation, involving principles and guidance and the associated supervisory reviews. In other jurisdictions the model includes a mix of regulation and supervisory oversight, with new regulations often supported by supervisory guidance that illustrates how the rules can be met. The US initially followed the supervisory model of implementation. However, with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act on 21 July 2010,[108] a mixed model of implementation was adopted. The Act includes two sets of provisions on executive compensation. On the one side, there are those applicable to all listed companies,[109] touching upon issues like say on pay; independence of compensation committees; enhanced proxy disclosure; "clawbacks" of incentive compensation; and disclosure of employee and director hedging. On the other, Section 956 of the Act (headed "Enhanced Compensation Structure Reporting") requires Federal regulators of financial institutions to issue new rules in two areas.[110] Firstly, they must jointly prescribe regulations or guidelines requiring each covered financial institution to disclose to the appropriate Federal regulator the structure of all incentive-based compensation arrangements in a manner sufficient to determine whether the same provide an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation or could lead to material loss to the covered institution. Secondly, they must prescribe regulations or guidelines that prohibit any type of incentive-based payment arrangements that encourage inappropriate risks by covered financial institutions by providing an

[107] Financial Stability Board, *Thematic Review on Compensation: Peer Review Report* (2010), available at: www.financialstabilityboard.org.

[108] *The Dodd-Frank Wall Street Reform and Consumer Protection Act ("The Act")*, Pub. L. No. 111-203, enacted 21 July, 2010.

[109] Provisions contained in Title IX of the Act: Sections 951, 952, 953, 954, 955 of the Act.

[110] The FED, the OCC, the OTS, the FDIC, the NCUA, the SEC and the FHFA are mandated by section 956 of the Act to jointly prescribe regulations or guidelines with respect to incentive-based compensation practices at covered financial institutions.

executive officer, employee, director, or principal shareholder with excessive compensation or that could lead to material financial loss to the covered financial institution.

In February 2011 the Federal agencies jointly exercised their mandate by approving a proposal on incentive-based compensation arrangements for "covered financial institutions".[111] These are institutions under the supervision of the respective Federal regulator, with total consolidated assets of $1 billion or more.[112] The Rule supplements existing rules and guidance adopted by the relevant agencies regarding compensation, including the Interagency Guidance on Sound Incentive Compensation Policies referred to above.

The use of "standards" rather than "rules" analytically defining the compensation structure not only reflects the international Principles, but also the Federal regulators' willingness to avoid a "one-size-fits-all" approach and keep the needed flexibility in compensation arrangements. Under the proposed standards of "reasonable" (as opposed to "excessive") compensation, "balanced" arrangements and "appropriate" risk-taking, the institutions concerned have to tailor their remuneration policies to their businesses and risks, assuming responsibility for the relevant arrangements through good corporate governance and internal control mechanisms. At the same time, the regulators will be in a condition to influence the supervised institutions' compensation practices through general guidance and individual inspections. To this effect, the proposed Rule also requires the covered financial institutions to submit an annual report to regulators describing the structure of incentive-based compensation arrangements.

Specific rules apply to "larger covered financial institutions",[113] such as bank holding companies with consolidated assets of more than $50 billion. In addition to mandating wider disclosure to the Federal regulators, the proposed Rule requires similar institutions to defer at least

[111] The FDIC issued *Notice of Proposed Rulemaking on incentive-based compensation arrangements* (February, 2011), available at: http://www.fdic.gov/news/news/press/2011/pr11027.html. In similar lines with the FDIC proposal, the SEC issued *Rules on Incentive-based Compensation for Large Broker-Dealers and Investment Advisors* (2011); available at: http://www.sec.gov/news/press/2011/2011-57.htm.
[112] Explanatory definitions S. III, § 3, Section 956 of the Act.
[113] For the Federal banking agencies and the SEC, the term ''larger covered financial institution'' refers to those covered financial institutions with total consolidated assets of $50 billion or more. Section 956, the Act.

50% of the incentive-based compensation payments to executive officers over a period of minimum three years, with the release of the deferred amount to occur no faster than on a pro-rata basis.[114] A "malus" mechanism also applies, in that the deferred amount should be adjusted for actual losses incurred by the institution or other measures of performance during the deferral period. Moreover, if the covered financial institution has consolidated assets of $50 billion or more, the board of directors (or a board committee) shall identify those covered persons (other than executive officers) who individually have the ability to expose the institution to possible "substantial" losses. These covered persons may include, for example, traders with large position limits and other individuals who have the authority to place at risk a substantial part of the capital of the covered financial institution. The board of directors (or a board committee) must approve the incentive-based compensation arrangements for covered persons after determining that the same effectively balance the financial rewards and the range and time horizon of risks associated with the covered person's activities.

4. CRD IV

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

[114] S. III, § 5, Section 956 of the Act.

recently adopted a delegated Regulation including regulatory technical standards on the identification of risk takers.[115]

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

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

Other requirements in Article 94, par. 1 are more specific, particularly regarding the "bonus-cap" that the European Parliament asked to include in CRD IV. Under Article 94 (1) (g), the variable component should not exceed 100% of the fixed component of the total remuneration for each individual. However, Member States may set a lower maximum percentage (as Belgium and

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

the Netherlands did, by setting 50% and 20% respectively). Moreover, Member States may allow shareholders of the institution concerned to approve a higher maximum level of the ratio between fixed and variable remuneration provided the overall level of the variable component shall not exceed 200% of the fixed component of the total remuneration for each individual. Member States may also set a lower percentage. In any case, approval of a higher percentage should occur through a special procedure that is described in detail by Article 94 (1) (g) (ii).

The official justification for this bonus-cap is to avoid excessive risk taking (65th considerandum). However, the provision has generated several debates, particularly on imposing the bonus cap, with arguments that it is unlikely that a bonus cap will avoid excessive risk taking by bank managers and traders. As argued by Kevin Murphy, several arguments show that neither the objective to reduce excessive risk-taking nor the one to reduce perceived excesses in the level of banking remuneration will be achieved by capping variable remuneration.[116]

First, the bonus cap may lead to an increase in the level of fixed remuneration, making banks more vulnerable to business cycles and therefore increasing the risk of bank failure. Anecdotal evidence already shows that fixed pay at large European banks is on the rise[117]. Secondly, the traditional bonus system at investment banks, which is characterised by below-market salaries and high bonus opportunities, provides strong incentives to avoid "bad" risks and to take "good" ones. On the contrary, the new system – which will be characterized by above-market salaries and "capped" bonuses – provides incentives to take "bad" risks and avoid "good" ones. In fact, if bad risks materialize, the bank manager will not suffer, for her remuneration is to a large extent fixed. But, if the bank shuns good risks and the relevant profits, the responsible manager will not be worse off a given that his bonus is capped. Indeed, the bonus cap reduces incentives to create value, which is the main purpose of variable pay. Thirdly, executive remuneration is largely set by the markets, so that a bonus-cap could also have unintended consequences on the firms' ability to

[116] Murphy, 2013.

[117] Steve Slater, *London Banks Are Responding To Bonus Caps With Higher Salaries*, Reuters (28 November 2013), available at: www.reuters.com; Nicholas Comfort, *Deutsche Bank will ask Shareholders to Ease Bonus Cap*, Bloomberg News (10 April 2014), available at www.bloomberg.com.

hire people of adequate standing in the international market for managers. In the end, remuneration "will reflect a less-talented workforce as the top producers leave for better-paying opportunities in financial firms not subject to the pay restrictions". In other words, the cap "will *not* lead to lower levels of overall remuneration after adjusting for ability and the risk of the remuneration package".[118] Furthermore, the cap on variable pay may reduce the competitiveness of the EU banking sector relative to non-EU banks and other non-bank financial intermediaries which are not subject to similar restrictions. Fourthly, the mandatory cap also reflects a "one-size-fits all" approach which is clearly too rigid, for different types of credit institutions present different levels of risk exposure, so that an incentive structure which is appropriate for one firm is not necessarily suited to another. Moreover, the EU bonus-cap applies to all credit institutions, without regard to their size and therefore to systemic risk considerations.

V. CONCLUSIONS

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

[118] *Ibidem*.

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

We have subsequently analysed regulatory developments in Europe in the last ten years and most recent proposals by the Commission, comparing the same with developments at member state level and in the US. In particular, we have highlighted the impact of say on pay rules on shareholder activism, expanding on the role of proxy advisors and the behaviour of the largest institutional investors, who have shown an autonomous and active stance on executive remuneration issues at large listed companies. We have lastly focussed on the regulation of pay structures, showing that long-term incentives are clearly favoured for both financial and non-financial companies by either regulators or institutional investors. However, financial institutions are the main target of post-crisis reforms, firstly at international level through soft-law initiatives like the FSB principles and standards, and secondly at US and EU levels where the FSB principles have been implemented along partially diverging routes. CRD IV, in particular, has marked a new trend in the regulation of bankers' pay, by imposing a bonus cap that we have criticized from an economic perspective and goes clearly beyond what required by the international principles.

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